REIT Wise®

March 31 - April 2
2015

NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

SOURCEBOOK

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National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

Accounting Committee Meeting

Tuesday, March 31st
1:15pm – 2:45pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Keri Shea, SVP-Finance & Treasurer, AvalonBay Communities, Inc.

Panelists:
Mark Mahar, Partner, Ernst & Young
Kimber Bascom, Partner, KPMG
Christopher Drula, VP-Financial Standards, NAREIT
Julie Valpey, Partner-National SEC Department, BDO

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

ACCOUNTING COMMITTEE MEETING
(Open to all REITWise Participants)
JW Marriott Desert Ridge Resort & Spa
Grand Sonoran G-K
Tuesday March 31st, 2015
1:15 p.m. – 2:45 p.m.

Co-Chairs:

Glenn Cohen, EVP, CFO & Treasurer, Kimco Realty Corporation
Ian Kaufman, SVP & CAO, Equity Residential
Stephen Theriot, CFO, Vornado Realty Trust

Panelists:

Kimber Bascom, Partner, KPMG LLP
Chris Drula, VP-Financial Standards, NAREIT
Mark Mahar, Partner, EY
Julie Valpey, Partner, BDO USA, LLP

NAREIT Staff Liaisons:

George Yungmann, Senior Vice President, Financial Standards
Chris Drula, Vice President, Financial Standards

I. FASB Leases Project

II. FASB Revenue from Contracts with Customers Standard

III. FASB Consolidation Standard

IV. FASB Clarifying the Definition of a Business Project

V. NAREIT FFO Reporting Update

Note: This meeting may qualify for 1.25 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

♦ ♦ ♦

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Accounting Committee

March 31, 2015

Panelists

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Julie Valpey – BDO USA, LLP

Mark Mahar – Ernst & Young, LLP

Kimber Bascom – KPMG LLP

Chris Drula - NAREIT

Discussion Topics

Lease Accounting

Revenue from Contracts with Customers

Consolidation

Clarifying the Definition of a Business

NAREIT FFO Update

Lease Accounting

Lessor Accounting

Determine lease classification (Type A versus Type B) on basis of whether the lease is a financing or a sale (Type A), or an operating lease (Type B)

- Determine whether the lease transfers substantially all risks and rewards incidental to ownership of the underlying asset to lessee
  - Classification criteria for Type A leases is similar to IAS 17 finance lease accounting*
- Recognition of selling profit and revenue at lease commencement prohibited if control of underlying asset is not transferred to the lessee
  - Look to revenue recognition standard to determine if a “sale” has occurred

* Potential implications for ground leases

Lease and Non-lease Components

Lessees	**Lessors**
• Allocate consideration to lease and non-lease components on a relative stand-alone price basis • Activities that do not transfer a good or service to the lessee are not components • Can elect, by class of underlying asset, to not separate lease/non-lease components	• Apply the guidance in ASC 606 on allocating transaction price to separate performance obligations • Reallocate consideration when there is a contract modification that is not accounted for as a separate, new contract. • NO option to not separate lease/non-lease components

Initial Direct Leasing Costs

- 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 or executed (*e.g.*, leasing commissions)
- The decision to allow the capitalization of only incremental costs represents a major change from existing U.S. GAAP and, in practice, IFRS.
- 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 member companies and potentially their share prices.

Summary of NAREIT's July 2014 Unsolicited Comment Letter on Initial Direct Leasing Costs

- Despite statements by the Boards that their intention was not to change lessor accounting, it appears that the Boards will change current practice given their recent decision.

- 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 – which led to no objections raised by constituents in the comment letter process.

- NAREIT understands that the accounting treatment for costs is an area that varies widely within U.S. GAAP.

- NAREIT's Recommendation: Forgo further consideration of Initial Direct Costs in the Leases Project, and Develop a Comprehensive and Consistent Accounting Standard for Costs (both Direct and Indirect)

Subleases

- Intermediate lessor (i.e. an entity that is both a lessee and a lessor) should account for a head lease and a sublease as separate contracts unless they meet the contract combination guidance in the standard
- When classifying a sublease, an intermediate lessor should determine lease classification by reference to the underlying asset
- Do not offset lease assets and lease liabilities from head lease and sublease unless right of offset exists under US GAAP
- Do not offset lease income and lease expense related to head lease and sublease unless sub-lessor acts as agent

Other Provisions

- Short term leases - 12 months or less. This test is based on the lease term that include renewal and termination options that are “reasonably certain” to occur.

- Portfolio approach – may be used if results are materially the same as if applied to individual leases.

- FASB is not expected to provide additional exemption for “small ticket” items.

Revenue from Contracts with Customers

Core Principal and 5-Step 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 seller expects to be entitled in exchange for those goods or services

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

Application to Real Estate Sales

Existence of a Contract

- No initial or continuing investment test
- Collectibility of consideration is **probable** (one of five criteria)
- **No** alternative methods for recognizing profit (i.e., deposit, cost recovery, or installment method)

Transaction Price

- If applicable, apply other GAAP on initial measurement (e.g., guarantees)
- Variable consideration? Significant financing component?

Partial Sales

- Seller contributes property to a venture and retains an interest in the venture
- Sale of a controlling or noncontrolling interest in an entity that owns real estate

Continuing Involvement

- May not preclude recognition of profit
  - Seller is GP in acquiring limited partnership
  - Seller guarantees
  - Seller supports operations

Other Revenue Issues for REITs

- Lessor maintenance obligations
- Performance fees
- Prepaid management services agreements

Consolidation

Consolidation (ASU 2015-02)

- New guidance makes targeted changes to ASC 810, *Consolidation*
  - *ASU rescinds the SFAS 167 deferral for investment companies and adds new guidance impacting all entities*
- Key amendments include:
  - *Modifies criteria for determining whether fees paid to decision maker represent a variable interest*
  - *Changes how to consider substantive kick-out or participating rights when determining whether a limited partnership is a Variable Interest Entity (VIE)*
  - *Changes to evaluations of fees paid to decision maker and indirect interests held through related parties when determining the primary beneficiary*
  - *Elimination of presumption that general partner controls a partnership evaluated under Voting Interest Entity (VOE) model*

Consolidation – VIE determination

- Amendments focus on limited partnerships (LPs) and similar entities (LLCs)
- Do the equity holders lack the power to direct the activities that most significantly impact the entity's economic performance?
  - *This evaluation previously focused on whether a 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 simple majority (or lower threshold) of limited partners*
  - *Previously these rights must have been held by a single partner*

Consolidation – VOE model

- Guidance in ASC 810-20, *Control of Partnerships and Similar Entities*, has been relocated to ASC 810-10 with certain modifications
  - *Changes are intended to better align the VOE models for LPs and similar entities to that of today's model for corporations or similar entities*
- The presumption that a general partner controls, and thus consolidates, a LP has been eliminated
  - *When in the VOE model, a general partner does not consolidate*
- The consolidation analysis focuses on whether a <u>single</u> LP holds the majority of the kick-out rights through voting interests
- The party with a majority of kick-out rights may not consolidate if other noncontrolling partners hold substantive participating rights

Clarifying the Definition of a Business

FASB Project to Define a Business

Project Objectives

1. Address whether transactions involving in-substance nonfinancial assets should be accounted for as business combinations / dispositions

2. Clarify the guidance on sales and acquisitions of partial interests in nonfinancial assets

Definition of a Business

- ***Decisions to Date***

- A business must include inputs and one or more substantive processes that contribute to the ability to create outputs
    - Acquirer must receive the substantive processes for a transaction to be a business combination
    - Staff to define a substantive process
- Staff to explore a value threshold to establish when a tangible / intangible asset acquired is not a business

NAREIT FFO Update

NAREIT FFO Update

Purpose

- To enhance the transparency, credibility, comparability, and usefulness of NAREIT FFO.

NAREIT FFO Update

Letter to REIT CEOs – September 2014

- Over 95% of equity REITs report FFO in SEC filings in accordance with the NAREIT definition
- About one-half of equity REITs use modified versions of NAREIT FFO, especially in earnings guidance
- Many companies do not provide earnings guidance based on the NAREIT definition of FFO

NAREIT FFO Update

Letter to REIT CEOs – September 2014

- NAREIT's request - "…one important step forward for the REIT industry would be for companies that provide earnings guidance to a company-defined version of FFO to also provide guidance to NAREIT-defined FFO. Such an approach would be entirely consistent with the standard practice of reconciling company-defined FFO to NAREIT-defined FFO in SEC filings" (Steve Wechsler).

NAREIT FFO Update

Letter to REIT Analysts – March 2015

- The use of varying definitions of FFO by companies and analysts has resulted in uncertainty around analysts' published estimates - both the estimates published in research reports as well as the estimates contributed to data providers like First Call, FactSet, SNL and Bloomberg – and whether those estimates are based on NAREIT-defined or company-defined FFO.

NAREIT FFO Update

Letter to REIT Analysts – March 2015

- NAREIT's request – analyst FFO estimates provided to First Call for the 100 largest equity REITs by market cap
- NAREIT plans to:
  - Evaluate whether the calculation of FFO consensus estimates by First Call are based on uniform FFO definitions, and
  - Determine the number of REIT analysts that use NAREIT FFO in calculating estimates.

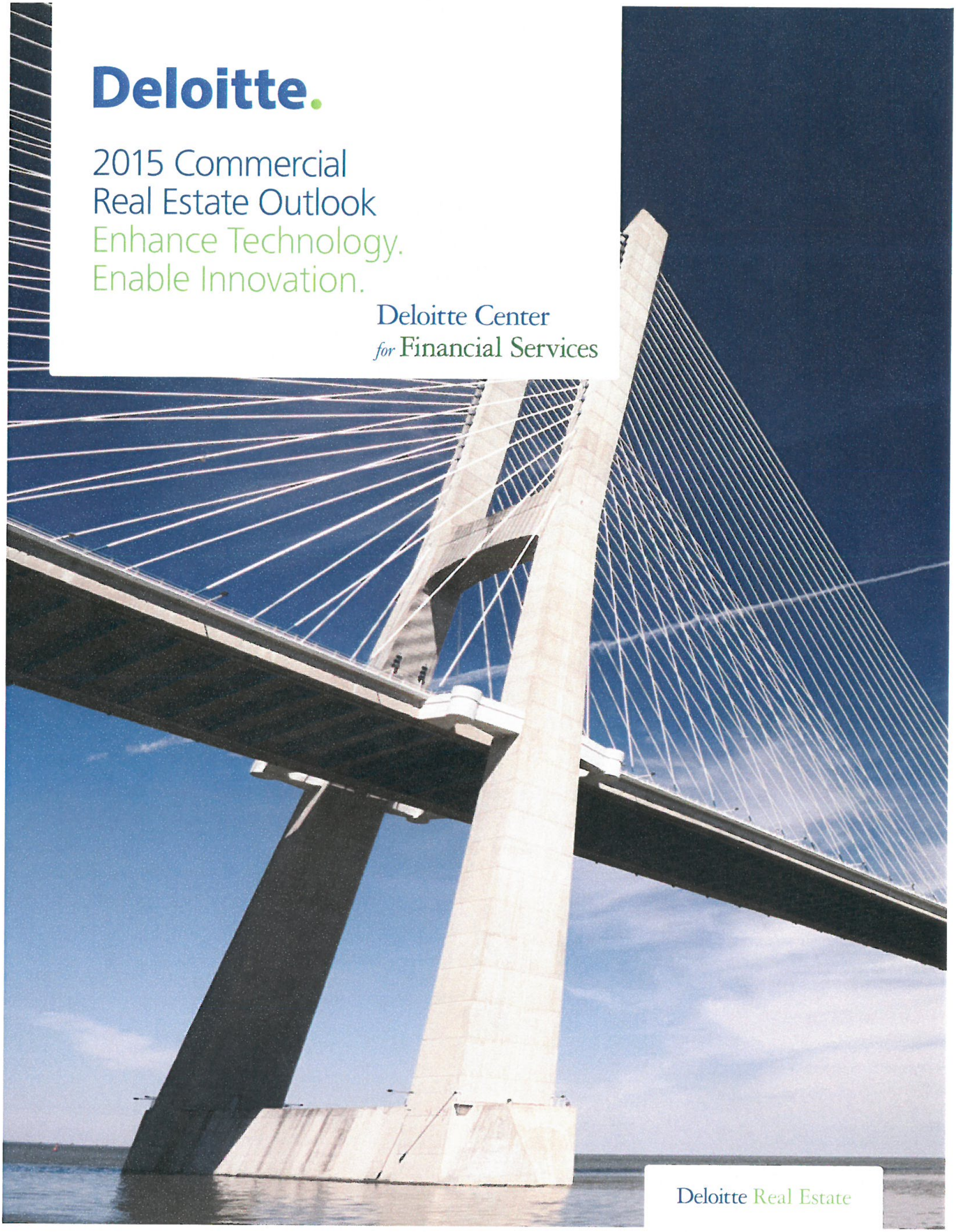
Questions

Deloitte.

2015 Commercial Real Estate Outlook

Enhance Technology. Enable Innovation.

Deloitte Center *for* Financial Services



Deloitte Real Estate

Contents

Foreword

Dear colleagues:

In many ways, the commercial real estate (CRE) industry is on more solid footing than it has been for quite some time. The U.S. economy continues to improve, although concerns remain in both Europe and some emerging markets. Investors are generally seeing solid performance, and profitability continues to improve across most property types and markets.

The sector is poised for strong growth over the next 12 months. Availability of financing through traditional and nontraditional channels is likely to continue to drive domestic investor interest in U.S. CRE. In addition, U.S. CRE is increasingly gaining international investor interest. Investor sentiment is a bit cautious going into 2015, despite profitability being quite strong in many sectors.

Property fundamentals continue to improve, and owners will likely benefit from investing in redevelopment of existing properties to enhance competitiveness with newer building stock. Companies cannot afford to ignore adoption of sustainability measures and smart building technology. Leveraging technologies such as social, mobile, and analytics will be increasingly important to drive operational efficiency and improve tenant loyalty.

But concerns — some new, some old — are keeping industry executives on their toes. Whether it's the pressure coming from nontraditional competitors, the evolving threat of cybercrime, or the rising cost of regulatory compliance, CRE executives have ever evolving challenges. Companies that are able to effectively steer through these challenges and build on the positive momentum in the industry by leveraging technology will maintain a competitive edge.

We are pleased to share with you our views on industry trends and priorities for 2015 based on the perspectives and firsthand experience of many of Deloitte's leading real estate practitioners, supplemented by research from the Deloitte Center for Financial Services.

Producing Outlooks of this type has the result of exposing the authors to second-guessing; hindsight is 20/20. Nevertheless, we feel it is important to reflect on what we said a year ago and put our prior prognostications to the test by analyzing what we got right — and perhaps not exactly right — in our 2014 CRE Outlook. You will find this "looking back" analysis leading off this year's edition, followed by a "looking forward " summary of our views on the coming year.

The report will then explore 10 top issues of importance for the industry over the coming year, with each including a specific look at the "Focus for 2015" and a "Bottom line" that provides some actionable takeaways for industry leaders to consider.

We hope you find this report insightful and informative as you consider your company's strategic decisions for 2015. Please share your feedback or questions with us. We value the opportunity to discuss the report directly with you and your team.

Bob O'Brien
Vice Chairman and Partner
Global and U.S. Deloitte Real Estate Leader
Deloitte & Touche LLP
+1 312 486 2717
robrien@deloitte.com

Jim Eckenrode
Executive Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Looking back

"It's tough to make predictions, especially about the future,"

Lawrence Peter "Yogi" Berra

As we move into the 16th year of our publication, we would like to first take a step back and compare our expectations for 2014 vis-à-vis the way things actually panned out in the industry for some of the top trends.

At first glance, we believe our central theme of last year's Outlook: "Trimming the Sails for Growth — Business Transformation is Key" holds true to a major extent. We have seen an accelerating trend of real estate industry leaders investing in enhanced information technology and processes to streamline operations, which provide enhanced visibility into current and future business performance. However, we also had our share of misses and surprises.

To dig a little deeper and garner a better understanding of how the story unfolded last year, we have categorized our assessment of what happened within three broad themes:

- Fundamentals
- Investments and financing
- Regulations

First, as anticipated, CRE fundamentals — rent and vacancy — continued to improve across property types, while development activity remained muted. Many of the improvements in construction activity were led by the apartment and hotel sectors. We also expected that tenants' technology use would have an influence on space demand and eventually supply. Public statements

Figure 1 Visual: Dashboard of 2014 issues and relevance to 2015

Fundamentals	Rent and vacancy continued to improve across property types, while development activity remained muted, except multifamily and hotels
	Tenants' technology use influencing leasing decisions
Investments & financing	Robust transaction activity, led by REITs and foreign investors
	Improved activity in secondary and tertiary markets
	REIT underperformance being a short-term phenomenon
	Banks easing lending standards for CRE loans, including construction loans
	Regional & community banks being confined to class 'A' markets
Regulatory	TRIA's non-resolution having a significant on CRE financing in 2014
	Regulatory uncertainty persists across key regulations such as TRIA, FIRPTA, and lease accounting standards

Real Estate Industry Focus
- Issue turned out the way we thought
- Issue still to be resolved
- Didn't turn out the way we thought

from many CRE c-suite executives allude that tenants' or their end-customers' technology use influenced leasing decisions. However, it's a little challenging for us to quantitatively assess the technology influence on leasing demand.

We forecasted improved real estate capital markets in 2014, brought about by global investors and improved lending conditions. However, capital market activity gained better-than-expected strength with strong foreign capital inflow into U.S. CRE and a broad-based recovery in lending activity. As expected, banks eased lending standards for CRE loans, including for construction. As per the April 2014 Senior Loan Officer Opinion Survey on Bank Lending Practices, banks reported net easing for CRE loans across loan size, loan-to-value (LTV), and debt service coverage ratio (DSCR). Improved lending by regional banks was a positive surprise. From an investment perspective, we thought that real estate investment trust (REIT) underperformance would likely be a short-term phenomenon as a result of an interest rate spike in 2013. And we were right: as of September 23, the FTSE NAREIT All REIT index outperformed benchmark indices such as the S&P 500 and Russell 2000. The increased availability of financing resulted in a stronger transaction and pricing environment. As a result, the improvement in activity in secondary and tertiary markets was much better than we expected.

Lastly, regulatory uncertainty continued, albeit much more than we had anticipated. We expected the Terrorism and Risk Insurance Act (TRIA) impasse to be over. However, the political logjam over the regulation is still not resolved. Yet, contrary to our expectation, the non-resolution has not significantly impacted CRE financing thus far.

In summary, the 12 months from our last Outlook probably turned out to be better than anticipated due to the broader recovery in financing availability that strengthened capital inflows, transactions, and pricing.

Looking forward
Enhance technology and enable innovation to capitalize on positive market fundamentals

As we look forward to 2015, the macroeconomic environment is expected to continue to improve. Our Deloitte Economics team expects positive change in important parameters such as job market indicators, including initial claims, unemployment rates, and job openings. Car sales remain strong, industrial production is accelerating, and exports are growing. The single-family housing sector — pricing and sales — continues to strengthen, albeit at a slow and inconsistent pace. These positive macroeconomic parameters could potentially provide a further boost to the strengthening CRE recovery.

Looking at trends likely to dominate in 2015, to begin with, an improved economy will continue to bolster global investments in U.S. CRE. REITs are likely to continue to offer positive returns against benchmark indices, and investors will benefit from additional diversification opportunities from the growing number of REIT conversions in nontraditional property sectors. The private equity real estate (PERE) funds appear to be having more success raising new capital and have increased opportunity to recycle capital due to higher property prices. Therefore, both domestic and foreign capital inflow will continue.

Compelling reasons exist for the increased interest in U.S. CRE. Geopolitical instability in a number of emerging markets may continue to lead to investment into safer and stable regions such as the United States. Closer to home, there is strong capital availability with traditional financing sources such as banks increasing lending. In addition, CRE players have opportunities to consider targeted capital raising using innovative sources such as green bonds and crowd funding. While construction loan availability from banks might fall short of actual demand, the industry will benefit from nontraditional funding sources and mezzanine and equity capitol from private equity and international sources.

The extensive availability of financing through domestic and international sources will likely support continued strong growth in transaction activity and asset pricing. Distressed assets as a percentage of transaction volume will likely continue to decline as prime markets turn expensive and more capital flows into secondary and tertiary ones.

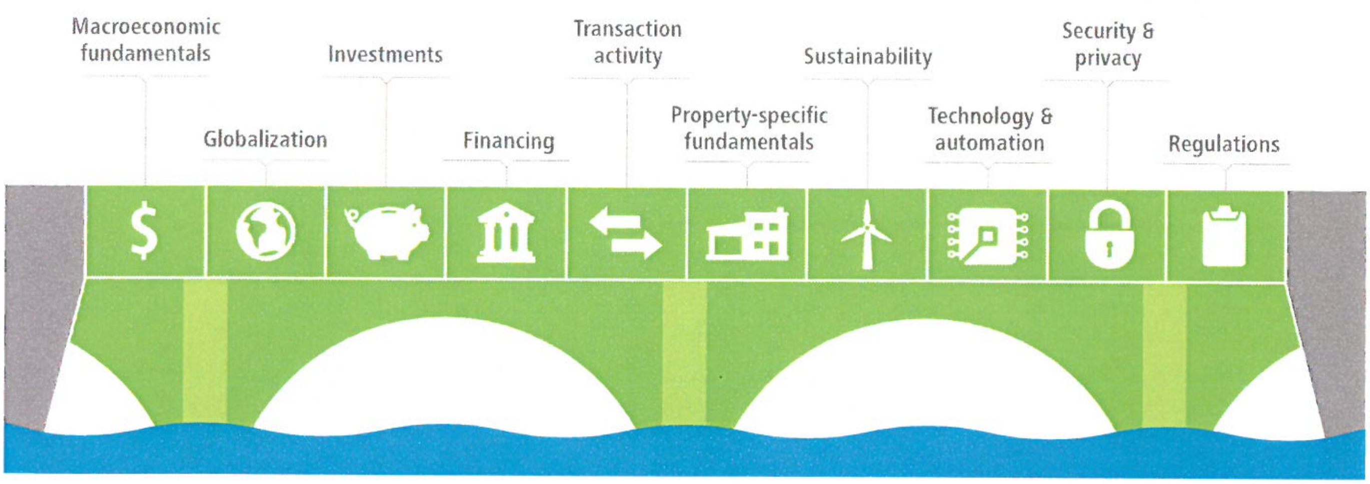
From a CRE fundamentals perspective, rents and vacancies will potentially continue to improve across property types, although development activity coming online may have a greater impact on this improvement in 2015, especially in the multifamily and office markets. We believe that tenants' sustainability focus and technology use will have a greater influence on space demand and supply than just market dynamics, not only in 2015 but longer term. Consequently, we expect to see increased redevelopment of existing properties to better position those properties to compete with new development.

Technology also will be integral to development activity as there will be higher demand for sustainability-enabled intelligent buildings. Further, adoption, measurement, and reporting of sustainability initiatives will be a business imperative, given its broader benefits on rental growth, yield premiums, total occupancy costs, asset values, and marketability. Lastly, as companies increase technology adoption, they will potentially benefit from adopting appropriate security and privacy measures.

On the flip side, regulatory uncertainty will persist. Particularly, the indecision on the renewal of TRIA, which is scheduled to expire by December 31, 2014, is cause for concern. Many insurers have included sunset clauses that withdraw terrorism risk coverage in 2015 in the event that TRIA is allowed to expire by the end of this year. Even if TRIA is renewed, insurance premiums may still rise. Therefore, along with uncertainty from a regulatory perspective, a nonrenewal or higher premiums may impact financing costs.

Overall, as we move into 2015, strong market fundamentals and the availability of a diverse array of funding sources will likely fuel industry growth. Increasingly, companies will seek to differentiate their appeal to tenants and capital sources based on their level of technology use to enable service and design innovation and operational excellence.

Figure 2



Macroeconomic fundamentals

Positive economic growth supporting the CRE industry

$

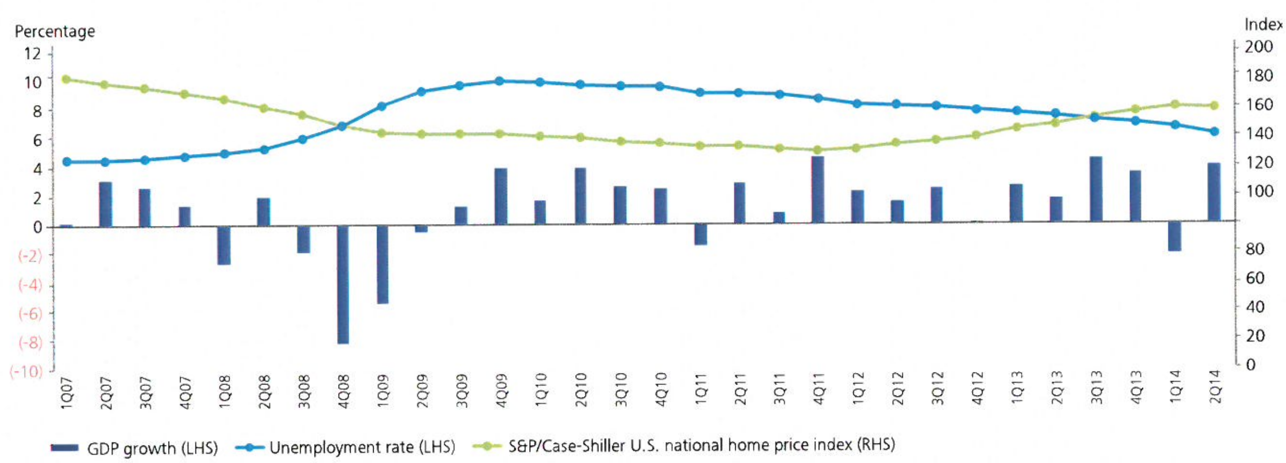
The global economy appears to be settling into a new normal of modest growth in developed economies, stabilization of growth in emerging economies, and a decline in systemic risks emanating from policy mistakes.[1] While geopolitical risks have emerged in 2014, financial market volatility has been low. According to Dr. Daniel Bachman, senior manager, U.S. Macroeconomics, Deloitte Services LP, "the stability will benefit the United States, which is likely to see acceleration from the relatively slow growth rates we've experienced in the past few years." Further, U.S. interest rates have remained stable.[2]

Let's look at some of the top macroeconomic indicators (Figure 3) that will influence the CRE industry:

Labor markets

The unemployment rate fell to 6.1 percent in August, the lowest since the 2008 financial crisis and closer to pre-recession levels.[3] And the pace of employment growth appears to have picked up. The long-term unemployed as a percentage of total unemployed has fallen recently.[4] While labor force participation remains low, a tightening labor market is likely to bring some of those people back into the labor force. The labor force participation rate could rise almost a full percentage point (from 62.8 percent in August to an average level of 63.7 percent in 2019) as many of the latent unemployed re-enter the labor market and are employed.[5]

Figure 3: GDP growth, unemployment, and home prices



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, and S&P/Case-Shiller, September 2014

Gross domestic product (GDP) growth

U.S. GDP rebounded strongly in 2Q14, growing by 4.2 percent compared to -2.1 percent in the prior quarter following an increase in exports, as well as state and local government spending.[6] According to Dr. Bachman, "although GDP growth may be lower in the third quarter 2014 because of a drop in inventory accumulation, faster job growth is likely to boost consumer spending and lead to higher levels of GDP growth in the future."

Housing

The housing market continues to improve, albeit at a slow pace. Many housing statistics, such as prices and sales, trended positively in 1H14. However, a large portion of existing home sales seems to be purchases by investment groups, rather than individuals.[7] Housing starts remain low as construction activity continues to be impacted by stringent lending standards and rising mortgage rates. That being said, recent international interest in the single-family housing market may act as an alternate source of funding and provide the much-needed boost to construction activity in the short to medium term.[8]

Focus for 2015

The improvement in GDP and employment numbers is supported by high consumer confidence, which is now at its highest level since the 2008 recession. Further, the personal savings rate has drifted down in the last few months, suggesting an increase in spending. According to the Deloitte Economics team, the positive news from labor markets suggests that there is a high probability of an acceleration in economic growth sometime in the next year or two.[9] Further, interest rates will likely increase by July 2015.[10] In addition, housing construction is probably less than required to meet the long-term need, so there is considerable pent-up demand for housing, which should result in robust starts in the future.[11]

From a CRE perspective, the improved economy will strengthen rent growth and occupancy rates. The industry will likely continue to benefit from easy financing availability and strong investment activity from both domestic and international sources. As a result, competition will continue to intensify for quality assets. However, the risk of rising interest rates can potentially impact property cap rates and the cost of financing real estate, which could mitigate the otherwise positive news impacting CRE transaction activity and pricing.

The bottom line

Risks related to interest rate hikes and regulatory uncertainty will potentially impact the CRE sector growth, although important parameters — fundamentals, transactions, lending — continue to strengthen. This suggests a cycle of investment and (re) development in many areas. Hence, CRE companies should capitalize on the increase in domestic and international capital inflows.

Globalization

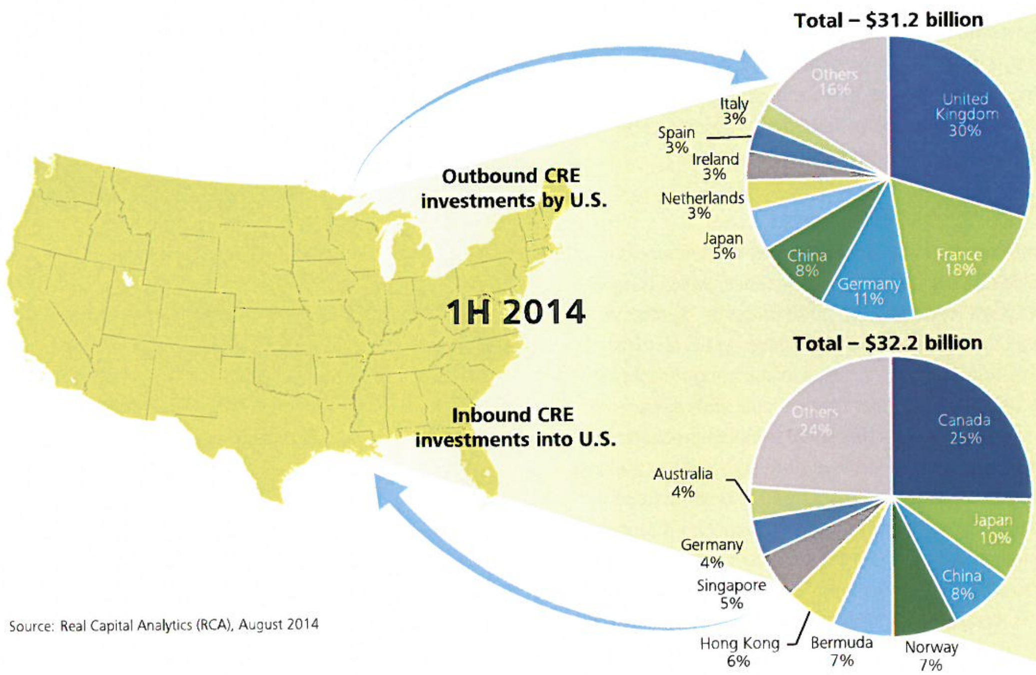
U.S. gaining traction as the preferred investment destination

Investors are pursuing international real estate investments to grow and diversify their portfolios, given more relaxed foreign investment regulations in many countries and improving global economic conditions. Investors are putting their committed capital to work, as highlighted in the growth in CRE investments across regions discussed below. The United States continues to regain its stature of "safe haven" for CRE investments with foreign investors. U.S. investors are also increasing their global presence, especially in Europe and China, with cross-border investments rising 100.8 percent YOY in 1H14 to $31.2 billion.[12] (Figure 4)

Global CRE transaction trends by region

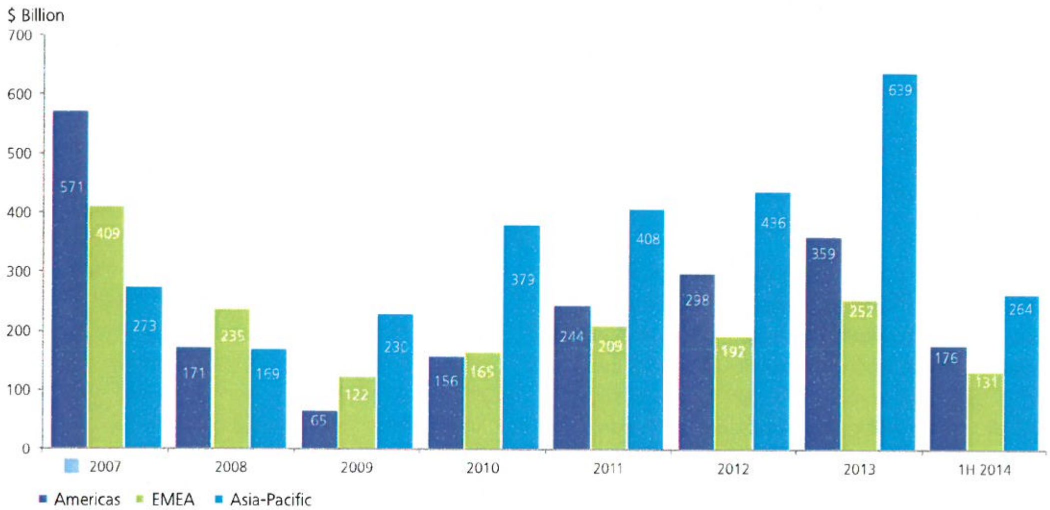
Global CRE transaction volume totaled $570.9 billion in 1H14 (Figure 5), an increase of 10.7 percent compared to 1H13. The 1H14 growth is slower compared to the 29.8 percent YOY volume growth in 1H13. This is primarily because of a relatively lower growth (+3.6 percent) in the Asia-Pacific (APAC) region, which is the largest contributor to global transaction volumes.[13] The Americas and Europe, Middle East, and East Africa (EMEA) sustained their positive clip with volume growth of 14 percent and 18 percent YOY in 1H14, respectively.[14] Consequently, both regions increased their share in the global transaction volume in 1H14 compared to the same period last year.

Figure 4: Foreign CRE investments in and out of U.S.



Source: Real Capital Analytics (RCA), August 2014

Figure 5: Global CRE transaction volume



Americas includes USA, Canada, and Latin America; EMEA includes UK, Western Europe, Eastern Europe, Middle East, and Africa; Asia-Pacific includes China, Japan, Australia, New Zealand, India, Hong Kong, Singapore, Malaysia, South Korea, Taiwan, and Others
Source: RCA, August 2014

Looking at the investment activity across regions, the slowdown in APAC was due to a decline in investment activity in top markets such as Australia, Japan, Singapore, and Hong Kong. In China, although volumes grew 12.9 percent YOY in 1H14, limited opportunities due to restricted bank lending and differing price expectations between buyers and sellers added pressure. The Americas continues to be dominated by the United States, where investors see opportunities in both primary and secondary markets. Canada, while continuing its "slow and steady" progress, is dominated by a limited number of institutional investors for premium assets. Elsewhere, in the EMEA region, there is broader and improved investor demand, as concerns over the future viability of the Eurozone gradually dispel. While the UK, France, and Germany continue to lead the region's activity, markets like Spain, Netherlands, and Ireland have shown strong YOY growth.

Foreign investor interest continues to grow in the United States

In 1H14, cross-border investment in the United States as a percentage of total CRE transaction activity was 10.8 percent, the highest in more than a decade.[15] The increased investor interest is driven both from a demand and supply perspective. Limited home-country options and the gradual relaxation of outbound investment norms are driving investors to scout for international options such as a more stabilized U.S. CRE market. Consequently, foreign investors are finding both core and opportunistic investment options. Therefore, we are witnessing foreign capital inflow not just in primary markets like New York and Chicago but also in secondary markets such as Houston, Dallas, and Seattle.

A case in point is the surge of Chinese investments in U.S. CRE, which in the 20 months through August 2014 was nearly thrice the cumulative amount invested in the previous eight years. Consequently, China has emerged as one of the top foreign investors (second in 2013 and third thus far in 2014 as of August) with nearly an 8 percent share of the total cross-border investments in U.S. CRE in 2013 and 2014YTD August.[16]

Focus for 2015

Unlike last year, we expect Europe to receive increased investor interest across both gateway and secondary markets, in line with stability in the Eurozone as well as continued distressed asset opportunities. That said, the United States is likely to remain the most attractive market in 2015. According to the 2014 Association of Foreign Investors in Real Estate survey, more than two-thirds of respondents consider it to be the most stable and secure real estate investment destination. Going forward, an equal number of respondents plan to increase their investments in U.S. secondary markets.[17] In addition, the United States is the leading target for single-country focused funds as 46 percent of the funds currently raising capital are targeting the country.[18]

The bottom line

The rising foreign investor interest bodes well for U.S. CRE players as it can provide an additional funding source, especially for development. In addition, these investments can help clear some of the distressed pipeline in the secondary and tertiary markets as seen with foreign investor deals in cities like Detroit. Companies looking to access foreign capital should understand the investment pattern and objectives of these investors to build long-term and mutually beneficial partnerships. However, many of these international investors lack knowledge of U.S. CRE markets, entitlement processes, and relevant regulations and tax laws, and seek out domestic partners to leverage their local marketplace and regulatory knowledge. Tax-efficient investing for foreign investors also remains challenging but can be accomplished with the help of professional advisers. According to Jeff Rubin, partner, Deloitte Tax LLP, "investments through intermediate vehicles and structures can reduce the overall tax burden and in some cases eliminate the requirement to directly file U.S. income tax returns." Similarly, with respect to outbound investing, U.S. CRE players can leverage long-term partnerships with foreign investors to better navigate international markets.

Investments

REITs and PERE funds demonstrate strong performance

The CRE sector continues to post strong returns, resulting in significant investor interest. After a period of lower returns in 2013, REITs bounced back in 2014 with relatively better returns against benchmark indices such as S&P 500 and the Russell 2000. PERE funds have continued to raise more capital on a YOY basis, reflecting investor confidence in U.S. CRE.

REITs

REIT fundraising declined 23.5 percent YOY to $41.3 billion as of August (Figure 6). The lower issuance is primarily due to REITs' preference for raising capital through asset disposition as property prices continue to head north.

From a performance perspective, REITs have had a strong year so far, unlike the last one. At September 23, YTD returns for the FTSE NAREIT All REIT Index totaled 13.1 percent, compared to 8.9 percent for the S&P 500, 2.9 percent for the Dow Jones Industrial Average, and -3.0 percent for the Russell 2000 (Figure 6).[19] Strong fundamentals have contributed to the equity outperformance through the year. Further, existing corporate governance practices are increasingly influencing investors' investment decisions. In this context, REITs continue to improve their corporate governance practices, specifically with respect to including/adding independent directors, eliminating staggered terms for board members, and publishing board

Figure 6: REIT fundraising, PERE dry powder, and returns by asset class

Returns by asset class	FY09	FY10	FY11	FY12	FY13	FY14 YTD*
Public REIT (All REIT Index)	27.5	27.6	7.3	20.1	3.2	13.1
S&P 500	26.5	15.1	2.1	16.0	32.4	8.9
DJIA	18.8	11.0	5.5	7.3	26.5	2.9
Russell 2000	27.2	26.9	-4.2	16.4	38.8	-3.0

* FY14YTD for REIT fundraising is as of August 2014 and for returns is as of September 23, 2014
Source: NAREIT and Preqin, September 2014

guidelines.[20] According to a recent survey conducted by the Institutional Shareholder Services, equity REITs ranked seventh among 43 industries on 80 corporate governance factors organized around four broad parameters such as board structure, compensation, shareholders rights, and audit.[21]

The U.S. PERE funds continue to maintain positive momentum of capital raising. In 1H14, they raised approximately $30.2 billion, an increase of 26 percent compared to 1H13.[22] These funds exhibited improved performance with an average internal rate of return (IRR) of 8.1 percent during the year ended March 31, 2014, compared to 6.7 percent in the prior year, driven by the sustained recovery in real estate prices.[23] In addition, PERE dry powder available for investment in North America continued to swell and aggregated $110 billion, accounting for 51.4 percent of the global total.[24] Overall, PERE funds continue to have a high risk appetite, as 85 percent of U.S. PERE funds that closed in 1H14 used a value-added (54 percent) or opportunistic strategy (31 percent).[25]

Focus for 2015

REITs as an asset class will continue to remain attractive in the near to medium term given a healthy operating environment. Notably, they now provide additional diversification opportunities with the advent of nontraditional[26] and single-family home REITs. However, there is uncertainty being generated by the U.S. Treasury Department looking at REIT qualifications and the impact on REIT conversions, as well as potentially broader portions of the REIT industry, remains to be seen. This may act as a potential headwind to investments in this asset class.

PERE fund managers plan to commit more capital — according to a recent Preqin survey, 37 percent and 26 percent plan to invest significantly and slightly more capital, respectively, over the next 12 months.[27] There are also likely to be more recycling of capital through exits and capital reinvestments due to improved financing conditions, robust transaction activity, and strong property valuations.

The bottom line

REITs will continue to benefit from the favorable transaction pricing and financing environment, as well as generally improving rental growth and occupancy fundamentals. Companies will potentially benefit from monitoring the developments around the REIT qualification guidelines, assess its potential impact on their business, and take appropriate action.

PERE funds also have a favorable financing environment with easy debt availability. This will likely lead to an increase in transaction activity in both core and non-core markets. As such, competition is on the rise and fund managers will likely search for value and attractive opportunities across wider markets and/or property types.

Financing
Innovative funding options increase financing availability

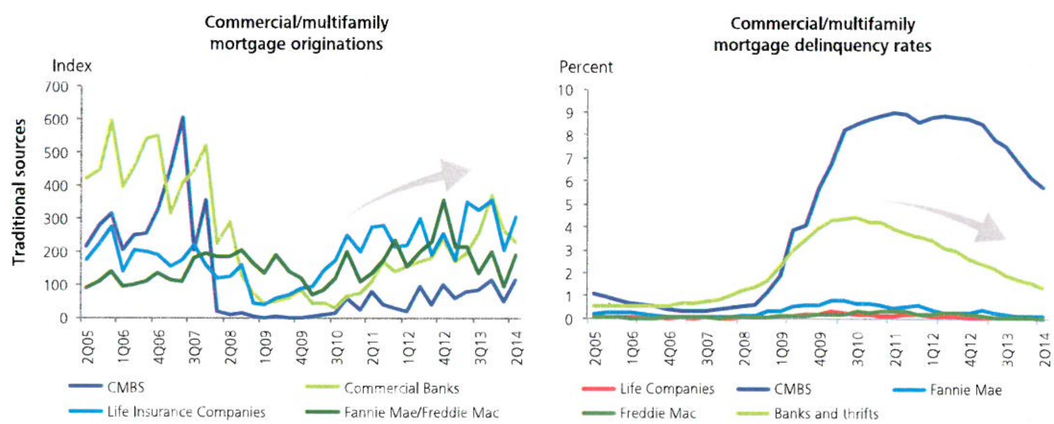
CRE financing is certainly more buoyant compared to a year ago, with lenders increasing commercial mortgage issuance on the back of improved property valuations and an active transaction pipeline. Unlike last year, we are seeing a broad-based recovery where lenders are increasingly competing for commercial mortgage issuances across all markets — primary, secondary, and tertiary. Further, construction financing is also showing signs of revival, albeit at a slow pace.

Lending scenario — Banks and CMBS

Compared to a year ago, banks continue to ease lending standards on CRE loans, including construction financing, although it varies by purpose and loan terms such as size and maturity.[28] As a result, commercial mortgage originations (CMOs) registered an 18.9 percent YOY growth in 2Q14.[29] Regional and community banks marred by troubled mortgages and confined to class "A" markets until last year are now going beyond core opportunities, driven by healthier balance sheets and increased risk appetite. The increase in bank lending has been supported by improved loan performance as visible in lower delinquency rates of 1.4 percent in 2Q14 — a 78 bps YOY decline.[30] (Figure 7)

Recovery in commercial mortgage backed securities (CMBS) markets, which accelerated in 2013, seems to have halted with 12.6 percent YOY decrease in issuance through August 2014 to $49.3 billion.[31] This is likely due to increased uncertainty around resolution and loss severities of $346 billion of CMBS maturing in the next three years, much of which was issued in 2006 and 2007.[32]

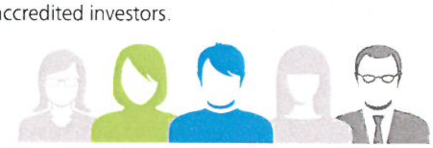
Figure 7: Traditional and nontraditional financing trends and options



Non-traditional sources

Green bonds
CRE companies have started to issue innovative fixed-income instruments such as green bonds. These bonds now provide access to low-cost and long-term debt capital for CRE companies to pursue their sustainability initiatives.

Crowd funding
CRE companies, especially the private ones, are using crowd funding, which essentially provides a mechanism to raise capital for diverse project needs directly from accredited investors.



Source: Mortgage Bankers Association, September 2014 and Deloitte Center for Financial Services analysis

Alternate financing sources

CRE players are also considering innovative ways (Figure 7) to fund specific requirements. One such source is green bonds, which are fixed-income instruments that tie bond proceeds to environment-friendly investments.[33] In 2Q14, a couple of CRE companies issued green bonds totaling $700 million to finance their sustainability efforts, such as construction or retrofitting of buildings to make them LEED certified.[34] These bonds now provide access to low-cost and long-term debt capital for CRE companies to pursue their sustainability initiatives.

Another innovation is crowd funding, which essentially provides a mechanism for private CRE players to raise capital for diverse project needs directly from accredited investors.[35] This financing mechanism got a boost from the 2012 Jumpstart Our Business Startups Act. Within a span of two years, real estate firms and new entrepreneurs have set up a dozen crowd funding firms, specifically targeting real estate project financing. Real estate is one of the leading sectors leveraging crowd funding, with $135 million of capital raised through June 2014.[36]

Focus for 2015

We expect regional and community banks to increase lending outside of primary markets, given their improved financial positions. Hence, we expect a further strengthening of the overall CRE lending environment, with large banks likely increasing CMOs as delinquency rates trend down. Also, with CRE players exploring new financing options such as green bonds and crowd funding, it will be interesting to see if competition intensifies among traditional and nontraditional lenders. That being said, nontraditional funding options run the risk of getting more regulated as the market evolves. For instance, crowd funding is coming under the lens of the Securities Exchange Commission and the Financial Industry Regulatory Authority to protect the interests of small investors. Further, maturity concerns and increased competition from regional and community banks will likely affect CMBS lenders. In summary, we believe it will likely be a win-win for the CRE industry, especially as lenders continue to ease standards for construction loans.

The bottom line

The robust financing environment is likely to benefit for the broader CRE market as players can not only refinance their existing mortgages at favorable terms but also have improved access to financing for a broader range of deals across various markets. An improved lending scenario is likely to increase investments for both developed and under-construction properties. Companies can leverage the newer sources of funding for targeted objectives such as sustainability investments. However, they also need to exercise caution as these sources come with their own quirks. For instance, green bonds require issuers to increase disclosure and transparency about sustainability goals and targeted use of funds to meet the stated objectives.

Transaction activity
A sweet spot driven by a broad-based recovery in deals and pricing

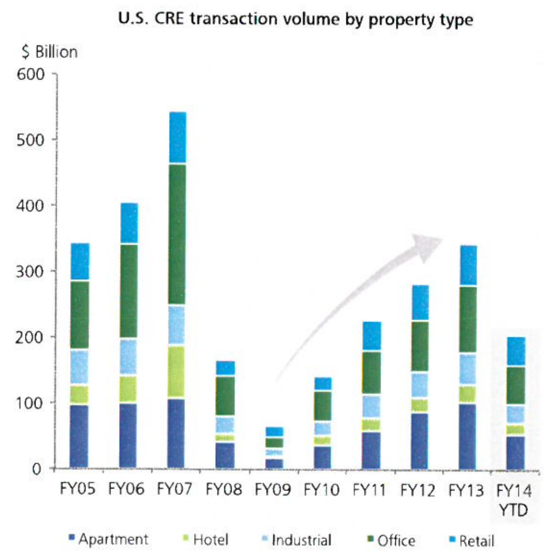
Transaction activity continues to be the highlight of this CRE recovery, with solid growth in both primary and secondary markets. In fact, capital availability is increasing competition as both domestic and international investors show significant interest in CRE as an asset class. Consequently, asset pricing continues to show sustained growth.

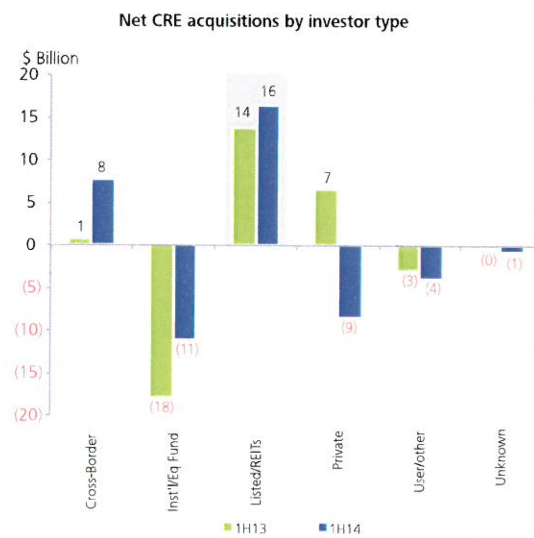
Transactions and pricing update

U.S. CRE transaction volume (Figure 8) grew 16.4 percent YOY in the first seven months of 2014 to $204.2 billion, driven by REITs and international investors.[37] Similar to 1H13, REITs and cross-border investors (Figure 8) continued to lead in terms of net investments in 1H14, which aggregated to $16.5 billion and $7.8 billion, respectively.[38] Within the broader REIT subsector, non-traded REITs have done significant asset purchases and provided individual investors an opportunity to own income earning CRE. Further, secondary markets have seen a strong pick-up in activity across property types, as investors seek opportunities in markets less competitive than the primary gateway markets.[39]

By property type, retail led the growth with a 40 percent rise in property sales in the first seven months of 2014,[40] as companies reposition portfolios by divesting underperforming assets and reinvest the proceeds in updating existing centers to attract new tenants and improve customer traffic. However, apartment sales seem to have cooled off a bit, being the only property to register a sales decline during the same period.[41]

Figure 8: CRE transactions by property and investor type





*YTD through July 2014
Source: RCA, August 2014

The overall favorable transactions landscape continues to have a positive impact on asset prices as shown by Green Street Advisors' Commercial Property Price Index, which rose 6.2 percent in the first eight months of 2014 and is up 11.3 percent from the 2007 peak.[42] Cap rate compression across property types continues to drive higher asset prices.[43]

Distressed asset holders have been the beneficiaries of the significant investor interest and strong pricing environment. The outstanding distressed CRE of $64.4 billion as of 1H14 (18.7 percent of the 2013 transaction volume of $343.8 billion) is significantly lower than the $97.2 billion at the end of 1H13 (34.2 percent of 2012 transaction volume aggregating $284 billion).[44]

M&A activity

M&A activity declined by 50.3 percent YOY in the first seven months of 2014.[45] This follows a rather strong year of M&A activity in 2013 as many companies sought to leverage discounted valuations in the listed REIT space, resulting from a rise in interest rates after the Federal Reserve's decision to taper its quantitative easing program. In fact, at the end of 2013, all property sectors, except hotels and health care, were trading at a discount to their net asset values.[46] In addition, there is an increase in spin-off activity, especially by REITs, as they capitalize on the healthy transaction market to refine their portfolio.[47]

Focus for 2015

We expect disposition activity is likely to continue in 2015 as CRE players evaluate and reposition their property portfolios in light of changing tenant demands and low development activity. In addition, we expect increased reinvestment activity by PERE investors as they find opportunities to liquidate their legacy investments with relative ease. Overall, transaction activity will likely continue to rise in 2015 with improving fundamentals and easier capital availability. This will likely benefit secondary and tertiary markets and distressed assets as numerous investors are moving up the risk curve in search of higher yields, given the increased competition and cap rate compression in primary markets.

The bottom line

CRE companies can take advantage of the robust transaction and pricing environment to reassess their portfolios. Companies can begin with a thorough due diligence of their existing portfolio, identify the non-accretive properties for disposal, and eventually plan new developments, redevelopments, and/or acquisitions. Players will potentially benefit from capitalizing on the improved liquidity in the secondary and tertiary markets as competition will likely continue to intensify in prime markets. Many companies can also take the spin-off route to retain a portfolio of core properties while carving out non-core properties into a separate entity to simplify and focus their company. This is a visible trend among large retail real estate players that can be considered by others as well.

Property-specific fundamentals
Tenants' sustainability focus and technology use redefines space demand and supply

Leasing activity continues to gain momentum. As a result, CRE fundamentals, including rent growth and occupancy levels, are now witnessing sustained improvement across property types (Figure 9). Technology and sustainability measures are increasingly influencing tenants' leasing decisions and vary across most property types. Increasingly, tenants are considering the positive impact of sustainability measures on employee morale, productivity, and well-being. According to the 2013 World Green Building Council report titled "The Business Case for Green Building," certain design attributes of a green office building enhance occupant health and well-being, therefore resulting in healthier, happier, more satisfied, and ultimately more productive workers. Consequently, CRE owners need to assess the usability of existing space and new supply in context of the changing demand dynamics.

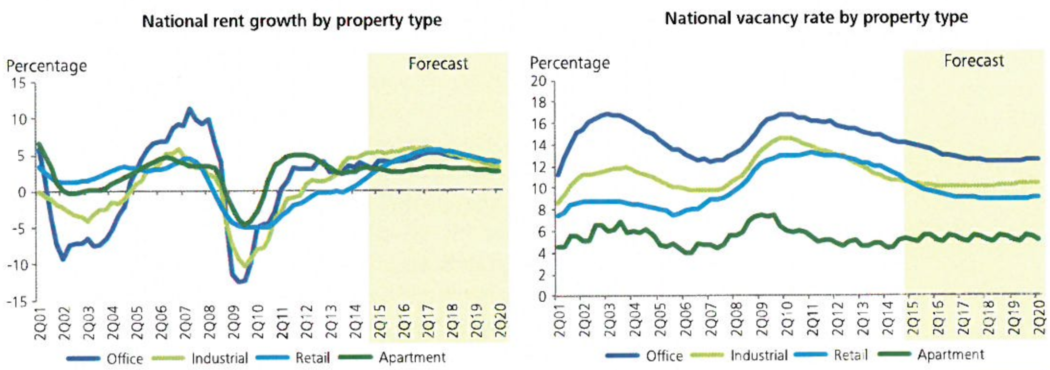
Industrial

Increase in online shopping, international trade, and manufacturing activity continue to have a positive impact on industrial fundamentals — rent growth for industrial space inched up to a solid 4.5 percent in 2Q14 from 1.6 percent in 2Q13, and vacancy declined to 10.8 percent, compared to 11.9 percent during the comparable prior year period.[48] Net absorption was a strong 53.4 million square feet in 2Q14, compared to 49.4 million square feet in 2Q13.[49] The increased use of technology and online sales in particular is redefining the supply chain. As omni-channel retailers with e-commerce activity focus on speed of delivery to improve competitiveness, location of the warehouse and distribution centers is likely to play a more critical role than before. Warehouse owners should collaborate and plug into the tenants' supply chain and strategically determine location for new developments. Further, industrial real estate owners need to be more flexible and responsive to the dynamic inventory levels and space requirements of their tenants, which implies a focus on size and design of warehouse and/or distribution centers. This will require extensive use of technology to build adaptable warehouses and distribution centers, specifically using advanced supply chain and automated warehouse management systems.

Retail

Retail vacancy and effective rents improved as higher consumer confidence led to an increase in spending. Vacancy was down 50 basis points YOY in 2Q14 to 11.7 percent[50] and effective rents increased 0.5 percent YOY, which is better than the 0.2 percent YOY decrease in 2Q13.[51] Further, retailers are embracing technology like never before to enhance both their brand and customer experience. Physical stores continue to remain core to creating an innovative and long-lasting shopping experience. Unlike the past, retailers position physical stores differently and consider them to be a part of the seamless omni-channel customer engagement model, rather than the "only channel." Commonly referred to as concept stores, they blend physical inventory, online access, and experiential retailing to customize and enhance the customer experience. With the focus on converting existing stores into concept stores, real estate owners will have to support technology-enabled retailing. For this, companies need to partner with tenants to understand their technology needs and incorporate them as integral to store redesign. The retail real estate sector is experiencing a spurt in redevelopment activity compared to new construction. A case in point is the contraction in net absorption to 7.4 million square feet in 2Q14 compared to 9.6 million in 2Q13.[52] CRE companies will also potentially benefit from continued increase in the use of mobile, social media, and predictive analytics to drive customer traffic in continuous support of their tenants' customer engagement strategies.

Figure 9: Fundamentals and technology and sustainability trends by property type



Tenants' sustainability focus and technology use redefines space demand and supply

Source: CB Richard Ellis — Econometric Advisors (CBRE-EA), August 2014, and Deloitte Center for Financial Services analysis

Office

Improved business sentiment and employment prospects have led to sustained recovery in office vacancy rates and rental growth. In 2Q14, vacancy rates and rental growth were 14.5 percent and 3.1 percent (compared to 15.2 percent and 2.5 percent, respectively, in 2Q13),[53] and net absorption was approximately 15.4 million square feet (compared to 10 million square feet as of 2Q13).[54] However, new development activity is likely to remain low as tenants continue to focus on flexible work spaces through efficient space utilization. Therefore, office property owners will potentially benefit from including design features that meet their tenants' flexibility and sustainability requirements, as redevelopment and refurbishment of existing space will likely prevail in the near to medium term.

Multifamily

The improving job scenario continues to support apartment-sector performance, with vacancy rates down to 4.4 percent in 2Q14 compared to 4.6 percent during 2Q13.[55] However, rent growth was 2.6 percent compared to 3.1 percent in 2Q13.[56] Net absorption totaled 145,429 units compared to 119,805 units in 2Q13.[57] The sector continues to witness a strong development pipeline. This will likely be supported by changing tenant preferences for multifamily homes over single-family ones, particularly among younger and older generations, in the medium term. While apartment owners/operators are comparatively less impacted by the onslaught of technology from a demand-supply perspective, they need to continue to leverage it in the leasing and tenant service processes to establish better rapport with existing and potential tenants.

Lodging

The lodging sector continues to post strong growth. In 2Q14, higher occupancy (+3.6 percent YOY to 68.1 percent) and average daily rates (+4.4 percent YOY to $115.5) led to an 8.2 percent YOY growth in revenue per available room.[58] However, hotel owners should consider adopting technology to offer innovative designs such as door lock technology (smartphone or finger print-enabled access) and in-room content (lighting and temperature control), among others.[59] This is important as competition from nontraditional and new players such as Airbnb[60] could potentially disrupt the industry in the long term.

Focus for 2015

Overall, in 2015, CRE fundamentals will likely demonstrate moderate and sustained growth across all property types, with improvements in vacancy, rent, and absorption levels. While construction activity will continue to pick up, it is unlikely to see the pre-recession heights across many property types (except hotel and multifamily). This is because of relatively lower demand for new space driven by tenants leveraging technology and more efficiently using existing space. Ultimately, CRE players will potentially benefit more from allocating resources to newer formats and design for redeveloping existing property than just solely focusing on new construction.

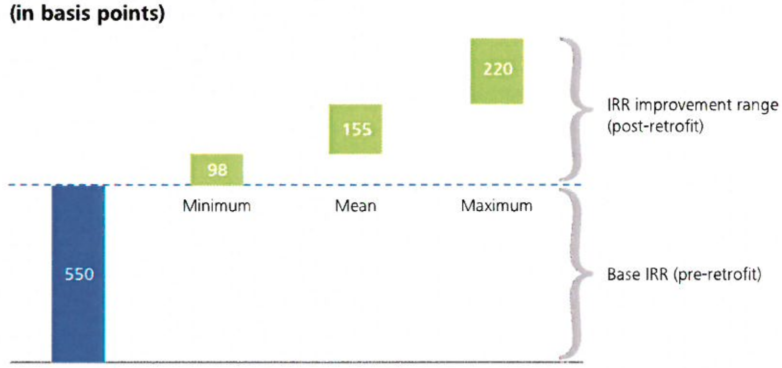
The bottom line

To maintain a positive momentum of rental growth and occupancy in the medium to long term, CRE players should change their demand-supply assessment and factor in the influence of technology and competition from new and innovative players along with traditional macroeconomic factors. While development activity is beginning to show signs of life across many property types, redesigning of existing space will likely be dominant. CRE players should consider using predictive analytics to conduct tenant and/or end-customer demography analysis, understand their needs and preferences, and determine demand for new or redesign of existing space. Thereafter, CRE players should increasingly collaborate with potential and existing tenants at the design stage to understand their technology needs and incorporate them as an integral part of design and/or redesign.

Sustainability
Adoption, measurement, and reporting is a business imperative

Sustainability initiatives have a significant bearing on CRE operations, which manifest themselves in various forms — environment, portfolio performance, top and bottom line, asset values, stakeholder engagement, and brand perception. Among other things, buildings with relatively better sustainability credentials tend to enjoy increased marketability to both tenants and investors.

Figure 10: IRR improvement post sustainability retrofit (in basis points)



Source: *IRR represents the unlevered internal rate of return on the overall building investment.
Source: Deloitte Center for Financial Services analysis

There is an increase in awareness and implementation of sustainability initiatives aimed at energy, water, and waste efficiency as indicated by the growth in green building certifications. That being said, the incremental cost of greening an existing building continues to influence sustainability decisions of many CRE players. A Deloitte Center for Financial Services analysis (Figure 10) of retrofitting an existing office building with sustainable measures suggests that CRE owners are likely to have broader benefits and higher IRR from their green investments than from comparable but non-sustainable investments. The study also suggests that the overall returns of a building have lower sensitivity to energy and operational and maintenance cost savings compared to top-line benefits arising from higher rental and occupancy rates and an eventual rise in property values. Further, the relatively higher LTV ratios provided to finance a LEED-certified building have a significant impact on the post-retrofit IRR of the equity investment.

According to Jon Lovell, director of sustainability, Deloitte Real Estate, United Kingdom, "strong sustainability performance has become a prerequisite for prime market expectations of quality, and the narrowing of capital flows to core product in recent years has arguably inflated values to the extent that some of the subtleties of sustainability performance have become hidden in the competition for stock. Moreover, it is reasonable to expect that rental growth will be more heavily suppressed in properties in which energy and other utility costs are high compared to rental levels. In this sense, sustainability is driving a greater divergence between prime and non-prime property. That said, these effects remain clouded by a deficit in proper in-use performance data across the sector."

Along with adopting sustainability measures, it is equally important for companies to measure internally and report externally (implementation and results) in a credible and reliable manner, and in accordance with recognized frameworks that demonstrate commitment to transparency around sustainability performance. For instance, investors require increasing levels of disclosure of credible narrative and nonfinancial information and greater rigor in related risk management processes.

The impact of measurement and reporting is also visible on brand value. Impact on brand value is at two levels — building and enterprise. This impact will vary across companies, and each CRE company needs to have the right metrics in place to measure its green performance.

Focus for 2015

Looking ahead, the combined demands of occupiers, investors, and regulators are such that tangible benefits can be derived from embedding sustainability into the full investment process. A range of property value fundamentals such as rental growth, yield premiums, total occupancy costs, and the like are increasingly sensitive to sustainability factors.

According to Jon Lovell, "Critically, value impacts are, and will continue to be, property specific, influenced as they are by local market context, tenant and leasing profiles, and climate conditions. We have every expectation that, as reliable data becomes more widespread, the transparency of real estate performance will increase and more informed capital pricing and rental decisions can be made."

As the wider market begins to transition toward integrated reporting, an opportunity exists for the CRE industry to further reinforce the value it delivers to investors as a result of the interface between the financial and nonfinancial aspects of its business processes. We therefore expect positive engagement with integrated reporting principles to be the next vanguard for sustainable business practices for the CRE sector.

The bottom line

Three critical factors to improve measurement and reporting of sustainability practices are awareness, analysis, and action. According to Will Sarni, director and practice leader, Enterprise Water Strategy, Deloitte, "It may not be long before all of these sustainability-related measurement trends become standard operating practices. As a business leader, what should your company begin doing now to get ready?" Hence, CRE players should put processes in place that drive environmental performance, which reinforce or enhance investment returns. In addition, companies need to embed enterprise sustainability risk management into core investment processes, and across the entire property life cycle. Further, companies should focus on quality over quantity i.e., disclosing the right metrics rather than a large volume of metrics, of which many may be redundant. Numerous industry organizations (Sustainability Accounting Standards Board, Global Reporting Initiative, and Carbon Disclosure Project) lay down the guidelines for measurement, reporting, and disclosure. In fact, these guidelines also highlight the market expectations from green buildings in general.

To read more about sustainability, please refer to our report Breakthrough for Sustainability in commercial real estate and our blog Sustainability in commercial real estate: Walking the green talk.

Technology and automation

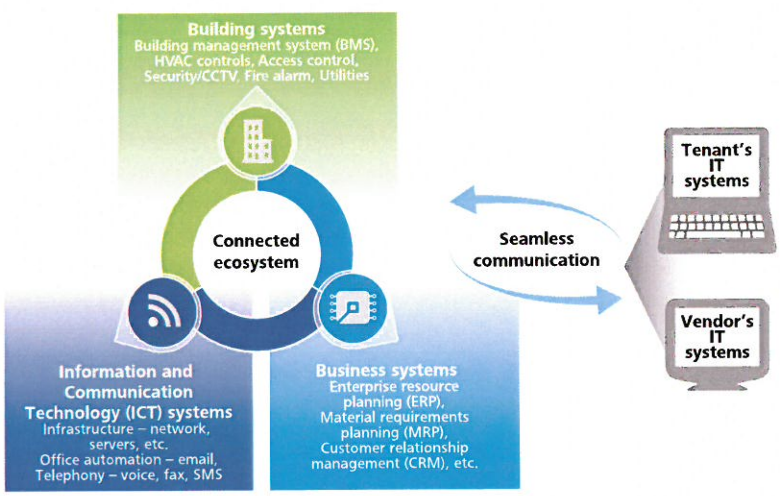
Adoption integral to enhancing tenant engagement

Technology-enabled operating efficiency and mobility are factors driving fundamental shifts in the CRE industry. For instance, mobility continues to significantly influence people's behaviors related to how one works, where one lives, and how one shops. As a result, a radical change has occurred in the need for physical space and the approaches used to engage and retain tenants. This requires companies to collaborate with their tenants beginning at the design/redesign stage to determine the latter's unique technology needs.

CRE owners can potentially implement smart building technology for maintenance and operations. This can help them realize the benefits of low-hanging fruit such as operational efficiency and cost savings through improved energy efficiency and reduced personnel costs, among other things. As such, CRE owners may be at a competitive disadvantage by relying on manual and traditional processes in building design and maintenance.

CRE owners are beginning to implement technology-enabled solutions at a building-level, although on a piecemeal basis. Some of the commonly implemented solutions pertain to HVAC, lighting, and/or safety systems. As building automation advances, CRE players can derive greater benefits beyond the above-mentioned low-hanging fruit by increasing connectivity among various electronic systems. Referred to as intelligent buildings (Figure 11), it implies integration between building management, communication technology, and business systems. As a result, companies can get a comprehensive and real-time view about various facilities and better adapt needs per the requirements of specific tenants and buildings. In addition, inter-linkage with other IT systems can aid real-time reporting and efficient portfolio management through better availability of information from various sources at the same time and place.

Figure 11: Intelligent buildings framework



Source: The Institution of Engineering and Technology, UK, and Deloitte Center for Financial Services analysis

Next, as tenant retention is largely driven by interactions and relationships between landlords and tenants, mobile and social media (Figure 12) can act as the perfect tools to increase tenant engagement. Social media adoption is gaining traction, as highlighted by 46.3 percent of the 1,400+ respondents to a polling question for a September Deloitte Dbriefs Webcast titled "Technology in Real Estate: Time to Cover New Ground." Importantly, mobile and social media can be used effectively to enhance employee engagement as well. According to the 1,400+ responses to another polling question of the same Dbrief, nearly 28 percent use social media to interact with employees.

Further, CRE companies are generating a large amount of data through multiple sources — internal and external such as market data, tenant property use through security passes and customer information generated through social media. And capturing, storing, and analyzing large sets of structured and unstructured big data appropriately and in real time can be used to identify business trends and opportunities (Figure 12). While this sounds simple, having the appropriate technology is critical to derive maximum benefits from large sets of data. Particularly, until very recently, data commonly resided in multiple, disparate systems — inside and beyond the firewall, which made it difficult to conduct meaningful analysis. Consider the case wherein retail property owners are using footfall technology that tracks movement of people into their property. Mining this data can help companies understand consumer behaviors, sales per store, and conversion rates per store in real time and appropriately drive rent increases.

Next, cloud computing (Figure 12) is helping CRE companies drive agility and scalability in a cost-effective manner. Typically, relatively less critical information is stored on the public cloud, whereas mission-critical data is hosted on the private cloud. Hence, a hybrid approach, using a mix of public and private cloud, can be an effective strategy for CRE companies.

Figure 12: Leveraging new technologies

Source: Deloitte Center for Financial Services analysis

Focus for 2015

Resistance to technology adoption remains, although the sector has increased its overall technology focus in the past few years in response to opportunities to drive more efficient operations and increase connectivity to tenants. Companies will likely increase their investments in intelligent buildings, as highlighted by the U.S. building automation systems market, which is expected to grow by 7 – 9 percent annually during the 2014 – 2017 period to $2.2 billion by 2017.[61] Further, according to the September Deloitte Dbrief, nearly 69 percent of the 1,100+ respondents to a polling question related to technology transformation foresee transformation over the next year or two. We believe this may include an increase in the adoption of one or more technologies. As technology adoption advances, CRE owners can consider using a combination of cloud, social media, big data analytics, and mobility to drive more informed decision making rather than on a stand-alone basis. Further, CRE owners should also ensure appropriate security and privacy measures for every technology adoption.

The bottom line

Adopting more advanced technology is rapidly becoming an imperative in CRE. Companies need to have a structured big data strategy that should be teamed with advanced analytics, business intelligence, and visualization that provides insights for strategic planning and decision making, and relative trend analysis and correlation to draw actionable insights. Companies at a nascent stage of adoption can begin with educating themselves about the value proposition of each of these technologies. They need to involve a wider array of people in decision making, particularly at three key stages. First, understand and align technology needs with that of the tenants. Second, assess the value proposition of these new technologies. Third, decide on the required systems from the multitude of options available in the marketplace, keeping scalability and adaptability in mind. Ultimately, CRE companies need to be progressively aware of new advancements in technology, and anticipate and step up adoption on a regular basis. They also need to ensure use of appropriate risk frameworks to manage any potential security and privacy concerns, which we will discuss in more detail in the next section. Having said that, companies will need to develop a customized plan for individual as well as overall technology adoption as a "one-size-fits-all" approach is unlikely to work.

Security and privacy
Appropriate measures important for successful technology adoption

As is the case with using any technology, security and privacy concerns tend to affect CRE players' decisions related to adoption, upgrade, and maintenance. This is because an increase in technology use within an organization and in automating building management results in inter-linkages between systems of property owners, tenants, and vendors. Information is now available through multiple entry points, and property owners and their tenants are vulnerable to cyberattacks such as information security breaches, hacking, malware, and viruses. For example, at a building management level, CRE companies currently focus more on the security of building management systems and less on the potential threat of information loss through cyberattacks.

Companies should manage three broad areas of vulnerability (Figure 13) at an entity and building management level:[62]

- **Access management**: Ensure that only authorized users are able to access the company's data or IT assets. With the advent of new technologies that allow anytime, anywhere availability, access management has become more complex.
- **Safeguarding personally identifiable information (PII)**: Real estate companies, like many other companies, deal with sensitive data, including confidential tenant, vendor, and employee information. Companies need to protect the PII that is stored within their firewalls as well as prevent access to interconnected tenant and vendor systems. Perpetrators are conducting attacks and aggregating PII through diverse channels such as social media sites, mobile devices, and offshore cloud service providers. According to the 2013 Trustwave Global Security Report, out of 450 global data breach investigations, 63 percent were due to lax security with third-party providers of IT services.[63]
- **Software vulnerability**: This is another important area over which companies may have less control. For instance, applications and software downloaded on different electronic devices, networks, and applications used by employees and vendors can potentially divulge PII and other data, including calendars, contacts, and passwords, to unknown perpetrators. In addition, software vulnerabilities across systems and devices provide opportunities for hackers to introduce malware into companies' systems.

Figure 13: Security and privacy framework

Focus for 2015

We expect companies to be exposed to new and complex risks as they step up their use of new technologies in 2015. Across these technologies, access management, loss of PII, and/or software vulnerability risks can have different manifestations. Use of the cloud involves risks through modes of data storage. For instance, the public cloud moves data management outside a company's walls and reduces direct control. Mobile and social media use provide an opportunity for perpetrators to steal sensitive information, introduce malware into company systems, or inflict reputational damage. The ongoing trend of bring your own device, commonly referred to as BYOD, potentially adds to the complexity as employees connect to unknown networks and applications. As CRE systems become more interconnected with systems of tenants and vendors, enhanced cybersecurity will become necessary to protect not only CRE company information and systems, but also to prevent unintended access to or information loss from tenant and vendor systems. It is important for CRE companies to appropriately secure data as any breach will have ramifications such as tenant loss, reputational damage, regulatory investigations, and privacy law violation penalties.

The bottom line

CRE companies can consider taking a step-by-step approach (Figure 13) to address the above-mentioned security and privacy concerns. To begin with, companies should develop a robust and comprehensive security and privacy framework, with specific strategies for unique risks related to individual technologies to be secure, vigilant, and resilient. For example, companies can consider appropriate tools for advanced user authentication; applications and data encryption; malware protection; and rigorous threat monitoring systems. Next, companies need to increase employee awareness by proactively educating them about the importance of strong passwords to reduce system vulnerability and accessing seemingly unsecure content or downloading freely available external apps. Third, companies should have a business continuity plan whereby, in case of a hacking incident, systems and processes can be restored with minimal business disruption and appropriate communication protocol is followed with partners, clients, regulators, and law enforcement agencies. Similar to technology adoption, a one-size-fits-all approach will likely not work with implementing security and privacy measures. Hence, it will be critical for companies to identify the appropriate course of action based on different assessment criteria such as size and complexity of the organization, interconnections with tenant and vendor systems, existing security systems, and plans to adopt new technologies.

Regulations
Continued uncertainty!

CRE players are currently dealing with varied regulatory issues that can have a direct impact on the industry from a tax, insurance, and accounting perspective.

Terrorism Risk and Insurance Act (TRIA)

The impending expiration of TRIA continues to be a top regulatory consideration for the CRE industry as the renewal stalemate in Congress continues. While the Senate passed a TRIA reauthorization bill in July with a clear majority, the House has proposed stiffer conditions to trigger a federal backstop for insurers.[64] Based on their recommendations, different scenarios can play out, which will potentially have a different impact (Figure 14) on both new and ongoing project financing.

Figure 14: Potential scenarios for TRIA and likely impact

TRIA — Scenarios	Likely impact
Renewed — Senate proposal accepted	↑
Renewed — House proposal accepted	↘
Renewed — A mix of Senate and House proposal passed	↘
Not renewed	↓
Short-term extension	↓

Source: Deloitte Center for Financial Services analysis

To begin with, the Senate proposal is very close to the existing regulation and if enacted will likely cause minimal disruption. The House proposal, on the other hand, suggests a smaller backstop for insurers, which, if passed, will increase insurance costs for CRE players.

A third scenario could be a compromise with elements from both proposals. In such a case, terrorism insurance costs will still rise, albeit potentially lower than in the prior scenario.

A fourth scenario, and one with the most far-reaching implications for the CRE industry, is letting TRIA expire. Such a situation may create a double whammy for the industry as not only will coverage become more expensive and/or unavailable, but financing will also, as a result, be hard to come by or significantly more expensive for the existing $1.6 trillion[65] in CRE loans scheduled to mature in the next five years.

There is also a fifth scenario, wherein Congress may pass a short-term extension so that the program does not expire, giving more time for lawmakers to work out a longer-term agreement. However, that would leave both the insurance market and CRE policyholders in limbo and have many of the same effects as if TRIA was allowed to expire altogether.

Foreign Investment in Real Estate Property Tax Act (FIRPTA)

The long-awaited FIRPTA reform continues to gain prominence given the rising foreign interest in U.S. CRE and increased government focus on promoting infrastructure investment and job creation. In addition to the earlier proposal of doubling the maximum tax-exempt foreign stake in public REITs from 5 percent to 10 percent,[66] another proposal is to allow the sale of foreign ownership interests in domestically controlled REITs to be treated as sales of stock, effectively exempting them from taxation.[67] If and when passed, these measures will likely result in U.S. CRE attracting more foreign investments (Figure 15).

Corporate tax reforms

In February 2014, the House Ways and Means Committee proposed a draft bill in an effort to reform and simplify the U.S. tax regime. It includes several proposals that, if enacted, will have a direct impact on the CRE industry. These potential changes include the repeal of the tax deferral provided by section 1031 like-kind exchanges, an extended cost recovery period for real estate, a higher individual tax rate (39.6 percent instead of 25 percent) on recaptured real estate depreciation on a retroactive basis, and the repeal of several other tax deductions, credits, and exemptions.[68]

Put together, the proposed tax reform, in its current form, may negatively impact (Figure 15) the bottom line of CRE companies due to higher effective tax paid and impede liquidity and stability of real estate markets. In addition, it will likely lead to inefficient use of capital, especially for REITs, which have limited ability to retain capital, given the distribution requirements.

Figure 15: Regulations and likely impact

Regulation	Issue	Likely impact
TRIA	Risk of non-renewal	
FIRPTA	Higher exemption limits	
Corporate tax reforms	Repeal of several tax benefits	
Lease Accounting Standards by IASB and FASB	Capitalization of operating leases	

Source: Deloitte Center for Financial Services analysis

Lease accounting standards

On the accounting front, U.S. and international standards-setters continue to work on issuance of new guidance that will require tenants to record leases as right-of-use assets and financing liabilities, instead of the "off balance sheet" operating lease treatment used for a majority of current real estate leases. While accounting boards aim to create greater transparency and consistency in lease accounting presentation, industry stakeholders have raised concerns about the potential negative impact (Figure 15) of the new standards on tenant behavior, existing CRE debt covenants, lending, and property valuations.

Focus for 2015

Looking ahead, the imminent uncertainty around renewal of TRIA may end up being an impediment to an otherwise strong lending environment. Some insurers have included sunset clauses that withdraw the terrorism risk coverage in 2015, in the event of the expiry of TRIA by the end of 2014.[69] In the past, Congress has used a wait-and-see approach on TRIA and extended it at the last minute. However, with diverse proposals in the Senate and House, it will be interesting to see if Congress manages to reach a consensus before year-end and, if it does, the shape of the final act that is passed. The delay in decision on FIRPTA is unlikely to have a significant impact as foreign investors are buoyant enough about U.S. CRE even without these reforms, but relaxing FIRPTA is likely to generate even additional foreign investor activity. While any movement in corporate tax reform is unlikely in 2015, the existence of the proposals creates future uncertainty as some or all provisions may be revived in the future as potential revenue raisers.

The bottom line

With the decision on most regulatory proposals still uncertain, CRE companies can use this time to prepare themselves for different outcomes. Companies can reach out to their insurers and bankers to assess the potential impact on their business across the different possible scenarios for TRIA. With respect to FIRPTA, companies can work with foreign investors to create tax-efficient deal structures, such as investing through a U.S. REIT, which will be a win-win for both stakeholders. Lastly, while companies need not take any immediate action on the proposed tax reforms and lease accounting standards, they will benefit from a thorough due diligence, assessment (scenario-based approach), and development of an implementation plan as these potential reforms move toward finalization.

Where do CRE executives go from here?

The CRE industry is likely to be on a stronger footing in 2015. The sector will likely experience strong capital flows — domestic and international — and availability through traditional and nontraditional sources. This will continue to strengthen transaction activity across primary, secondary, and tertiary markets at attractive valuations. Consequently, companies can take advantage of these trends, harvest gains from improved property valuations and financing conditions, and redeploy capital in development and redevelopment of properties to respond to changing tenant demand dynamics driven by technology. CRE executives can also consider using a wider variety of capital sources to fund targeted areas such as construction or sustainability implementation.

The industry will likely continue to feel the impact of the tectonic shift in the way it does business due to the growing influence of automation and technology on real estate use, design, operations, and service. CRE senior management and their directors should increasingly ask "Why not automate and use technology?" and "Where do we automate and use technology?" rather than "Is automation and technology required?" This will likely be important as technology usage will increasingly determine tenant leasing decisions, asset values, and real estate demand. For instance, companies could potentially benefit from leveraging technology such as analytics to assess tenant and/or end-customer demand and align design/redesign of physical space and enhance service. This may take the form of improving sustainability implementation, using smart building technology, and/or taking advantage of social media and mobility to attract and retain tenants, or, in the retail sector of CRE, retail customers. Another area where technology use will be critical is improving measurement and reporting of sustainability. Use of predictive analytics will help preempt potential risks, increase transparency, and meet tenant, investor, and regulator expectations. And while companies plan technology adoption across various business lines and functions, it is critical that they consider appropriate security and privacy measures to safeguard against data breaches and/or cyberattacks.

Another important focus area and an immediate one for CRE executives will be navigating the uncertainty around the renewal of TRIA. Companies will likely want to assess and prepare for a wide range of possible outcomes such as non-renewal, short-term extension, renewal with higher insurance costs, or passage of renewal legislation that maintains TRIA in its current form.

Technology will play a major role in generating differentiated returns, both in proactively responding to the impact technology is having on tenants' use of real estate, and by embracing technology to improve CRE design and performance. In conclusion, 2015 will be an exciting year for CRE growth, which will be enhanced by innovation.

Contacts

Industry leadership

Bob O'Brien
Vice Chairman and Partner
Global and U.S. Deloitte Real Estate Leader
Deloitte & Touche LLP
+1 312 486 2717
robrien@deloitte.com

Deloitte Center for Financial Services

Jim Eckenrode
Executive Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Authors

Lead author

Surabhi Sheth
Research Leader, Real Estate
Deloitte Center for Financial Services
Deloitte Services India Pvt. Ltd.
+1 615 718 8364
susheth@deloitte.com

Co-author

Saurabh Mahajan
Assistant Manager, Real Estate
Deloitte Center for Financial Services
Deloitte Services India Pvt. Ltd.

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The Center wishes to thank the following Deloitte client service professionals for their insights and contributions to this report:

Ken Meyer, Principal, Deloitte Consulting LLP
Francisco Acoba, Director, Deloitte Consulting LLP
Bob Kroner, Specialist Leader, Deloitte Consulting LLP
Guy Langford, Partner, Deloitte & Touche LLP
Christopher Dubrowski, Partner, Deloitte & Touche LLP
Damian Winterburn, Partner, Deloitte Australia
Sheila Botting, Partner, Deloitte Canada
Jeff Rubin, Partner, Deloitte Tax LLP
Patrick Kelley, Partner, Deloitte Tax LLP
Charles B. Temkin, Director, Deloitte Tax LLP
Lynn Kawaminami, Partner, Deloitte Tax LLP
Wyndham Smith, Partner, Deloitte & Touche LLP
Jon Lovell, Director, Deloitte UK
Kristen Sullivan, Partner, Deloitte & Touche LLP
William Sarni, Director, Deloitte Consulting LLP
Sam Friedman, Senior Manager, Deloitte Services LP
Daniel Bachman, Senior Manager, Deloitte Services LP
Courtney Naudo, Senior Manager, Deloitte Consulting LLP

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Carrie Winell, Senior Manager, Deloitte Services LP
Catherine Flynn, Senior Marketing Manager, Deloitte Services LP
Lisa Lauterbach, Senior Marketing Manager, Deloitte Services LP
Michelle Chodosh, Manager, Deloitte Services LP
Lauren Wallace, Lead Marketing Specialist, Deloitte Services LP
Robert Libbey, Manager, Deloitte Services LP
Aditya Muppa, Senior Research Analyst, Deloitte Services India Pvt. Ltd.
Prasad Yadav, Senior Research Analyst, Deloitte Services India Pvt. Ltd.

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Real Estate
Accounting and Financial Reporting Update

November 24, 2014

Financial Services Industry

Contents

Foreword

November 24, 2014

To our clients and colleagues in the real estate sector:

We are pleased to announce our seventh annual accounting and financial reporting update. Some of the notable standard-setting developments that occurred during 2014 were (1) the issuance of new guidance on the recognition of revenue from contracts with customers and discontinued operations; (2) the continued work of the FASB on accounting for leases, consolidation, and financial instruments; and (3) the SEC's continued focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act.

This publication is divided into three sections: (1) "Updates to Guidance," which highlights changes to accounting and reporting standards that real estate entities need to start preparing for now; (2) "On the Horizon," which discusses standard-setting topics that will affect real estate entities as they plan for the future; and (3) "Other Topics" that may be of interest to entities in the real estate sector.

The 2014 accounting and financial reporting updates for the banking and securities, insurance, and investment management sectors are available (or will be available soon) on US GAAP Plus, Deloitte's Web site for accounting and financial reporting news.

In addition, be sure to check out the eighth edition of our *SEC Comment Letters — Including Industry Insights*, which discusses our perspective on topics that the SEC staff has focused on in comment letters issued to registrants over the past year, including an analysis of comment letter trends in each financial services sector.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

Chris

Chris Dubrowski
Real Estate Industry Professional Practice Director
Deloitte LLP

Bob

Bob O'Brien
Global Real Estate Leader
Deloitte & Touche LLP

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Teri Asarito	Chris Donovan	Adrian Mills	Jiaojiao Tian
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Lynne Campbell	Trevor Farber	Magnus Orrell	Karen Wiltsie
Mark Crowley	Paul Josenhans	Jeanine Pagliaro	Ana Zelic
Chris Cryderman	Tim Kolber	Sean Prince	
Erica Czajkowski	Elise Lambert	Shahid Shah	
Joe DiLeo	Stephen McKinney	Scott Streaser	

If you have any questions concerning this publication, please contact the following Deloitte industry specialists:

Chris Dubrowski
Real Estate Industry Professional Practice Director
+1 203 708 4718
cdubrowski@deloitte.com

Bob O'Brien
Global Real Estate Leader
+1 312 486 2717
robrien@deloitte.com

Wyn Smith
Real Estate Industry Deputy Professional Practice Director
+1 713 982 2680
gesmith@deloitte.com

Bob Contri
Vice Chairman, U.S. Financial Services Leader
+1 212 436 2043
bcontri@deloitte.com

Susan L. Freshour
Financial Services Industry Professional Practice Director
+1 212 436 4814
sfreshour@deloitte.com

Introduction

The real estate market continued its modest recovery from 2013 into 2014. Through late 2014, the national home price index gained single-digit year-to-date returns compared with double-digit growth in 2013. Factors contributing to the continued increase in home prices include shrinking unemployment, low mortgage rates, and rising income for consumers. The commercial real estate market has also seen tapering price increases over the past year.

Economic Growth by Major Group

Commercial Real Estate

In 2009 and 2010, rental revenues in the commercial real estate industry declined dramatically because of weakened demand for commercial spaces. In 2014, revenues increased marginally, resulting in a five-year compound average revenue growth rate of about 2 percent. However, several factors could constrain long-term increases (e.g., increases in telecommuting, e-commerce).

Growth in REITs

REIT[1] fundraising has been increasing in recent years. REIT IPOs have been at their highest level (in terms of number and value of transactions) since 2005 and have involved both traditional and nontraditional real estate asset classes (e.g., single family rentals, data centers).

Property Management

As a result of the economic downturn, rental vacancy rates have decreased as more consumers have opted to rent a home rather than purchase one. However, this trend may change since the housing market is expected to expand over the next few years. Demand for office and factory space has also declined as firms have either reduced their workforces or closed operations. However, growth in this area was strong in 2014 and is forecasted to remain so.

Accounting Changes

During 2014, the FASB and IASB issued their final standard on revenue from contracts with customers, which supersedes most of the current revenue recognition guidance, including the guidance on real estate derecognition for most real estate disposals. The new standard is one of the most significant releases of guidance affecting the real estate industry since the issuance of FASB Statement 66 in October 1982. See the Revenue Recognition section for a discussion of key accounting issues and potential challenges related to real estate disposals.

The FASB also issued ASU 2014-08,[2] which amends the definition of a discontinued operation in ASC 205-20. The revised guidance will change how entities identify disposal transactions that are required to be accounted for as a discontinued operation under U.S. GAAP. The FASB issued the ASU to elevate the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance). The ASU also requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued operations criteria. See the Discontinued Operations Reporting section for a discussion of key accounting issues and potential challenges related to real estate.

For additional information about industry issues and trends, see Deloitte's 2014 Financial Services Industry Outlooks.

1 For a list of abbreviations used in this publication, see Appendix B.

2 For the full titles of standards, topics, and regulations used in this publication, see Appendix A.

Updates to Guidance

Revenue Recognition

Background

On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued by the FASB as ASU 2014-09, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including the guidance on real estate derecognition for most transactions.

The ASU's model is based on a core principle under which an entity "shall 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" and includes five steps to recognizing revenue:

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.

Thinking It Through

The ASU will have a significant effect on the accounting for real estate sales. The ASU eliminates the bright-line guidance that entities currently apply under ASC 360-20 when evaluating when to derecognize real estate assets and how to measure the profit on the disposal. It will change the accounting for both real estate sales that are part of an entity's ordinary activities (i.e., real estate transactions with customers) and real estate sales that are not part of the entity's ordinary activities. While the ASU eliminates the guidance in ASC 360-20 on real estate sales, entities will still need to apply ASC 360-20 to sales of real estate that are part of sale-leaseback transactions, at least until the FASB has completed its project on leasing.

Key Accounting Issues

Some of the key accounting issues and potential challenges related to real estate disposals are discussed below.

Financing Arrangements (Existence of a Contract)

Under current guidance, when the seller of real estate also provides financing to the buyer, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

Under the ASU, collectibility of the sales price affects the evaluation of whether a contract "exists." That is, the ASU requires an entity to determine whether a contract exists by assessing whether it is probable that the entity will collect the consideration to which it will be entitled (the collectibility threshold). However, the ASU does not include specific initial and continuing investment thresholds for performing this evaluation. If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under the ASU's criteria. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would evaluate the arrangement under the derecognition criteria in the ASU. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received as a gain.

Identifying Performance Obligations

Often, a seller remains involved with property that has been sold. Under current guidance, profit is generally deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under the ASU, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a "separate performance obligation," constitutes a guarantee, or prevents the transfer of control.[1] If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized as revenue when (or as) the entity transfers the related good or service to the customer.

Thinking It Through

Views are evolving on how real estate developers should account for contracts that may contain multiple performance obligations. For example, views differ on how a community developer that agrees to provide common areas (e.g., a community center, parks, or a golf course) as part of the development would evaluate whether the promise to provide these additional amenities represents separate performance obligations (to which a portion of the transaction price would be allocated and potentially deferred until the separate performance obligations were satisfied).

Determining the Transaction Price

A sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. Any additional revenue would be recorded only when the contingent revenue is realized. Under the ASU, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (the "constraint").

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price, which may be recognized up front. As a result, revenue may be recognized earlier under the ASU than under current requirements.

The ASU also requires entities to adjust the transaction price for the time value of money when the arrangement provides either the customer or the entity with a significant benefit of financing the transfer of real estate to the customer. In such instances, the entity will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the customer had paid cash for the promised property at the time control was transferred to the customer. In calculating the amount of consideration attributable to the significant financing component, the entity should use an interest rate that reflects a hypothetical financing-only transaction between the entity and the customer. As a practical expedient, the ASU does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all of the payments and the transfer of the promised goods and services is one year or less.

Accordingly, if an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the customer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the customer or the entity a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the entity or the customer).

[1] Certain forms of continuing involvement would not constitute a separate performance obligation. For example, an option or obligation to repurchase a property is specifically addressed by the ASU and would preclude derecognition of the property. Further, a seller obligation that qualifies as a guarantee under ASC 460 would be outside the scope of the ASU.

Recognizing Revenue When (or as) Performance Obligations Are Satisfied

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer.

Under the ASU, a seller of real estate would evaluate whether a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying assets is transferred to the purchaser.[2] An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred to the customer. If control is transferred at a point in time, revenue is recognized when the good or service is transferred to the customer.

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is 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 . . . 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."

Thinking It Through

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. The ASU contains an example[3] in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete. In one scenario in this example, the seller does recognize revenue over time; however, the example indicates that this conclusion is based on legal precedent in the particular jurisdiction where the contract is enforceable.

If a performance obligation does not meet any of the three criteria for recognition over time, the performance obligation is deemed satisfied at a point in time. Under the ASU, entities would consider the following indicators in evaluating the point in time at which control of real estate has been transferred to the buyer and when revenue should be recognized:

- "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."

[2] ASC 606-10-25-25 (added by the ASU) states that "[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

[3] ASC 606-10-55-173 through 55-182.

While entities will be required to determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP, the FASB decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under the ASU.[4]

Effective Date and Transition

For public entities, the ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the ASU's guidance. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (transactions in periods presented in the financial statements before that date are reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those that are not completed) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date. Entities that elect the modified approach must disclose the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

For additional information, see Deloitte's May 28, 2014, and July 2, 2014, *Heads Up* newsletters and Deloitte's September 22, 2014, *Real Estate Spotlight*.

Thinking It Through

Real estate entities will need to reassess their historical accounting for all real estate disposals to determine whether any changes are necessary. In addition to the issues discussed above, real estate entities will need to consider the ASU's guidance when accounting for (1) repurchase agreements (the seller may be required to account for the transaction as a lease, a financing, or a sale with a right of return) and (2) partial sales (entities that enter into partial sales will need to determine whether control of the real estate is transferred to the customer).

The ASU also requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, entities used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer. To comply with the ASU's new accounting and disclosure requirements, real estate entities may want to consider whether they need to modify their systems, processes, and controls to gather and review information that may not have previously been monitored.

[4] An entity would not consider parts of a contract that are accounted for under guidance outside the ASU (e.g., guarantees within the scope of ASC 460) when determining whether control of the remaining goods and services in the contract has been transferred to a customer.

Discontinued Operations Reporting

Background

On April 10, 2014, the FASB issued ASU 2014-08, which amends the definition of a discontinued operation in ASC 205-20 and requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued-operations criteria. The revised guidance will change how entities identify and disclose information about disposal transactions under U.S. GAAP. The FASB issued the ASU to provide more decision-useful information to users and to elevate the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance). Under the previous guidance in ASC 205-20-45-1, the results of operations of a component of an entity were classified as a discontinued operation if all of the following conditions were met:

- The component "has been disposed of or is classified as held for sale."
- "The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction."
- "The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."

The new guidance eliminates the second and third criteria above and instead requires discontinued-operations treatment for disposals of a component or group of components that represents a strategic shift that has or will have a major impact on an entity's operations or financial results. The ASU also expands the scope of ASC 205-20 to disposals of equity method investments and acquired businesses held for sale.

Further, the ASU (1) expands the disclosure requirements for transactions that meet the definition of a discontinued operation and (2) requires entities to disclose information about individually significant components that are disposed of or held for sale and do not qualify as discontinued operations.

The ASU also requires entities to reclassify assets and liabilities of a discontinued operation for all comparative periods presented in the statement of financial position. Before these amendments, ASC 205-20 neither required nor prohibited such presentation.

Regarding the statement of cash flows, an entity must disclose, in all periods presented, either (1) operating and investing cash flows or (2) depreciation and amortization, capital expenditures, and significant operating and investing noncash items related to the discontinued operation. This presentation requirement represents a significant change from previous guidance.

The new guidance is likely to have the greatest impact on entities that enter into routine disposal transactions, such as those in the real estate or retail industries.

Scope

Previously, investments in equity securities accounted for under the equity method were outside the scope of ASC 205-20. The ASU eliminates that scope exception. In addition, the ASU notes that a "business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale is reported in discontinued operations." Further, the ASU removed the discontinued-operations scope exceptions in ASC 360-10-15-5 but retained the exception for oil and gas properties accounted for under the full-cost method.

Recognition Criteria

Under the revised guidance, the unit of account for evaluating disposals (other than an acquired business or nonprofit activity) continues to be a component of an entity or a group of components of an entity; the ASU retains the existing definition of a component of an entity.

Discontinued Operation

ASU 2014-08 defines a discontinued operation as a component or group of components of an entity that (1) has been disposed of by sale or other than by sale in accordance with ASC 360-10-45-15, or is classified as held for sale, and (2) "represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results." According to the ASU, a strategic shift that has (or will have) a major effect on an entity's operations and results includes the disposal of any of the following:

- A major geographical area.
- A major line of business.
- A major equity method investment.
- Other major parts of an entity.

The ASU does not define the terms "major," "line of business," or "geographical area." It does, however, provide examples illustrating the evaluation of whether a disposal qualifies as a discontinued operation. These examples illustrate the quantitative thresholds of various metrics (e.g., assets, revenue, net income) — ranging from 15 percent to 20 percent as of the disposal date and 30 percent to 40 percent in historical periods — in various scenarios in which there was a strategic shift in an entity's operations that has (or will have) a major effect on the entity's financial results.

Thinking It Through

Entities will need to use judgment in determining what constitutes "major." Some may interpret the illustrative guidance in ASC 205-20-55-83 through 55-101 as implying that breaching quantitative thresholds in the range of 15 percent to 20 percent indicates that a disposal is major. However, note that the FASB intentionally avoided creating a bright-line quantitative threshold because qualitative factors may also affect this assessment.

Entities may also find it challenging to define the terms "line of business" and "geographical area." For example, some entities may define a geographical area as a county, state, country, or continent, while others may base this definition on how management determines its regions. Further, there may be differences in how entities define a major line of business: some may weight quantitative considerations more heavily, while others may stress qualitative factors.

Example

A publicly traded REIT in the United States has a regional mall division, a shopping center division, and an other commercial property division. The REIT's regional mall division consists of shopping malls in cities across the United States. In October, the REIT decides to sell two shopping malls in Washington because of declining operations. The two malls in Washington comprise 2 percent of the REIT's total net income and 5 percent of its total assets. Because the sale of the malls in Washington does not represent a strategic shift in the REIT's operations and because the quantitative thresholds are not significant, the sale does not meet the criteria for presentation as a discontinued operation, although disclosures may be required (as discussed below).

Disclosures

The ASU introduces several new disclosure requirements for both (1) disposals that meet the criteria for a discontinued operation and (2) individually significant disposals that do not meet these criteria.

The following are some of the noteworthy new disclosure requirements:

- Major line items constituting the pretax profit or loss for all periods for which the discontinued operation's results of operations are reported in the income statement. Some examples of major line items are (1) revenue, (2) cost of sales, (3) depreciation and amortization, and (4) interest expense.

- For most discontinued operations, an entity must disclose either of the following in the statement of cash flows or the notes to the financial statements:

  - Operating and investing cash flows for the periods for which the discontinued operation's results of operations are reported in the income statement.

  - Depreciation and amortization, capital expenditures, and significant operating and investing noncash items for the periods for which the discontinued operation's results of operations are reported in the income statement.

- "For the initial period in which the disposal group is classified as held for sale and for all prior periods presented in the statement of financial position, a reconciliation of" (1) total assets and total liabilities of the discontinued operation that are classified as held for sale in the notes to the financial statements to (2) "[t]otal assets and total liabilities of the disposal group classified as held for sale that are presented separately on the face of the [balance sheet]."

- For disposal of an individually significant component that does not meet the definition of a discontinued operation, all entities must disclose pretax profit or loss reported in the income statement for the period in which the disposal group is sold or is classified as held for sale. In addition, public entities must also disclose pretax profit or loss for all prior periods presented in the income statement.

These disclosures are required for both interim and annual reporting periods.

Transition Guidance

The ASU is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) or components initially classified as held for sale in periods beginning on or after December 15, 2014, with early adoption permitted.

See Deloitte's April 22, 2014, *Heads Up* for further discussion of ASU 2014-08.

Going Concern

Background

In August 2014, the FASB issued ASU 2014-15, which provides guidance on determining when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued.[5] An entity must provide certain disclosures if "conditions or events raise substantial doubt about [the] entity's ability to continue as a going concern."

Under U.S. GAAP, an entity's financial reports reflect its assumption that it will continue as a going concern until liquidation is imminent.[6] However, before liquidation is deemed imminent, an entity may have uncertainties about its ability to continue as a going concern. Because there are no specific requirements under current U.S. GAAP related to disclosing such uncertainties, auditors have used applicable auditing standards[7] to assess the nature, timing, and extent of an entity's disclosures. Consequently, there has been diversity in practice. The ASU is intended to alleviate that diversity.

[5] An entity that is neither an SEC filer nor a conduit bond obligor for debt securities that are traded in a public market would use the date the financial statements are available to be issued (in a manner consistent with the ASU's definition of "issued").

[6] In accordance with ASC 205-30, an entity must apply the liquidation basis of accounting once liquidation is deemed imminent.

[7] PCAOB AU Section 341.

The ASU extends the responsibility for performing the going-concern assessment to management and contains guidance on (1) how to perform a going-concern assessment and (2) when going-concern disclosures would be required under U.S. GAAP.

Key Provisions of the ASU

Disclosure Thresholds

An entity would be required to disclose information about its potential inability to continue as a going concern when there is "substantial doubt" about its ability to continue as a going concern, which the ASU defines as follows:

> Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued . . . . The term probable is used consistently with its use in Topic 450 on contingencies.

In applying this disclosure threshold, entities would be required to evaluate "relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued." Reasonably knowable conditions or events are those that an entity may not readily know of but can be identified without undue cost and effort.

Time Horizon

In each reporting period (including interim periods), an entity would be required to assess its ability to meet its obligations as they become due for one year after the date the financial statements are issued.

Disclosure Content

The disclosure requirements in the ASU closely align with those under current auditing literature. If an entity triggers the substantial-doubt threshold, its footnote disclosures must contain the following information, as applicable:

Substantial Doubt Is Raised but Is Alleviated by Management's Plans	Substantial Doubt Is Raised and Is Not Alleviated
• Principal conditions or events. • Management's evaluation. • Management's plans.	• Principal conditions or events. • Management's evaluation. • Management's plans. • Statement that there is "substantial doubt about the entity's ability to continue as a going concern."

The ASU explains that these disclosures may change over time as new information becomes available.

Effective Date

The guidance in the ASU is "effective for annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016." Early application is permitted.

For additional information, see Deloitte's August 28, 2014, *Heads Up*.

Accounting for Investments in Qualified Affordable Housing Projects

Background

In January 2014, the FASB issued ASU 2014-01, which is based on the final consensus reached by the EITF on Issue 13-B. This ASU amends the criteria that must be met to qualify for an alternative method of accounting for low income housing tax credit (LIHTC) investments. It also replaces the previous alternative accounting method — the effective yield method — with the proportional amortization method. Lastly, it introduces new disclosures that all entities must provide about their LIHTC investments.

ASU 2014-01 is effective for public business entities for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. For entities that are not public business entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted for all entities.

Scope

Before the issuance of ASU 2014-01, few entities were able to apply the effective yield method of accounting to their LIHTC investments because of the restrictive nature of the previous scope requirements. ASU 2014-01 amends the scope requirements so that more LIHTC investments will qualify for an alternative method of accounting. Specifically, ASU 2014-01 eliminates the requirement that the tax credits from the LIHTC investment must be "guaranteed by a creditworthy entity" and also allows entities to consider both the tax credits and other tax benefits (e.g., depreciation expense) when determining whether the projected yield of the investment is positive.

As a result of these and other changes to the scope requirements, more LIHTC investments are likely to qualify for the alternative method of accounting.

New Alternative Approach

As noted above, ASU 2014-01 replaces the effective yield method with the proportional amortization method. The new approach, however, retains the effective yield method's presentation method, under which an entity presents the amortization of the LIHTC investment as "a component of income tax expense (benefit)."

Under the proportional amortization method, an entity would amortize the initial carrying amount of the LIHTC investment "in proportion to the tax credits and other tax benefits allocated to the investor." Specifically, the amortization amount for each period would be equal to the product of (1) the initial carrying amount of the investment and (2) the "percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment."

The proportional amortization approach also requires entities to test their LIHTC investments for impairment "when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized." If the investment is impaired, an impairment loss would be recognized equal to the amount by which the carrying amount of the investment exceeds its fair value.

New Disclosures

ASU 2014-01 also introduces new disclosure requirements for all entities that hold LIHTC investments, irrespective of whether they have elected to apply the proportional amortization approach. The objective of these new disclosure requirements is to help financial statement users understand the "nature of [the entity's] investments in qualified affordable housing projects" and "the effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations."

Thinking It Through

ASU 2014-01 significantly changes both the scope requirements and measurement method for the alternative measurement approach for investments in LIHTC partnerships. As a result, to qualify for the generally preferred accounting method, investors in LIHTC partnerships may seek to modify the terms of the partnership agreements.

Definition of a Public Business Entity

In December 2013, the FASB issued ASU 2013-12, which defines the term "public business entity" (PBE). The definition establishes the scope of accounting alternatives developed by the Private Company Council (PCC).[8] Specifically, entities that do not qualify as PBEs are generally eligible for private-company accounting alternatives. In addition, the term PBE will be incorporated by the FASB into future standard setting. Under the recently issued revenue standard, for example, an entity would refer to the definition of a PBE to determine whether it qualifies for effective date and disclosure relief. Therefore, even if an entity has no plans to elect a private-company accounting alternative, it should consider whether it meets the definition of a PBE and therefore would qualify for such relief under future standards. An entity would apply the definition of a PBE in connection with its adoption of the first ASU that uses the term.

The ASU defines a PBE as a business entity that meets any one of the following criteria:

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It 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.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

Although these criteria are largely drawn from similar definitions under other standards (e.g., ASC 280 defines a "public entity"), some are new. For example, criterion (a) is not in certain definitions and criterion (e) is not in any. Further, an entity would meet criterion (a) if its financial statements are included in another entity's SEC filing (e.g., as a significant investee or an acquiree of an SEC registrant). As a result, there may be some cases in which an entity that would have been considered nonpublic under previous guidance will now qualify as a PBE. Conversely, because a subsidiary of a public entity is not by extension automatically a PBE under the ASU, there may be instances in which an entity that would have been considered public will not qualify as a PBE for stand-alone financial statement purposes.

[8] The PCC was established by the Financial Accounting Foundation in 2012 to improve the accounting standard-setting process for private companies.

Thinking It Through

An entity that determines it is not a PBE and can therefore elect the private-company accounting alternatives should remain cognizant of the following:

- *The mandates, if any, of its financial statement users* — The ASU's basis for conclusions acknowledges that "decisions about whether an entity may apply permitted differences within U.S. GAAP ultimately may be determined by regulators (for example, the SEC and financial institution regulators), lenders and other creditors, or other financial statement users that may not accept financial statements that reflect accounting or reporting alternatives for private companies." Therefore, entities should seek to understand the views of their regulators and other users about the acceptability of the accounting alternatives before making an election.

- *The absence of transition guidance* — The ASU does not provide guidance on situations in which an entity subsequently meets the definition of a PBE as a result of changed circumstances. Entities should assume that they would be required to eliminate any private-company accounting alternatives from their historical financial statements if they later meet the definition of a PBE (e.g., in connection with an IPO). Therefore, from a practical perspective, entities considering electing a private-company accounting alternative should consider the likelihood that they may later meet the definition of a PBE — and the potential effort associated with unwinding the accounting alternative — before making an election.

For more information on ASU 2013-12, see Deloitte's January 27, 2014, *Heads Up*.

Accounting Alternatives for Private Companies

During 2014, the PCC finalized alternative accounting guidance on the following (early adoption of each ASU is permitted):

- *Goodwill* — ASU 2014-02 allows private companies to use a simplified approach to account for goodwill after an acquisition. Under this alternative, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. In addition, the ASU eliminates "step 2" of the goodwill impairment test; as a result, entities would measure goodwill impairment as the excess of the entity's (or reporting unit's) carrying amount over its fair value. Entities would adopt the ASU prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions). See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Hedge accounting* — ASU 2014-03 gives private companies a simplified method of accounting for interest rate swaps used to hedge variable rate debt. An entity that elects to apply simplified hedge accounting to a qualifying hedging relationship continues to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, it would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement effects as if it had issued fixed-rate debt. An entity that applies the simplified hedge accounting approach also may elect to measure the related swap at its settlement value rather than fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. Entities would adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Consolidation* — ASU 2014-07 gives private-company lessees an exemption from having to apply the consolidation guidance on variable interest entities to a related-party lessor when the entity and the lessor are under common control. The entity must evaluate additional criteria about the relationship between the lessee and lessor before applying this exception. If it applies the ASU, the entity may no longer be required to consolidate a related-party lessor entity. The ASU would be adopted retrospectively. See the March 21, 2014, *Deloitte Accounting Journal* entry for more information.

- *Intangible assets* — The upcoming ASU on this alternative is expected to give private companies an exemption from having to recognize certain intangible assets in a business combination. Specifically, an entity would not be required to recognize intangible assets for noncompete agreements and certain customer-related intangible assets. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to elect the goodwill accounting alternative, resulting in the amortization of goodwill. Entities would adopt the ASU prospectively and apply it to new business combinations occurring after its adoption. The FASB expects to issue the ASU by the end of this year.

Throughout 2014, the PCC has discussed aspects of financial reporting that are complex and costly for private companies. The accounting for stock-based compensation was a significant focus of these discussions. In a recent meeting, the PCC and FASB Board members agreed that the PCC would incorporate its views on this topic into the separate stock-based compensation project that the FASB is undertaking as part of its simplification initiative.

Thinking It Through

While entities in the industry may be particularly interested in the goodwill alternative, some may want to wait until the FASB completes its overall goodwill project before committing to the private-company alternative.

Pushdown Accounting

Background

On November 18, 2014, the FASB issued ASU 2014-17, which represents the final consensus reached by the EITF on Issue 12-F at its September 2014 meeting. The ASU provides guidance on determining when an acquired entity can establish a new accounting and reporting basis in its stand-alone financial statements (commonly referred to as "pushdown" accounting).

Also, in connection with the FASB's issuance of ASU 2014-17, the SEC rescinded SAB Topic 5.J, which contained the SEC staff's views on the application of pushdown accounting for SEC registrants. As a result of the SEC's actions, all entities — regardless of whether they are SEC registrants — will apply ASU 2014-17 for guidance on the use of pushdown accounting.

ASU 2014-17 reaffirms the EITF's consensus-for-exposure to provide an acquired entity[9] with the option of applying pushdown accounting in its stand-alone financial statements upon a change- in-control event. An acquired entity that elects pushdown accounting would apply the measurement principles in ASC 805 to push down the measurement basis of its acquirer to its stand-alone financial statements. In addition, the acquired entity would be required to provide disclosures that enable "users of [its] financial statements to evaluate the nature and effect of the pushdown accounting."[10] Under ASU 2014-17, when an acquired entity elects to apply pushdown accounting, it would be:

- Prohibited from recognizing acquisition-related debt incurred by the acquirer unless the acquired entity is required to do so in accordance with other applicable U.S. GAAP (e.g., because the acquired entity is legally obligated).
- Required to recognize the acquirer's goodwill.
- Prohibited from recognizing bargain purchase gains that resulted from the change-in-control transaction or event.

However, the acquired entity would treat the bargain purchase gain as an adjustment to equity (i.e., additional paid-in capital). ASU 2014-17 also clarifies that the subsidiary of an acquired entity would have the option of applying pushdown accounting to its stand-alone financial statements even if the acquired entity (i.e., the direct subsidiary of the acquirer) elected not to apply pushdown accounting.

[9] The scope of the final consensus will include both public and nonpublic acquired entities, whether a business or a nonprofit activity.
[10] Entities would achieve that disclosure objective by providing the relevant disclosures required by ASC 805.

ASU 2014-17 departs from the guidance in the proposed ASU in two notable ways:

- Rather than limiting the election of pushdown accounting to change-in-control events occurring after the effective date of the final consensus, the ASU permits entities to elect to apply pushdown accounting as a result of the most recent change-in-control event in periods after the event as long as it was preferable to do so. Entities would not be permitted to unwind a previous application of pushdown accounting (i.e., an acquired entity can change its election for the most recent change in control from not applying pushdown accounting to applying pushdown accounting, if preferable, but not vice versa).
- An entity is **not** required to disclose that a change-in-control event had occurred for which the entity had elected not to apply pushdown accounting.

Effective Date and Transition

ASU 2014-17 applies to all pushdown elections occurring after November 18, 2014. At transition, an acquired entity is permitted to elect to apply pushdown accounting arising as a result of change-in-control events occurring before the standard's effective date as long as (1) the change in-control event is the most recent change-in-control event for the acquired entity and (2) the election is preferable. Pushdown accounting applied in issued (or available-to-be issued) financial statements by an acquiree before the effective date of the guidance is irrevocable.

On the Horizon

Leases

Background

The FASB has been working with the IASB for almost a decade to address concerns related to the off-balance-sheet treatment of certain lease arrangements by lessees. The boards' proposed model would require lessees to adopt a right-of-use (ROU) asset approach that would bring substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability.

Thinking It Through

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor would continue to account for initial direct costs in a manner consistent with the current requirements. However, the boards decided to amend the definition of initial direct costs. In May 2014, the boards tentatively decided that the definition of initial direct costs for both lessees and lessors should include only those costs that are incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. This definition would be consistent with the definition of incremental cost in the recently issued revenue recognition standard. Under this definition, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. In 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) would be excluded from this definition.

Lessee and Nonlease Components

Lessees and lessors would be 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 forthcoming 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, the boards have noted that lessees would be permitted "to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract . . . as a single lease component." For more information, see the May 23, 2014, *Deloitte Accounting Journal* entry.

Thinking It Through

The boards agreed that an activity should be considered a separate nonlease component when 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 lessee would have been required to otherwise contract for these services separately. However, the boards have not addressed whether payments for property taxes would be considered a nonlease component.

Lessee Accounting

While the boards agree that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, the FASB and the IASB support different approaches for the lessee's subsequent measurement of the ROU asset. The FASB decided on a dual-model approach under which a lessee would classify a lease by using criteria that are similar to the lease classification criteria currently in IAS 17. For leases that are considered Type A leases (many current capital leases are expected to qualify as Type A), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would separately recognize interest expense and amortization of the ROU asset, which typically would result in a greater total expense during the early years of the lease. For leases that are considered Type B leases (many current operating leases are expected to qualify as Type B), the lessee would recognize a straight-line total lease expense.

While the FASB tentatively decided on a dual-model approach, the IASB decided on a single-model approach under which lessees would account for all leases similar to a financed purchase arrangement.

Thinking It Through

Under the FASB's dual-model approach, a lease would be classified as Type A 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."
- It is reasonably certain that a lessee will "exercise an option to purchase the underlying asset."
- "The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease."

These criteria are essentially the same as the existing lease classification criteria in IAS 17 but are not identical to the requirements in ASC 840. For example, under the proposed criteria, a lessee would be required to assess land and other elements separately unless the land element is clearly immaterial,[1] whereas under ASC 840 the land would only be evaluated separately if its fair value at lease inception was 25 percent or more of the fair value of the leased property. This change may result in more bifurcation of real estate leases into separate land and building elements that would be evaluated separately for lease classification purposes.

In addition, the FASB's tentative decision effectively eliminates the bright-line rules under the ASC 840 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. The decision could also affect the lease classification.

Lessor Accounting

Earlier this year, the boards discussed constituent feedback on the ED and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are similar to current sales-type leases, the lessor would only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

Thinking It Through

The inability to recognize profit on a transaction if it would not have qualified as a sale under the new revenue recognition guidance will probably not have a significant impact on real estate lessors since they typically do not enter into sales-type leases. However, the effect of the proposed changes to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. In addition, the proposed guidance would require real estate lessors to disclose more information.

[1] "Clearly immaterial" is not a defined term or threshold under U.S. GAAP. It is expected, however, that this threshold will be extremely low. We anticipate that, once adopted, an acceptable level for "clearly immaterial" will evolve based on industry practice and the profession.

Next Steps

The FASB and IASB are expected to complete their redeliberations during the first half of 2015 and, although they have not indicated a release date, are likely to issue final guidance during the second half of 2015. In addition, while the boards have not indicated when the final guidance would be effective, a date as early as January 1, 2018, is possible. See Deloitte's March 27, 2014, *Heads Up* for additional information about the boards' tentative decisions in connection with the proposed lessee and lessor accounting models.

Consolidation

Introduction

The FASB is currently finalizing its forthcoming ASU on consolidation. While the Board's deliberations have largely focused on the investment management industry, its decisions could have a significant impact on the consolidation conclusions for reporting entities in the real estate industry. Specifically, the amended guidance could affect a real estate entity's evaluation of whether (1) limited partnerships and similar entities should be consolidated, (2) variable interests held by the real estate entity's related parties or de facto agents affect its consolidation conclusion, and (3) fees it receives for decision-making services result in the consolidation of a variable interest entity (VIE).

Accordingly, real estate entities will need to reevaluate their previous consolidation conclusions in light of their involvement with current VIEs, limited partnerships not previously considered VIEs, and entities previously subject to the deferral in ASU 2010-10.

For additional information, see Deloitte's October 7, 2014, *Heads Up*.

Determining Whether Fees Paid to Decision Makers or Service Providers Are Variable Interests

One of the first steps in assessing whether a fund manager or property manager is required to consolidate a real estate fund or real estate operating entity is to determine whether the fund manager or property manager holds a variable interest in the entity. While the ASU will retain the current definition of a variable interest, it modifies the criteria for determining whether a decision-making arrangement is a variable interest.

Under current U.S. GAAP, six criteria must be met for an entity to conclude that its fee does not represent a variable interest. The ASU will eliminate the criteria focused on the subordination of the fees (ASC 810-10-55-37(b)) and the significance of the fees (ASC 810-10-55-37(e) and (f)). Under the ASU, the evaluation of whether fees are a variable interest would focus on whether (1) the fees "are commensurate with the level of effort" (ASC 810-10-55-37(a)), (2) the decision maker has any other direct or indirect interests (including indirect interests through its related parties) that absorb more than an insignificant amount of the VIE's variability (ASC 810-10-55-37(c)), and (3) the arrangement includes only customary terms (ASC 810-10-55-37(d)).

It is expected that with the elimination of three of the criteria in ASC 810-10-55-37, fewer fee arrangements would be considered variable interests.

Limited Partnerships (and Similar Entities)

Determining Whether a Limited Partnership Is a VIE

The ASU will amend the definition of a VIE only for limited partnerships and similar entities. Under the ASU, a limited partnership would be considered a VIE regardless of whether it has sufficient equity or meets the other requirements to qualify as a voting interest entity unless a single limited partner (LP) or a simple majority of all partners (including interests held by the general partner (GP) and its related parties) has substantive kick-out rights (including liquidation rights) or participating rights. As a result of the proposed amendments to the definition of a VIE for limited partnerships and similar entities, partnerships that historically were not considered VIEs may need to be evaluated under the new VIE consolidation model. Although the consolidation conclusion may not change, an updated analysis on the basis of the revised guidance would be required. In addition, even if a reporting entity determines that it does not need to consolidate a VIE, it would have to provide the existing extensive disclosures for any VIEs in which it holds a variable interest.

Example

A limited partnership is formed to acquire a real estate property. The partnership has a GP that holds a nominal interest in the partnership; five unrelated LPs hold the remaining equity interests. Profits and losses of the partnership (after payment of the GP's fees, which represent a variable interest in the entity) are distributed in accordance with the partners' ownership interests. There are no other arrangements between the partnership and the GP/LPs.

The GP is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing. In addition, the GP can be removed without cause by a simple majority of all of the LPs.

Under the Proposed Guidance

Although the GP has power over the activities that most significantly affect the limited partnership, a simple majority of all LPs can remove the GP. Accordingly, the equity holders as a group do not lack the criteria in ASC 810-10-15-14(b),and therefore, the partnership would not be considered a VIE provided that the conditions in ASC 810-10-15-14(a)[2] and ASC 810-10-15-14(c)[3] are not met. However, if kick-out rights did not exist, the limited partnership would be a VIE.

Consolidation of a Limited Partnership

Under current U.S. GAAP, a GP is required to perform an evaluation under ASC 810-20 to determine whether it controls a limited partnership that is not considered a VIE. This evaluation focuses on whether certain rights held by the unrelated LPs are substantive and overcome the presumption that the GP controls (and therefore is required to consolidate) the partnership. To overcome the presumption that the GP controls the partnership, the LPs (excluding interests held by the GP, by entities under common control of the GP, and by other entities acting on behalf of the GP) must have either (1) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the GP without cause (as distinguished from with cause) or (2) substantive participating rights.

Like an entity's analysis under the current guidance in ASC 810-20, its analysis under the proposed guidance on determining whether the GP should consolidate a partnership that is not considered a VIE would focus on an evaluation of whether the kick-out, liquidation, or participating rights held by the other partners are considered substantive. Unlike current guidance, however, the FASB's tentative approach requires entities to assess interests held by the GP, by entities under common control of the GP, and by other entities acting on behalf of the GP. That is, the rights would be considered substantive if they can be exercised by a simple majority of all of the partners, including the GP.

Partnerships would be VIEs when a single partner or a simple majority (or a lower threshold) of all partners do not have a substantive kick-out right or participating rights. The evaluation of whether the GP should consolidate a limited partnership (or similar entity) that is considered a VIE is consistent with how all other VIEs would be analyzed (i.e., the GP's economic exposure to the VIE would be considered). Accordingly, the GP would generally not be required to consolidate a limited partnership if the partners do not have substantive kick-out or participating rights unless the GP (or an entity under common control of the GP) has an interest in the partnership that could potentially be significant.

[2] ASC 810-10-15-14(a) states that an entity is a VIE if the "total equity investment . . . at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support."

[3] ASC 810-10-15-14(c) states that an entity is a VIE if (1) "voting rights of some investors are not proportional to their obligation to absorb the expected losses [or] their rights to receive the expected residual returns" and (2) substantially all of the potential VIE's activities "either involve or are conducted on behalf of an investor that has disproportionately few voting rights."

Real Estate Funds That Are Not Limited Partnerships (or Similar Entities)

The ASU will eliminate the deferral of ASU 2010-10 for investment funds. Accordingly, while kick-out and participating rights may have been considered for entities that qualified for the deferral, for real estate funds that are not limited partnerships (or similar entities), kick-out and participating rights will not be considered in the determination of whether the equity-at-risk group controls the fund unless the rights are held by a single party (including its related parties and de facto agents). As a result, an entity other than a partnership that qualified for the deferral and was not a VIE because its board of directors, as a group, held simple majority kick-out or participating rights may become a VIE if the equity holders as a group are no longer considered to have "power" over the entity through their kick-out rights. Accordingly, more funds could become VIEs under the ASU (particularly if the fund manager has other potentially significant interests in the fund).

Under current guidance, a real estate fund manager's assessment of whether it is the primary beneficiary of a VIE (and therefore must consolidate the VIE) that qualifies for the deferral would focus on whether the fund manager absorbs the majority of the VIE's variability as determined through quantitative analysis. Under the ASU, the reporting entity would be required to consolidate a VIE if it has both (1) the power to direct the activities of the VIE that most significantly affect the entity's economic performance ("power") and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. Accordingly, a fund manager that has power over a VIE, but did not previously consolidate the VIE because it did not absorb a majority of the VIE's variability, may be required to consolidate the VIE if it holds an economic interest that could potentially be significant to the VIE (e.g., a 15 percent economic interest in the VIE).

Effective Date and Transition

Modified retrospective application (including a practicability exception) would be required, with an option for full retrospective application. For public business entities, the ASU's guidance would be effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the ASU's guidance would be effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. The ASU would allow early adoption for all entities but would require entities to apply its guidance as of the beginning of the annual period containing the adoption date.

Thinking It Through

More entities are likely to qualify as VIEs under the ASU than under current guidance, and real estate entities would be required to provide additional disclosures regardless of whether they consolidate the VIE. Specifically, any real estate venture or fund that is formed as a limited partnership would automatically be a VIE unless the partners hold simple majority kick-out or participating rights. However, as a result of the ASU's changes to the guidance on (1) how to evaluate partnerships for consolidation, (2) how a reporting entity's related parties' interests in the VIE affect the consolidation analysis, and (3) whether a decision maker's fees represent a variable interest, fewer VIEs are likely to be consolidated. Accordingly, real estate entities will need to reevaluate their previous consolidation conclusions.

Real estate fund managers and property managers should start considering the extent to which they may need to change their processes and controls to apply the revised guidance, including those related to obtaining additional information that may have to be provided under the disclosure requirements. Changing such processes and controls may be particularly challenging for entities that intend to early adopt the proposed guidance. In addition, companies should consider the effect of the revised guidance as they enter into new transactions.

Financial Instrument Impairment

Background

In late 2012, the FASB issued a proposed ASU to obtain feedback on its current expected credit loss (CECL) model. Under the CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce complexity of U.S. GAAP by decreasing the number of different credit impairment models for debt instruments.[4]

Under the existing impairment models (often referred to as incurred loss models), an impairment allowance is recognized only after a loss event (e.g., default) has occurred or its occurrence is probable. In assessing whether to recognize an impairment allowance, an entity may only consider current conditions and past events; it may not consider forward-looking information.

The CECL Model

Scope

The CECL model[5] would apply to most[6] debt instruments (other than those measured at fair value through net income (FVTNI)), lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts, and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320.

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. An entity would, however, write off the carrying amount of a financial asset when it is deemed uncollectible, which is consistent with existing U.S. GAAP.

Thinking It Through

Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided at its September 17, 2013, meeting that an "entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero." U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

[4] Although impairment began as a joint FASB and IASB project, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of its July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

[5] This discussion of the CECL model reflects the FASB's redeliberations to date, including tentative decisions made at the October 29, 2014, Board meeting.

[6] The CECL model would not apply to the following debt instruments:

- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

Measurement of Expected Credit Losses

An entity's estimate of expected credit losses represents all contractual cash flows it does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it "reasonably expects" that it will execute a troubled debt restructuring.

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period that the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets that are within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

The FASB tentatively decided to permit the use of practical expedients in measuring expected credit losses for two types of financial assets:

1. *Collateral-dependent financial assets* — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value.

2. *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — The estimate of expected credit losses would be measured consistently with other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value (adjusted for selling costs, when applicable).

Thinking It Through

The FASB's tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined "similar risk characteristics." As a result, it remains to be seen whether the FASB expects an aggregation based on "similar risk characteristics" to be consistent with the existing practice of pooling purchased credit-impaired (PCI) assets on the basis of "common risk characteristics." Entities may need to make systems and process changes to capture loss data at more granular levels than they do now, depending on the expectations of market participants such as standard setters, regulators, and auditors.

Available-for-Sale Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, in August 2014, the FASB tentatively decided that AFS debt securities would not be included within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security's cost basis).

- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.

- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Thinking It Through

The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in OCI. However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write down of the AFS security's cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

1. If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.

2. If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The requirement to use an allowance approach for AFS debt securities may affect how a REIT communicates to its investors changes in cash flow expectations and their impact on the effective yield of the security. For example, under the proposed approach, the REIT would recognize any increase in cash flow expectations as a reversal of credit losses through earnings and a corresponding adjustment to its allowance. To the extent that the expected cash flows exceed the cash flows originally expected at acquisition of the asset, the REIT would recognize the excess as an income statement gain in the current period (as opposed to a prospective yield adjustment).

Purchased Credit-Impaired Assets

For PCI assets, as defined[7] in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of *contractual* cash flows not expected to be collected. After initial recognition of the PCI asset and its related allowance, a reporting entity would continue to apply the CECL model to the asset. Consequently, any subsequent changes to its estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change.

[7] The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

Thinking It Through

Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. In addition, under the CECL model, the discount embedded in the purchase price attributable to expected credit losses as of the date of acquisition must not be recognized as interest income, which is consistent with current practice.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows due to deterioration in the asset's credit quality since origination. Under the FASB's tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

Beneficial Interests Whose Credit Quality Is Not High or That Have Significant Prepayment Risk (Within the Scope of ASC 325-40)

The FASB tentatively decided at its June 11, 2014, meeting that an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of *contractual* cash flows not expected to be collected). In addition, the FASB indicated that "changes in expected cash flows due to factors other than credit would be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would never be included in interest income)."[8]

Thinking It Through

Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Disclosures

Many of the disclosures required under the proposal are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities would be required to disclose information related to:

- Credit quality.[9]
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

[8] Quoted text is from a handout for the June 11, 2014, FASB meeting.
[9] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

The Board plans to discuss at a future meeting rollforward disclosures of an entity's allowance and amortized cost balances and whether all of the tentative disclosure requirements should also apply to AFS debt securities.

Next Steps

At a future meeting, the Board plans to discuss additional matters related to disclosures, transition, and effective date.

Thinking It Through

Measuring expected credit losses will most likely be a significant challenge for real estate entities with lending activities. As a result of moving to an expected loss model, such entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

Today, financial institutions use various methods to estimate credit losses. Some apply simple approaches that take into account average historical loss experience over a fixed time horizon. Others use more sophisticated "migration" analyses and forecast modeling techniques. Under the CECL model, for any approach that is based solely on historical loss experience, an entity would need to consider the effect of forward-looking information over the remaining contractual life of a financial asset. In addition, the FASB tentatively decided at its August 13, 2014, meeting that when an entity is "developing its estimate of expected credit losses . . . for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts, [the] entity is allowed to revert to its [unadjusted] historical credit loss experience."

For instance, assume that an entity uses annualized loss rates to determine the amount of probable unconfirmed losses on its homogeneous pools of loans as of the reporting date. When moving to the CECL model, the entity may need to revise its allowance method by adjusting the fixed time horizon (i.e., annualized loss rates) to equal a period that represents the full contractual life of the instrument. Entities using a probability-of-default (PD) approach may need to revise their PD and loss-given-default (LGD) statistics to incorporate the notion of lifetime expected losses. Today, an entity's PD approach might be an estimate of the probability that default will occur over a fixed assessment horizon, which is less than the full contractual life of the instrument (often one year). Similarly, an entity would need to revise its LGD statistic to incorporate the notion of lifetime expected losses (i.e., the percentage of loss over the total exposure if default were to occur during the full contractual life of the instrument).

Classification and Measurement

Recent Redeliberations

The FASB is no longer pursuing a converged approach to the classification and measurement of financial instruments. Instead, the Board has decided to retain existing requirements related to (1) the classification and measurement categories for financial instruments other than equity investments, (2) the method for classifying financial instruments, (3) bifurcation of embedded derivatives in hybrid financial assets, and (4) accounting for equity method investments (including impairment of such investments). However, the Board has discussed targeted improvements to the requirements related to accounting for equity investments and presentation of certain fair value changes for fair value option liabilities.

Classification and Measurement of Equity Investments

Under the FASB's tentative approach, entities will be required to carry all investments in equity securities that do not qualify for the equity method or a practicability exception at FVTNI. For equity investments that do not have a readily determinable fair value, the FASB would permit entities to elect the practicability exception to fair value measurement under which the investment would be measured at cost less impairment plus or minus observable price changes. This exception would not be available to reporting entities that are investment companies or broker-dealers.

Impairment Assessment of Equity Investments That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the FASB has tentatively decided to eliminate the requirement to assess whether an impairment of such an investment is other than temporary. In each reporting period, an entity would qualitatively consider certain indicators to determine whether the investment is impaired, including:

> a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
>
> b. A significant adverse change in the regulatory, economic, or technological environment of the investee
>
> c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates
>
> d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment
>
> e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

An entity that determines that the equity security is impaired on the basis of an assessment of the above indicators would recognize an impairment loss equal to the difference between the security's fair value and carrying amount. In contrast, the existing guidance in ASC 320-10-35-30 requires entities to perform a two-step assessment under which an entity first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.

Thinking It Through

Under existing U.S. GAAP, marketable equity securities other than equity-method investments (those for which the investor has significant influence over the investee) are classified as either held for trading (FVTNI) or available for sale (FVTOCI). For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity-method investments are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities can no longer be accounted for as AFS securities or by using the cost method, REITs that hold such equity investments could see more volatility in earnings under the proposed guidance.

Presentation of Fair Value Changes Attributable to Instrument-Specific Credit Risk for Fair Value Option Liabilities

The FASB has tentatively decided to introduce a new requirement related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this tentative decision, an entity would be required to separately recognize in OCI the portion of the total fair value change attributable to instrument-specific credit risk. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income.

Under the FASB's tentative approach, an entity would measure the portion of the change in fair value attributable to instrument-specific credit risk as the excess of total change in fair value over the change in fair value "resulting from a change in a base market risk, such as a risk-free interest rate . . . . Alternatively, an entity may use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk." In either case, the entity would be required to disclose the method it "used to determine the gains and losses attributable to instrument-specific credit risk and [to] apply the method consistently from period to period."[10]

See Appendix A in Deloitte's August 8, 2014, *Heads Up* for a comparison of classification and measurement models under current U.S. GAAP and the FASB's tentative approach.

[10] Quoted text is from a handout for the April 23, 2014, FASB meeting.

Next Steps

Additional matters that the Board plans to discuss at future meetings include disclosures (e.g., core deposits), transition, effective date, and cost/benefit considerations.

Hedging

At its meeting on November 5, 2014, the FASB voted to move its current research project on hedge accounting to its active agenda. In deliberating the project, the FASB will discuss the following issues:

- Hedge effectiveness requirements.
- Whether the shortcut and critical-terms-match methods should be eliminated.
- Voluntary dedesignations of hedging relationships.
- Recognition of ineffectiveness for cash flow underhedges.
- Hedging components of nonfinancial items.
- Benchmark interest rates.
- Simplification of hedge documentation requirements.
- Presentation and disclosure matters.

Formal deliberations in the hedging project will continue on a future date.

Thinking It Through

The FASB's hedging project may lead to welcome simplification of the existing guidance. For example, on the basis of constituent feedback received on the FASB's initial proposals, the criteria to qualify for applying hedge accounting are expected to be easier for entities to satisfy (e.g., from "highly effective" to a lower threshold). It is also expected that the guidance resulting from the project will simplify the actual application of hedge accounting for eligible entities by, for example, only requiring qualitative (rather than quantitative) ongoing assessments of hedge effectiveness.

Accounting for Goodwill by Public Business Entities and Not-for-Profit Entities

Overview

In November 2013, the FASB endorsed a decision by the PCC to allow nonpublic business enterprises to amortize goodwill and perform a simplified impairment test. The Board has received feedback indicating that many public business entities and not-for-profit entities have similar concerns about the cost and complexity of the annual goodwill impairment test. Thus, the Board added this project to its agenda for 2014 and has asked the staff to analyze the views below.

Current Status

The Board is considering the following alternatives for the accounting for goodwill by public business entities and not-for-profit entities:[11]

> View A — Goodwill would be amortized "over 10 years or less than 10 years if an entity demonstrates that another useful life is more appropriate." Goodwill would be tested for impairment "only when a triggering event occurs."
>
> *View B* — Goodwill would be amortized over its expected useful life, which would not exceed a specified number of years; the current impairment test would be retained.
>
> *View C* — An entity would write off goodwill directly at initial recognition or transition and would reflect the charge in net income or equity and provide additional disclosures for each acquisition. Under this alternative, there would be no subsequent goodwill accounting considerations.
>
> *View D* — An entity would not amortize goodwill but would perform a simplified impairment test. Such a model would most likely eliminate step 2 of the goodwill impairment test in ASC 350 and would potentially simplify the unit of account (i.e., raise it to a level above the reporting unit). In addition, "[a]n entity would make an accounting policy election to test goodwill for impairment at the entity level or at the reporting unit level. It would test goodwill for impairment only when a triggering event occurs."

Next Steps

At its November 5, 2014, meeting, the FASB discussed the results of the IASB's post-implementation review (PIR) of IFRS 3. The Board also discussed findings of a study on how the qualitative assessment has been used since the issuance of ASU 2011-09. On the basis of discussions during the meeting, the Board decided to add a project to its agenda on the accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities. The purpose of this project will be to evaluate whether certain intangibles assets could be subsumed into goodwill.

Clarifying the Definition of a Business

Background

The FASB currently has a project on its agenda to clarify the definition of a business. According to the FASB's project update page, the objective of the project is to address "whether transactions involving in-substance nonfinancial assets (held directly or in a subsidiary) should be accounted for as acquisitions (or disposals) of nonfinancial assets or as acquisitions (or disposals) of businesses." The project will also include clarifying the guidance on partial sales of nonfinancial assets. The FASB has not yet made any technical decisions in connection with the project.

Thinking It Through

Accounting for real estate acquisitions as a business combination (rather than as an asset acquisition) affects whether (1) the real estate is initially measured at fair value or on an allocated cost basis, (2) acquisition related costs are capitalized or expensed, and (3) contingent consideration should be recorded as of the acquisition date. In addition, the differences between the asset-based or business-based derecognition requirements could affect when to derecognize real estate assets sold and how to measure any retained interests if a company sells a partial interest in an asset.

[11] Quoted text is from the FASB's tentative decisions at its March 26, 2014, meeting.

Other Topics

Disclosure Framework

Background

In July 2012, the FASB issued a discussion paper as part of its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. See Deloitte's July 17, 2012, *Heads Up* for additional information. The FASB subsequently decided to distinguish between the "Board's decision process" and the "entity's decision process" for evaluating disclosure requirements.

FASB Decision Process

Overview

On March 4, 2014, the FASB released for public comment an ED of a proposed concepts statement that would add a new chapter to the Board's conceptual framework for financial reporting. The ED proposes a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FASB's objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte's March 6, 2014, *Heads Up* for additional information.

Summary of Comment-Letter Feedback

Comments on the FASB's ED were due by July 14, 2014. The FASB received over 50 comment letters from various respondents, including preparers, professional and trade organizations, and accounting firms. Respondents generally expressed support for the development of a conceptual framework for use in evaluating disclosure requirements that would apply to existing and future standards.

However, many respondents were concerned that the ED's "intentionally broad" proposed decision questions may result in excessive disclosure (which respondents had also noted in their comments on the discussion paper). Accordingly, many respondents suggested that the FASB use a filtering mechanism (e.g., based on cost and decision usefulness) to further narrow disclosure requirements.

Respondents also suggested that the FASB clarify the difference between relevance and materiality and align the definition of materiality in the FASB's concepts statement with that established by the Supreme Court.[1]

Further, many respondents encouraged the Board to work with regulatory bodies, such as the SEC, to develop requirements that result in disclosures that are more effective and less redundant in the overall financial reporting package.

Next Steps

The FASB will continue its redeliberations related to concerns raised in comment letters and will review feedback received as a result of its outreach activities, which included testing the entity's decision process against various Codification topics (see the Entity's Decision Process section). A final concepts statement is expected to be issued after the outreach process is complete.

[1] Paragraph QC11 in Chapter 3 of FASB Statement of Financial Accounting Concepts No. 8 states that "[i]nformation is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity." Further, PCAOB AS 11 explains that "[i]n interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is 'a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' As the Supreme Court has noted, determinations of materiality require 'delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him'" (footnotes omitted).

Entity’s Decision Process

Topic-Specific Disclosure Reviews

The FASB staff is currently analyzing ways to “further promote [entities’] appropriate use of discretion” in determining proper financial statement disclosures. This process will take into account “section-specific modifications” to the following Codification topics:

ASC Topic	Status
820 (fair value measurement)	Testing in progress. Results discussed with Board.
330 (inventory)	Not started.
715 (defined benefit plans)	Testing in progress. Results discussed with Board.
740 (income taxes)	Not started.

A proposed ASU could be issued as a result of this process. No tentative decisions have been made on this matter to date.

Thinking It Through

The financial statements of real estate entities often contain lengthy fair value measurement disclosures. The FASB is currently using the ED’s conceptual framework to test ASC 820 and expects that disclosures will ultimately be reduced as a result (i.e., by identifying disclosures that are beyond the scope of the conceptual framework).

During deliberations, the FASB discussed the Level 3 rollforward. The ED’s decision question L7 contains information to be considered for disclosure, including “the causes of changes from the prior period (such as major inflows and outflows summarized by type or a detailed roll forward),” which may imply that a rollforward (or similar information) is required for each significant balance sheet line item.

In addition, the February 2014 post-implementation review report on FASB Statement 157 stated that “preparers and practitioners are concerned with the decision-usefulness of the Statement 157 disclosures. They cited concerns about disclosure overload, particularly as it relates to Level 3 disclosures, including the Level 3 rollforward.”

At its September 2014 meeting, the Board discussed the following:

- Adding disclosures about:
  - Alternative measures.
  - Gains and losses.
- Modifying disclosures about:
  - The Level 3 rollforward. During deliberations, it was acknowledged that performing the rollforward every quarter was difficult for entities (see the Interim Reporting section).
  - Transfers between Level 1 and Level 2.
  - The policy for timing of transfers between levels.
  - Valuation process for Level 3 fair value measurements.
  - Sensitivity information.
  - Estimates of timing of future events.

No decisions were made, and the views of Board members were mixed. Board members also indicated that they would need to assess whether users would prefer (1) the application of materiality on a company basis or (2) uniform disclosures among all companies (including immaterial items).

Interim Reporting

The FASB deliberated modifications to the guidance on interim reporting. The Board tentatively decided that an update to an annual footnote disclosure is warranted as of an interim period if the update would alter the "total mix" of information available to investors. This is consistent with the guidance in SAB 99, which is based on a Supreme Court ruling.[2]

During future redeliberations on interim reporting, the Board will continue reviewing comment-letter feedback on the ED.

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

As part of its simplification initiative, the FASB issued a proposed ASU that would remove from U.S. GAAP the concept of extraordinary items and therefore eliminate the requirement for entities to separately present such items on the income statement and disclose them in the footnotes. Currently, extraordinary items (1) are unusual in nature and (2) occur infrequently. The proposed ASU retains the reporting and disclosure requirements for an event that demonstrates either of those characteristics. Accordingly, users of financial statements would continue to be informed about unusual or infrequent events after the concept of extraordinary items is eliminated.

The FASB believes that eliminating the concept would also improve the efficiency of the financial reporting process since it would relieve entities from having to identify extraordinary items and comply with associated presentation and disclosure requirements.

In October, 2014, the FASB voted to issue final guidance in an ASU. The Board tentatively decided to allow either prospective or retrospective application of the guidance. For all entities, the ASU will be effective for periods beginning after December 15, 2015. Early adoption is permitted when the guidance is applied from the beginning of the reporting period in the year of adoption.

Debt Issuance Costs

On October 14, 2014, the FASB issued a proposed ASU that would change the presentation of debt issuance costs in the financial statements. Under the proposal, an entity would be required to present such costs in the balance sheet as a direct deduction from the debt liability in a manner consistent with its accounting treatment of debt discounts. Amortization of the issuance costs would be reported as interest expense.

The proposed guidance would replace the guidance in ASC 835-30 that requires an entity to report debt issuance costs in the balance sheet as deferred charges (i.e., as an asset). It would also align U.S. GAAP on this topic with IFRSs, under which transaction costs that are directly attributable to the issuance of the liability are treated as an adjustment to the initial carrying amount of the financial liability.

Comments on the proposal are due by December 15, 2014. For more information about the proposed ASU, see Deloitte's October 14, 2014, *Heads Up*.

Liabilities and Equity — Short-Term Improvements

In November 2014, the FASB voted to move part of its current research project on liabilities and equity to its active agenda. Specifically, the FASB decided to add a project addressing (1) practice issues related to ASC 815-40 and (2) targeted improvements to the organization of the related Codification topics.

To date, no technical decisions have been made in the project.

[2] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

COSO Framework

Background

Since the Committee of Sponsoring Organizations of the Treadway Commission issued an updated version of its *Internal Control — Integrated Framework* (the "2013 Framework") in May, 2013,[3] companies have been taking steps to implement it by December 15, 2014. While the internal control components[4] in the 2013 Framework are the same as those in the original framework issued in 1992, the updated framework requires companies to assess whether 17 principles underlying five components are present and functioning in determining whether their system of internal control is effective. Further, the 17 principles are supported by points of focus, which are important considerations in a company's evaluation of the design and operating effectiveness of controls to address the principles.

These changes will result in the need for entities to develop a different deficiency evaluation process. From an ICFR perspective, when one or more of the 2013 Framework's 17 principles are not present and functioning, a major deficiency exists, which equates to a material weakness under Section 404 of the Sarbanes-Oxley Act.[5]

See Deloitte's September 5, 2014, *Heads Up* for additional discussion of challenges and leading practices related to implementing the new framework, including observations and perspectives regarding its application for operational and regulatory compliance purposes.

SEC Rules

Background

The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

SEC Issues Proposed Rule Related to Treatment of Certain Communications Involving Security-Based Swaps

On September 8, 2014, the SEC issued a proposed rule under which "the publication or distribution of price quotes relating to security-based swaps that may be purchased only by persons who are eligible contract participants and are traded or processed on or through a facility that either is registered as a national securities exchange or as a security-based swap execution facility, or is exempt from registration as a security-based swap execution facility pursuant to a rule, regulation, or order of the Commission, would not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase such security-based swaps or any guarantees of such security-based swaps that are securities for purposes of Section 5 of the Securities Act."

Comments on the proposed rule were due by November 10, 2014.

[3] See Deloitte's June 10, 2013, *Heads Up* for an overview of the 2013 Framework.

[4] Control environment, risk assessment, control activities, information and communication, and monitoring activities.

[5] The 2013 Framework contains the following new guidance on a major deficiency in internal control:

> "When a major deficiency exists, the organization cannot conclude that it has met the requirements for an effective system of internal control. A major deficiency exists in the system of internal control when management determines that a component and one or more relevant principles are not present or functioning or that components are not operating together. A major deficiency in one component cannot be mitigated to an acceptable level by the presence and functioning of another component. Similarly, a major deficiency in a relevant principle cannot be mitigated to an acceptable level by the presence and functioning of other principles."

SEC Issues Final Rule on Asset-Backed Securities

On September 4, 2014, the SEC issued a final rule that is intended to enhance the disclosure requirements for ABSs. Specifically, the final rule requires "loan-level disclosure for certain assets, such as residential and commercial mortgages and automobile loans" and gives investors more time "to review and consider a securitization offering, revise[s] the eligibility criteria for using an expedited offering process known as 'shelf offerings,' and make[s] important revisions to reporting requirements."

The final rule will become effective on November 24, 2014.

For more information, see the September 3, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final Rule on Nationally Recognized Statistical Rating Organizations

On August 27, 2014, the SEC issued a final rule that revises the requirements for NRSROs in response to a mandate of the Dodd-Frank Act. The amendments "address internal controls, conflicts of interest, disclosure of credit rating performance statistics, procedures to protect the integrity and transparency of rating methodologies, disclosures to promote the transparency of credit ratings, and standards for training, experience, and competence of credit analysts." The ultimate objective of these new requirements is "to enhance governance, protect against conflicts of interest, and increase transparency to improve the quality of credit ratings and increase credit rating agency accountability."

The final rule became effective on November 14, 2014.

For more information, see the September 3, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final and Proposed Rules Related to Money Market Funds

On July 23, 2014, the SEC issued a final rule that amends the way money market funds (MMFs) are regulated. The rule eliminates the use of penny rounding for institutional nongovernment MMFs and establishes a current NAV — or floating NAV — like that used in other mutual funds. Government and retail MMFs may continue using amortized cost to value a fund´s investments instead of calculating the fund´s value by using a floating NAV (i.e., they may continue to use a stable NAV, which is typically $1).

The final rule notes that MMFs with floating NAVs will be permitted to "continue to use amortized cost to value debt securities with remaining maturities of 60 days or less if fund directors, in good faith, determine that the fair value of the debt securities is their amortized cost value, unless the particular circumstances warrant otherwise." The final rule also includes provisions related to redemption gates and liquidity fees.

The SEC has also issued a reproposed rule related to (1) MMF communications to investors and (2) the replacement of credit rating references in Rule 2a-7 and Form N-MFP with other factors a fund would use to assess liquidity and creditworthiness of investments to comply with Section 939A of the Dodd-Frank Act.

The final rule became effective on October 14, 2014. Comments on the proposed rule were also due by October 14, 2014.

For more information, see the July 24, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final Rule on Cross-Border Security-Based Swaps

On June 26, 2014, the SEC issued a final rule that explains "when a cross-border transaction must be counted toward the requirement to register as a security-based swap dealer or major security-based swap participant." In addition, the rule addresses "the scope of the SEC's cross-border anti-fraud authority."

The final rule became effective September 8, 2014.

For more information, see the press release on the SEC's Web site.

SEC Proposes Rule for Covered Clearing Agencies

On March 12, 2014, the SEC issued a proposed rule that would amend the Exchange Act to establish additional regulations for "covered clearing agencies" (i.e., certain types of SEC-registered clearing agencies) that (1) the Financial Stability Oversight Council deems "systemically important" or (2) participate in "more complex transactions" (e.g., securities-based swaps). The new requirements would affect such agencies' financial risk management, operations, governance, and disclosures.

Comments on the proposed rule were due by May 27, 2014.

For more information, see the press release on the SEC's Web site.

SEC Extends Exemptions Related to Security-Based Swaps

On February 7, 2014, the SEC published amendments extending the expiration date for "interim final rules that provide exemptions under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939 for those security-based swaps that [1] prior to July 16, 2011 were security-based swap agreements and [2] are defined as 'securities' under the Securities Act and the Exchange Act as of July 16, 2011 due solely to the provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act." The amendments affect the following interim final rules:

- Rule 240 of the Securities Act.
- Rules 12a-11 and 12h-1(i) of the Exchange Act.
- Rule 4d-12 of the Trust Indenture Act.

The new expiration date for the interim final rules is February 11, 2017.

SEC Issues Risk Alert on Investment Advisers' Use of Due Diligence

On January 28, 2014, the SEC's Office of Compliance Inspections and Examinations issued a risk alert summarizing its observations regarding the due-diligence procedures investment advisers follow when "recommending alternative investments to their clients." The SEC staff's observations fall into two main categories: (1) trends in investment advisers' due-diligence processes and (2) the extent to which the advisers have complied with applicable rules and regulations, including the Investment Advisers Act and the advisers' own codes of ethics that the Commission mandates for SEC-registered advisers.

For more information, see the press release on the SEC's Web site.

SEC Issues Interim Final Rule Related to Certain Collateralized Debt Obligations

On January 17, 2014, the SEC, in conjunction with the OCC, the Federal Reserve, the FDIC, and the CFTC, issued an interim final rule that "would permit banking entities to retain investments in certain pooled investment vehicles that invested their offering proceeds primarily in certain securities issued by community banking organizations of the type grandfathered under Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

The interim final rule became effective on April 1, 2014.

For more information, see the press release on the SEC's Web site.

SEC Issues Final Rule and Interpretive Guidance Related to Rules for Registration of Municipal Advisers

On January 13, 2014, the SEC issued a final rule granting a temporary stay on the Commission's rules for registration of municipal advisers, which "require municipal advisors to register with the Commission if they provide advice to municipal entities or certain other persons on the issuance of municipal securities, or about certain investment strategies or municipal derivatives." The new date by which municipal advisers must comply with the rules is July 1, 2014. The temporary stay is effective as of January 13, 2014.

In addition, on January 10, 2014, the SEC issued a series of FAQs in response to questions the Commission has received from market participants about the municipal adviser registration rules. Topics covered in the FAQs include:

- Content that entities are permitted to provide to a municipal entity to avoid having to register as a municipal adviser.
- How to provide a request for proposals or request for qualifications that is consistent with the exemption to the definition of a municipal adviser.
- Requirements for the independent registered municipal adviser exemption.
- Exclusions related to underwriters and registered investment advisers.
- Whether a broker-dealer that served as underwriter for an issuance of municipal securities can continue to rely on the underwriter exemption after the issuance and the underwriting period.
- Whether advice provided by remarketing agents is within the scope of the underwriter exclusion.
- Opinions offered by public officials and citizens.
- Effective and compliance dates of the final rules.

For more information, see the January 10, 2014, and January 13, 2014, press releases on the SEC's Web site.

SEC Releases Examination Priorities for 2014

On January 9, 2014, the SEC's Office of Compliance Inspections and Examinations published a document highlighting the Commission's examination priorities for 2014. The objective of the document is to inform SEC registrants and investors about issues that the Commission is planning to focus on for the remainder of the year. These issues include fraud detection and prevention, corporate governance and conflicts of interest, new laws and regulations, and the Commission's programs for investment advisers and broker-dealers.

For more information, see the press release on the SEC's Web site.

SEC Implements Volcker Rule

On December 10, 2013, the SEC, OCC, FDIC, and Federal Reserve jointly issued a final rule to implement Section 619 of the Dodd-Frank Act (also known as the "Volcker Rule"). The final rule "contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the [Federal Reserve] to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund."

For more information, see the press release on the SEC's Web site.

Appendixes

Appendix A — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

FASB Accounting Standards Updates and Other FASB Literature

See the FASB's Web site for the titles of:

- Accounting Standards Updates.
- Proposed Accounting Standards Updates (exposure drafts and public comment documents).
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

PCAOB Literature

PCAOB AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*

SEC Final Rules

33-9616, *Money Market Fund Reform; Amendments to Form PF*

33-9638, *Asset-Backed Securities Disclosure and Registration*

34-71288, *Registration of Municipal Advisors; Temporary Stay of Final Rule*

34-72472, *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant Definitions to Cross-Border Security-Based Swap Activities"*

34-72936, *Nationally Recognized Statistical Rating Organizations*

SEC Interim Rules

33-9545, *Extension of Exemptions for Security-Based Swaps*

BHCA-2, *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*

SEC Proposed Rules

33-9643, *Treatment of Certain Communications Involving Security-Based Swaps That May Be Purchased Only by Eligible Contract Participants*

34-71699, *Standards for Covered Clearing Agencies*

IC-31184, *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*

SEC Staff Accounting Bulletins

SAB 99, codified as SAB Topic 1.M, "Materiality"

SAB Topic 5.J, "New Basis of Accounting Required in Certain Circumstances" (rescinded)

SAB Topic 13, "Revenue Recognition"

International Standards

See Deloitte's IAS Plus Web site for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- Exposure documents.

Appendix B — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
CECL	current expected credit loss
CFTC	U.S. Commodity Futures Trading Commission
COSO	The Committee of Sponsoring Organizations of the Treadway Commission
ED	exposure draft
EITF	Emerging Issues Task Force
FAQs	frequently asked questions
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FVTNI	fair value through net income
FVTOCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
GP	general partner
HTM	held to maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting

Abbreviation	Description
IFRS	International Financial Reporting Standard
IPO	initial public offering
LGD	loss given default
LIHTC	low income housing tax credit
LP	limited partner
MMF	money market fund
NAV	net asset value
NRSROs	nationally recognized statistical rating organizations
OCC	Office of the Comptroller of the Currency (U.S. Department of the Treasury)
OCI	other comprehensive income
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCI	purchased credit-impaired
PD	probability of default
PIR	post-implementation review
REIT	real estate investment trust
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
Investment Advisers Act	Investment Advisers Act of 1940
Sarbanes-Oxley Act	The Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933
Trust Indenture Act	Trust Indenture Act of 1939

Appendix C — Other Resources

Deloitte Publications

Register to receive other Deloitte industry-related publications by going to www.deloitte.com/us/subscriptions, choosing the Industry Interests category, and checking the boxes next to your particular interests. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

Dbriefs

We also offer *Dbriefs* webcasts, which feature discussions by Deloitte professionals and industry specialists on critical issues that affect your business. Aimed at an executive-level audience, *Dbriefs* are designed to be timely, relevant, interactive, convenient, and supportive of your continuing professional education objectives. For more information about *Dbriefs*, please visit www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, the AICPA, the SEC, the IASB, and the IFRS Interpretations Committee. Check it out today!

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.

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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

No. 2015-12
19 February 2015

To the Point

FASB — final guidance

New consolidation guidance will affect entities in all industries

Reporting entities will need to change how they evaluate limited partnerships or similar entities for consolidation.

What you need to know

- The FASB issued final guidance that eliminates the deferral of FAS 167 and makes changes to both the variable interest model and the voting model.
- While the new guidance is aimed at asset managers, all reporting entities involved with limited partnerships or similar entities will have to re-evaluate these entities for consolidation and revise their documentation.
- In some cases, consolidation conclusions will change. In other cases, a reporting entity will need to provide additional disclosures if an entity that currently isn't considered a variable interest entity (VIE) is considered a VIE under the new guidance.
- Under the new guidance, a general partner will not consolidate a partnership or similar entity under the voting model.
- For public business entities, the guidance is effective for annual and interim periods beginning after 15 December 2015. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standard Update (ASU)[1] that eliminates the deferral of FAS 167,[2] which has allowed reporting entities with interests in certain investment funds to follow the previous consolidation guidance in FIN 46(R),[3] and makes other changes to both the variable interest model and the voting model.

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While the ASU is aimed at asset managers, it will affect all reporting entities involved with limited partnerships or similar entities. In some cases, consolidation conclusions will change. In other cases, reporting entities will need to provide additional disclosures about entities that currently aren't considered VIEs but will be considered VIEs under the new guidance when they have a variable interest in those VIEs. Regardless of whether conclusions change or additional disclosure requirements are triggered, reporting entities will need to re-evaluate limited partnerships or similar entities for consolidation and revise their documentation. This publication highlights the effects on reporting entities transitioning from FAS 167.

Key considerations

Deferral of FAS 167

The new guidance eliminates the deferral of FAS 167 but permanently exempts reporting entities from consolidating money market funds that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940. A reporting entity that has an interest in a fund that qualifies for the exception is required to disclose any financial support it provided to the fund during the periods presented and any explicit arrangements to provide financial support in the future.

Variable interest model

The ASU changes (1) the identification of variable interests (fees paid to a decision maker or service provider), (2) the VIE characteristics for a limited partnership or similar entity and (3) the primary beneficiary determination.

Variable interests

In the first step in the variable interest model, a reporting entity determines whether it has a variable interest in the entity being evaluated for consolidation. Fees received by decision makers or service providers may represent variable interests depending on the facts and circumstances. Decision makers and service providers include asset managers, real estate property managers, oil and gas operators, and providers of outsourced research and development.

The variable interest model in FAS 167 lists six criteria that fees received by an entity's decision makers or service providers must meet for them to conclude that the fees do not represent a variable interest in that entity. The FASB decided to eliminate three of those six criteria, including the requirement that substantially all of the fees be at or above the same level of seniority as the entity's other operating liabilities for the decision maker or service provider to conclude that the fees do not represent a variable interest.

The ASU retained the following three criteria:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision maker or service provider (and its related parties or de facto agents) does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.
- The service arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The ASU requires that, when evaluating whether its fee is a variable interest, a decision maker or service provider consider only its direct interests plus its proportionate share of the related parties' or de facto agents' interests. However, if the decision maker and a related party are under common control, the decision maker will consider the related party's entire interest.

For purposes of this analysis, the term related parties excludes employees or employee benefit plans of the decision maker or service provider (and their related parties), unless they are used to circumvent the provisions of the variable interest model.

How we see it

We believe a decision maker or service provider will have to exercise significant judgment to determine whether its fee is at market, particularly for new service offerings.

VIE characteristics

The ASU changes how reporting entities determine whether limited partnerships or similar entities are VIEs. Specifically, the ASU changes the evaluation of power when determining whether, as a group, the holders of the equity investment at risk lack the characteristics of a controlling financial interest. Under the ASU, partners lack power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact its economic performance if they do not hold kick-out or participating rights over the general partner(s).

Said differently, assuming the other characteristics of a VIE are not met, a limited partnership or similar entity is not a VIE and should be evaluated for consolidation under the voting model if (1) a single limited partner, partners with a simple majority of voting interests or partners with a smaller voting interest with equity at risk are able to exercise substantive kick-out rights or (2) limited partners with equity at risk are able to exercise substantive participating rights. When evaluating whether the threshold for kick-out (or liquidation) rights has been met, a reporting entity will not consider voting interests held by the general partner, entities under common control with the general partner or other parties acting on behalf of the general partner.

The ASU changes the criteria for determining whether limited partnerships or similar entities are VIEs.

The ASU generally does not change how a reporting entity evaluates corporations and similar entities as VIEs but does illustrate how to evaluate series funds for consolidation under the variable interest model.

Primary beneficiary determination

Consistent with FAS 167, a reporting entity will still have a controlling financial interest in a VIE and must consolidate if it has both (1) the power to direct the activities of a VIE that most significantly impact the entity's economic performance (power) and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (collectively, benefits). However, under the ASU, a reporting entity that is determining whether it satisfies the benefits criterion will now exclude most fees that meet both of the following conditions:

- The fees are compensation for service provided and are commensurate with the level of effort required to provide those services.
- The compensation arrangement includes only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The ASU changes how related parties and de facto agents are considered in the primary beneficiary determination. Under the ASU, a reporting entity that does not individually have power and benefits must consider whether the arrangement involves a single decision-maker or multiple decision makers. In other words, a reporting entity must consider whether a single variable interest holder has the power to direct the activities of a VIE that most significantly impact its economic performance or whether two or more parties together have that power.

If a single decision maker has power but no benefits (i.e., the decision maker does not individually satisfy the characteristics of a primary beneficiary), the decision maker must consider whether it and one or more variable interest holders are under common control and, as a group, whether they have benefits. If they do, the party in the common control group that is most closely associated with the VIE is the primary beneficiary.

If a single decision maker concludes that it (1) individually does not satisfy the characteristics of a primary beneficiary and (2) is not under common control with one or more entities that, as a group, have the characteristics of a primary beneficiary, it will still need to determine whether both of the following new criteria are met:

- The single decision maker and one or more variable interest holders are related parties or de facto agents and, as a group, they have the characteristics of a primary beneficiary.
- Substantially all of the activities of the VIE are conducted on behalf of a single variable interest holder that is a related party or de facto agent of the decision maker.

If both criteria are met, the variable interest holder on whose behalf substantially all of the activities of the VIE are conducted would consolidate the VIE.[4]

The ASU does not change the primary beneficiary determination when there are multiple decision makers.

Voting model

The ASU eliminates the presumption in today's voting model that a general partner controls a limited partnership or similar entity unless that presumption can be overcome. Under the new guidance, a general partner will not consolidate a partnership or similar entity under the voting model. Generally, only a single limited partner that is able to exercise substantive kick-out rights will consolidate. The ASU does not change the voting model for consolidation of corporations and similar entities.

Effective date and transition

For public business entities, the ASU is effective for annual and interim periods beginning after 15 December 2015. For nonpublic business entities, it is effective for annual periods beginning after 15 December 2016, and interim periods beginning after 15 December 2017. Early adoption is permitted, including adoption in an interim period. Therefore, a company that has not issued its year-end financial statements can early adopt the guidance for its 2014 financial statements.

A reporting entity must apply the amendments using a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the period of adoption or apply the amendments retrospectively.

Endnotes:

1 ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*.

2 FAS 167, *Amendments to FASB Interpretation No. 46(R)* now codified in ASC 810, *Consolidation*.

3 FIN 46(R), *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51*.

4 Reporting entities that apply ASU 2014-01, *Investments–Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*, to account for their investments in qualified affordable housing projects are exempt from applying this provision.

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28 May 2014

To the Point

FASB — final guidance

Boards issue sweeping joint revenue standard

Companies will need to make more estimates and use more judgment than under current guidance.

What you need to know

- The FASB and the IASB issued a comprehensive new revenue recognition standard that will supersede virtually all existing revenue guidance under US GAAP and IFRS.
- Calendar year-end public entities will be required to apply the standard for the first time in the first quarter of 2017.
- While the effect on companies will vary, some companies may face significant changes in revenue recognition. Companies should assess how they will be affected as soon as possible so they can determine how to prepare to implement the new standard.
- Public entities should disclose information about the new standard in their next SEC filing.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) jointly issued a comprehensive new revenue recognition standard that will supersede nearly all existing revenue recognition guidance under US GAAP and IFRS.

The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under today's guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation.

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The standard is effective for public entities for annual and interim periods beginning after 15 December 2016. This means that calendar year-end public entities will apply the new standard in the quarter ended 31 March 2017. There is a one-year deferral for nonpublic companies, but some companies that consider themselves private may have to follow the public company effective date if they fall under the FASB's new definition of a public business entity. Early adoption is not permitted under US GAAP, but nonpublic companies may adopt the new standard as of the public entity effective date. Early adoption is permitted under IFRS. As a result, companies applying IFRS could adopt the new revenue standard as soon as the start of their next fiscal period.

With over two years until the effective date, it may appear that companies have ample time to prepare. However, the potential changes to revenue recognition for some companies may be significant, making it difficult to prepare in that timeframe. That's why it is important for companies to assess the potential impact immediately. This publication discusses what companies need to consider when implementing the standard. Appendix A summarizes the standard's five-step model.

Key considerations

Scope

All companies that provide goods or services to customers will be affected by the standard (unless their contracts are in the scope of other US GAAP requirements, such as the leasing literature). One of the first steps companies will need to take is to identify the arrangements within the scope of the standard.

Companies may need to evaluate their relationship with the counterparty to a contract to determine whether a vendor-customer relationship exists. For example, some collaboration arrangements are more akin to partnerships, while others are more like vendor-customer relationships. Only arrangements involving the transfer of goods or services to a customer are within the scope of the new standard.

The standard also provides a model for measuring and recognizing gains and losses on the sale of certain nonfinancial assets such as property and equipment and real estate. Applying the standard to these transactions may yield different results than current guidance.

Evaluate the potential effect

A company should carefully evaluate its existing revenue recognition policies to determine whether any contracts in the scope of the guidance will be affected by the new requirements.

For example, a company that sells software may currently account for software contracts with multiple elements (or promises to a customer) as a single arrangement. Under the new standard, the company may reach a very different conclusion about which goods and services in an arrangement should be accounted for separately.

Begin monitoring implementation activities

Companies may want to establish a process for monitoring developments related to the new standard. While the standard includes some implementation guidance and illustrations, it does not provide as much implementation guidance as the US GAAP revenue literature that will be eliminated. Interpreting the new standard may be especially challenging for companies that currently follow industry-specific accounting guidance that will be superseded. Companies should work with auditors and other advisers to address interpretation and application issues. Companies also may want to monitor the discussions of the joint transition resource group the FASB and the IASB plan to establish as well as other industry working groups formed by the American Institute of Certified Public Accountants to discuss the application of the new standard to common transactions.

Companies should consider changes in accounting policies and accounting systems, which may be significant for many companies.

Internal control considerations

Companies should consider changes in accounting policies and accounting systems, which may be significant for many companies. They also should consider whether any changes are needed in internal control over financial reporting.

Companies generally will be required to make more estimates and use more judgment than under current guidance. To evaluate the effects of these changes, management must identify areas in which key judgments and estimates will be required. These areas may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Companies may want to consider developing special training for individuals who will be responsible for making these key estimates and judgments because their decisions may affect a company's financial results.

Transition method and disclosures

The standard allows for either "full retrospective" adoption, meaning the standard is applied to all of the periods presented, or "modified retrospective" adoption, meaning the standard is applied only to the most current period presented in the financial statements. A decision about which method to use will affect a company's implementation plans. For example, a Securities and Exchange Commission (SEC) registrant that chooses full retrospective transition must present three years of financial information in accordance with the new standard and present summarized financial data for five years. As a result, it may want to begin tracking revenue amounts under the new standard as early as 1 January 2015.

Once public entities choose a transition method, they should disclose it in registration statements and reports filed with the SEC. In addition, SEC Staff Accounting Bulletin Topic 11.M requires companies to disclose the potential effects of recently issued accounting standards, to the extent those effects are known, in management's discussion and analysis and the financial statements. Calendar year-end public entities will have to provide these disclosures for the quarter ended 30 June 2014.

An entity's disclosures should evolve over time. That is, as the date of adoption nears, an entity may need to provide more information about the effects of the new standard on its financial statements.

The new standard also requires significantly more interim and annual disclosures. Companies should carefully consider whether they have the information they will need to satisfy the new requirements or whether new processes and controls must be put into place to gather the information and ensure its accuracy.

How we see it

While some companies will be able to implement the new standard with limited effort, others may find implementation to be a significant undertaking. Companies with more work in front of them will need to move at a faster pace and may need to consider adding resources. An early assessment is vital to managing implementation.

Additional resources

Early communication with key stakeholders (e.g., audit committees, investors) will be important if a company anticipates significant changes in the amount, timing and presentation of revenues. We will issue a series of publications and host webcasts to provide companies with the information they need to initiate these discussions.

Our first webcast on the new standard is scheduled for 2 June 2014. It will feature a panel of EY and external subject-matter experts who will discuss the effect of the new standard on companies reporting under US GAAP. Please register at www.ey.com/webcasts.

We will issue a Technical Line publication providing more analysis of the new standard in the coming weeks.

Appendix A: The five-step model

The standard creates a five-step model that requires companies to exercise judgment when considering the terms of the contract(s) and all relevant facts and circumstances. The requirements will need to be applied consistently to contracts with similar characteristics and in similar circumstances.

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

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

The model applies to each contract with a customer. Contracts may be written, verbal or implied by customary business practices but must be enforceable and have commercial substance. An entity can combine two or more contracts that it enters into at or near the same time with the same customer and account for them as a single contract, if they meet specified criteria.

The standard provides detailed requirements for contract modifications. Depending on the facts and circumstances, a modification may be accounted for as a separate contract or a modification of the original contract.

Before the model is applied to a contract, an entity must conclude it is probable[1] that it will collect the consideration to which it will be entitled. This includes considering only the customer's ability and intention to pay the consideration when due.

How we see it

If it is not probable that an entity will collect the consideration to which it is entitled, revenue will not be recognized until cash is collected from the customer (and other criteria have been met). This is similar to current US GAAP, where revenue recognition is permitted only when collectibility is reasonably assured (assuming other basic revenue recognition criteria have been met).

Step 2: Identify the separate performance obligations in the contract

An entity will then evaluate the terms and its customary business practices to identify which promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations.

The key determinant for identifying a separate performance obligation is whether a good or service (or a bundle of goods or services) is distinct. A good or service (or bundle) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and the good or service is separately identifiable from other promises in the contract. Each distinct good or service (or bundle) will be a single performance obligation.

An entity may provide a series of distinct goods or services that are substantially the same and have the same pattern of transfer. Examples include services provided on an hourly or daily basis. If the specified criteria are met, such a series is considered a single performance obligation.

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled and includes:

- An estimate of any variable consideration (e.g., amounts that vary due to rebates 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 is generally not adjusted for credit risk. However, it 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[2] that a subsequent change in estimated variable consideration will not result in a significant revenue reversal. 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.

For sales and usage-based royalties from the license of intellectual property, the standard specifies that an entity does not include the royalties in the transaction price before the subsequent sales or usage occurs.

How we see it

Estimating variable consideration will be a significant change for entities that currently do not estimate it.

Step 4: Allocate the transaction price to the separate performance obligations

An entity must allocate the transaction price to each separate performance obligation on a relative standalone selling price basis, with limited exceptions. One exception in the standard permits an entity to allocate a variable amount of consideration, together with any subsequent changes in that variable consideration, to one or more (but not all) performance obligations, if specified criteria are met.

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. Examples of reasonably available information include an adjusted market assessment approach or an expected cost plus a margin approach.

As explained in the standard, the residual approach can be used only when the standalone selling price of a good or service is highly variable or uncertain. However, the standard does not prescribe any particular technique for applying the residual approach. Whichever approach is selected, it must be consistent with the basis of a standalone selling price, maximize the use of observable inputs and be applied on a consistent basis for similar goods or services and customers.

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

An entity satisfies a performance obligation by transferring control of a promised good or service to the customer. The transfer can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- 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 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.

Assessing whether each criterion is met will likely require significant judgment.

Revenue is recognized in line with the pattern of transfer. Revenue that is allocated to performance obligations satisfied at a point in time will be recognized when control of the goods or services has transferred. If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognized over the period the performance obligation is satisfied, using the method that best depicts the pattern of the transfer of control over time. Additional implementation guidance is provided to help companies determine whether a license of intellectual property transfers to a customer over time or at a point in time.

Endnotes:

[1] A collectibility threshold of "probable" will be used by both US GAAP and IFRS preparers. However, the term is used in the standards in a manner consistent with existing definitions of "probable" under US GAAP and IFRS, which differ.

[2] The IASB standard uses "highly probable," which has the same meaning as "probable" in US GAAP.

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Defining Issues®

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Contents

FASB and IASB Continue Discussions on Lease Accounting

During the second quarter of 2014, the FASB and IASB (the Boards) continued redeliberations on the proposals in their 2013 exposure drafts (EDs) on lease accounting.[1] While they agreed on many aspects of lease accounting, the Boards disagreed about when lessees would reassess variable lease payments and how a sublessor would determine the classification of a sublease.

Key Facts

The Boards reached converged decisions about:

- ***Definition of a Lease.*** The Boards expressed support for the EDs' proposed definition of a lease – i.e., a contract that conveys the right to use an asset for a period of time in exchange for consideration, and agreed to clarify some of the key factors in applying the definition.[2]
- ***Lease Modifications and Contract Combinations.*** The Boards agreed on how to define and account for lease modifications and on guidance for when it is appropriate to combine contracts.
- ***Separating Lease and Non-lease Components.*** The Boards agreed to keep the EDs' proposals for lessors to separate lease and non-lease components and allocate consideration to those separate components using the guidance in the new revenue recognition standard. However, they decided to modify the EDs' proposals about when and how lessees would separate lease and non-lease components and allocate consideration to those separate components.[3]

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[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org. The Boards met to discuss the project on April 23, May 22, and June 18. For more information about the Boards' previous redeliberations on the EDs see KPMG's Defining Issues No. 14-17, FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting. For more information about the EDs' proposals, see KPMG's Defining Issues No. 13-24, FASB and IASB Issue Revised Exposure Drafts on Lease Accounting, and Issues In-Depth No. 13-3, Implications of the Revised FASB and IASB Exposure Drafts on Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network.

[2] The IASB voted to retain the EDs' proposed definition of a lease. The FASB expressed general support for the principle supporting the EDs' proposed definition of a lease, but did not proceed to a formal vote.

[3] FASB Accounting Standards Update 2014-09, Revenue from Contracts with Customers, May 28, 2014, available at www.fasb.org, and IASB IFRS 15, Revenue from Contracts with Customers.

- ***Initial Direct Costs.*** The Boards agreed that only *incremental* direct costs – i.e., costs that an entity would not have incurred if the lease had not been *obtained* – would qualify for capitalization on origination of a lease.
- ***Discount Rate.*** The Boards agreed to limit the lessor discount rate to the implicit rate and to change the circumstances that would require a reassessment of the discount rate, but to otherwise keep the EDs' discount rate proposals.
- ***Financial Statement Presentation.*** The Boards substantially agreed on several aspects of financial statement presentation, including balance sheet presentation for lessees and cash flow presentation for lessees and lessors.

The Boards failed to reach converged decisions about:

- ***Variable Lease Payments.*** The Boards agreed that only variable payments that (a) are in-substance fixed payments, or (b) depend on an index or rate would be included in the initial measurement of lease assets and liabilities, consistent with the EDs' proposals. However, the Boards disagreed about the circumstances that would require a lessee to reassess the measurement of those payments.
- ***Subleases.*** The Boards agreed on the presentation of lease assets and liabilities and income and expense related to a head lease and a sublease. However, the Boards disagreed about how a sublessor would determine the classification of a sublease.

Key Impacts

- Changes in the definition of a lease are likely to mean that some arrangements will no longer be accounted for as leases. For example, some power purchase agreements that are leases under current GAAP because the purchaser obtains substantially all of the output from the asset during the term of the arrangement may be affected.
- Many of the Boards' decisions are designed to simplify the guidance and reduce its application costs, while others are designed to align the concepts supporting lease accounting with those underpinning the new revenue recognition requirements.
- Further divergence in the Boards' decisions (i.e., for variable lease payments and sublessor lease classification), which is in part due to their earlier lack of convergence on key aspects of lessee accounting, will make the task of comparing lessees applying U.S. GAAP with those applying IFRS more difficult than under current accounting standards – particularly given the lack of consistency in how lease liabilities will be measured during the lease term.
- For lessors, the Boards' recent decisions continue to be guided by an objective of keeping current lessor accounting requirements largely intact.

Background

The Boards began the leases project with the objective of developing a converged standard that would reduce complexity and arbitrary rules in current GAAP and require lessees to recognize all leases on-balance sheet. The EDs proposed that for all leases other than short-term leases, a lessee would recognize a right-of-use (ROU) asset for its right to use the underlying asset during the lease term and a lease liability for its obligation to make lease payments based on the present value of the lease payments. Subsequently, the lessee would measure the lease liability at amortized cost. However, subsequent accounting for the ROU asset and presentation of lease expense would depend on whether the lease was classified as Type A or Type B.

- For Type A leases – most leases of assets other than land or buildings – the lessee would measure the ROU asset at amortized cost and would typically amortize the ROU asset on a straight-line basis. The lessee would recognize amortization of the ROU asset and interest expense on the lease liability separately in profit or loss. Overall, the lessee would typically recognize a front-loaded pattern of total non-contingent lease expense.
- For Type B leases – most leases of land and buildings – the lessee would recognize total non-contingent lease expense generally on a straight-line basis over the lease term, and present this as a single expense in profit or loss. To achieve this accounting outcome, the lessee would plug the measurement of the ROU asset.

At the Boards' March 2014 meeting, the FASB decided to retain the EDs' proposed dual model but to replace the EDs' proposed lease classification approach for all types of underlying assets with a classification test similar to that in IAS 17.[4] The IASB opted for a single model based on the EDs' proposed Type A model. These differing approaches will cause significant differences between lessees applying U.S. GAAP and lessees applying IFRS in the measurement and presentation of lease expense, with consequential impacts on the balance sheet.

During the eight years the leases project has been on their respective agendas, the Boards have increasingly focused primarily on the goal of requiring lessees to recognize leases on-balance sheet and less on their other original objectives. Even so, many constituents were surprised by the Boards' decreased willingness to converge the key aspects of their proposals – particularly for lessee accounting – in previous redeliberations of the EDs' proposals. Although the additional divergence in their decisions during the second quarter of 2014 is in part a result of their earlier lack of convergence on key aspects of lessee accounting, one development is particularly noteworthy. Before the decisions the Boards reached during the second quarter, lease liabilities for lessees reporting under U.S. GAAP would have been measured the same way throughout the lease term as lease liabilities for lessees reporting under IFRS. This is no longer the case for some leases given the Boards' disagreement about when a lessee would be required to reassess the measurement of variable lease payments based on an index or rate.

The Boards will continue redeliberations of the EDs during the second half of 2014 and expect to discuss the following issues:

- Sale and lease-back transactions;
- Small-ticket leases;
- Disclosures;
- Leveraged leases (FASB only);
- Private company and not-for-profit issues (FASB only);

[4] IAS 17, Leases.

- Transition and effective date;
- Cost-benefit considerations; and
- Related-party leases, consequential amendments, etc.

This edition of *Defining Issues* discusses the Boards' more significant decisions during the second quarter of 2014 and provides KPMG's observations on their potential impacts. The Boards' remaining decisions during the quarter are included in the Summary of Decisions Reached in Redeliberations.

Definition of a Lease

The IASB decided to retain the EDs' proposals that a contract would 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. The proposed guidance is expected to clarify when and how these aspects of the definition are applied. The FASB expressed general support for the principle underlying the EDs' proposed definition of a lease, but directed its staff to provide additional information about the way the principle would be articulated in the standard along with examples of its application before proceeding to a formal vote.

One of the areas that constituents asked the Boards to clarify is how to determine whether an asset is identified when the supplier has a substitution right. The Boards agreed that a supplier's substitution right must be substantive to overcome the conclusion that there is an identified asset. A supplier's substitution right would be substantive only if:

- The supplier has the practical ability to substitute an alternative asset; and
- The benefits to the supplier of exercising the substitution right would be expected to outweigh the costs.

A supplier would not be considered to have the practical ability to substitute an alternative asset if:

- The customer could prevent the supplier from substituting the asset, or
- An alternative asset is not expected to be readily available and could not be sourced by the supplier within a reasonable period of time.

In addition, the Boards agreed to clarify that a customer would be required to assume that a supplier's substitution right is not substantive if it is impractical for the customer to determine that the conditions for the right to be considered substantive are met.

KPMG Observations

The assessment of whether an arrangement is, or contains, a lease is, in effect, the new test to determine whether an arrangement is on-balance sheet or off-balance sheet for the customer. Realistically, it is likely to remain a key judgment however hard the Boards work to clarify and supplement the definition.

Changes in the definition of a lease will require all entities to reassess current leases and service arrangements upon adoption of the final leases standard to determine whether lease accounting applies. The new definition is unlikely to exclude most common lease arrangements (e.g., leases of vehicles, office equipment, and real estate) from the revised lease accounting requirements, however the result could be different for outsourcing and similar arrangements that include significant services. The implementation guidance and illustrative examples in the final standard will be critical in helping entities make this evaluation.

The guidance the Boards decided to provide about substitution rights is likely to limit the circumstances in which they would be a basis for concluding that there is not an identified asset in a potential lease arrangement. However, some arrangements that are currently accounted for as leases may no longer be as a result of the guidance on the right to control the use of an identified asset. This is most likely to be the case in arrangements that include significant services where the purchaser receives substantially all of the output of identified assets that are necessary for the seller to perform in accordance with the terms of the arrangement (e.g., certain outsourcing, power purchase and shipping arrangements).

The determination of whether the purchaser obtains the right to control the use of an identified asset often will depend on the extent of the decisions the purchaser can make about how the asset will be used – i.e., that are not pre-specified in the agreement. Two of the examples the Boards considered with respect to purchaser decisions involved shipping arrangements.

In the first arrangement, the contract specified cargo to be transported that would fill the capacity of an identified ship, where the cargo would be picked up, its destination, and the timing of transportation. In this example, the Boards concluded that because the customer did not have the right to redirect the use of the ship after executing the agreement, the customer did not have the right to control the use of the ship and therefore the arrangement did not contain a lease.

In the second arrangement, the contract specified that the customer would have the right to transport cargo on an identified ship for a specified time period to destinations of the customer's choosing during the contract term. In this example the Boards concluded that the arrangement contained a lease because the customer had the right to control the use of the ship during the term of agreement.

Example 1: Lease Definition

Facts:

- A lessee enters into a three-year lease of a multifunction copier/printer.
- The contract provides the lessee the right to determine how to use the machine during the three-year term subject to the limitations of its design and capabilities.
- The vendor is required to provide an equivalent machine if the one originally delivered ceases to operate properly.
- The lessee has agreed that the vendor may substitute an equivalent machine for the original machine at any time at the vendor's expense.
    - The vendor has other equivalent machines readily available.
    - It is unlikely that the vendor would be able to generate more income by substituting an equivalent machine for the original machine than it would by leaving the original

machine in place.

– The vendor would incur costs to transport and install an equivalent machine at the lessee's location.

Results:

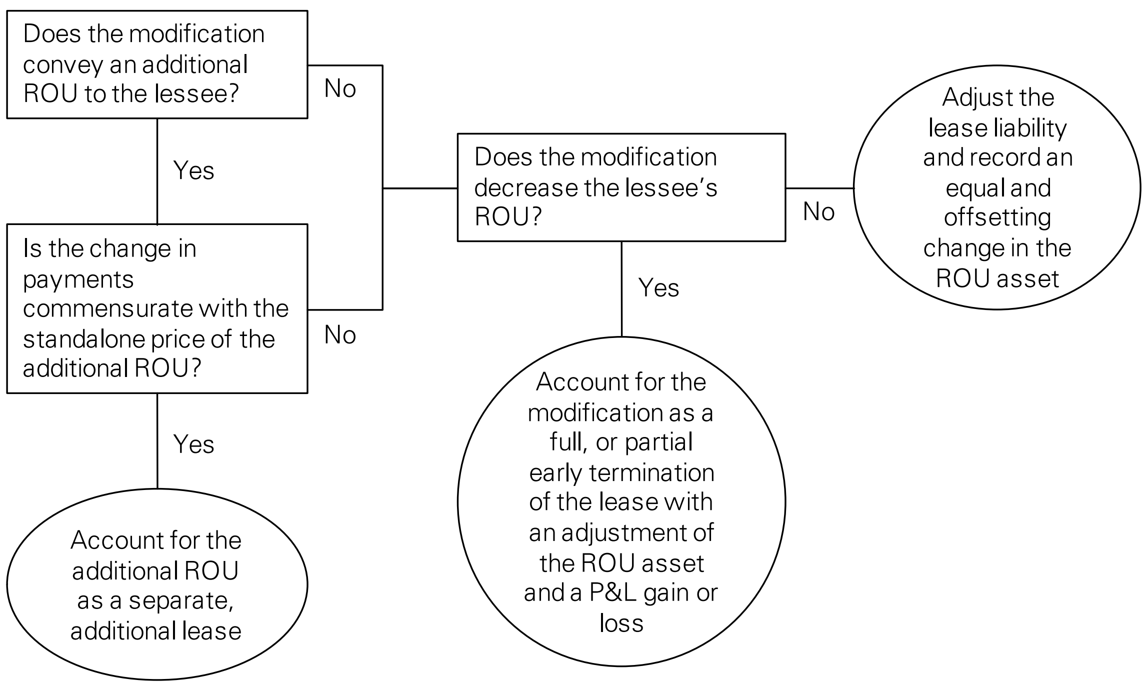
The substitution rights in this example are not considered substantive because the benefits to the vendor of exercising the substitution right would not be expected to outweigh the costs, and the contract therefore contains a lease.

Lease Modifications and Contract Combinations

Lease Modifications

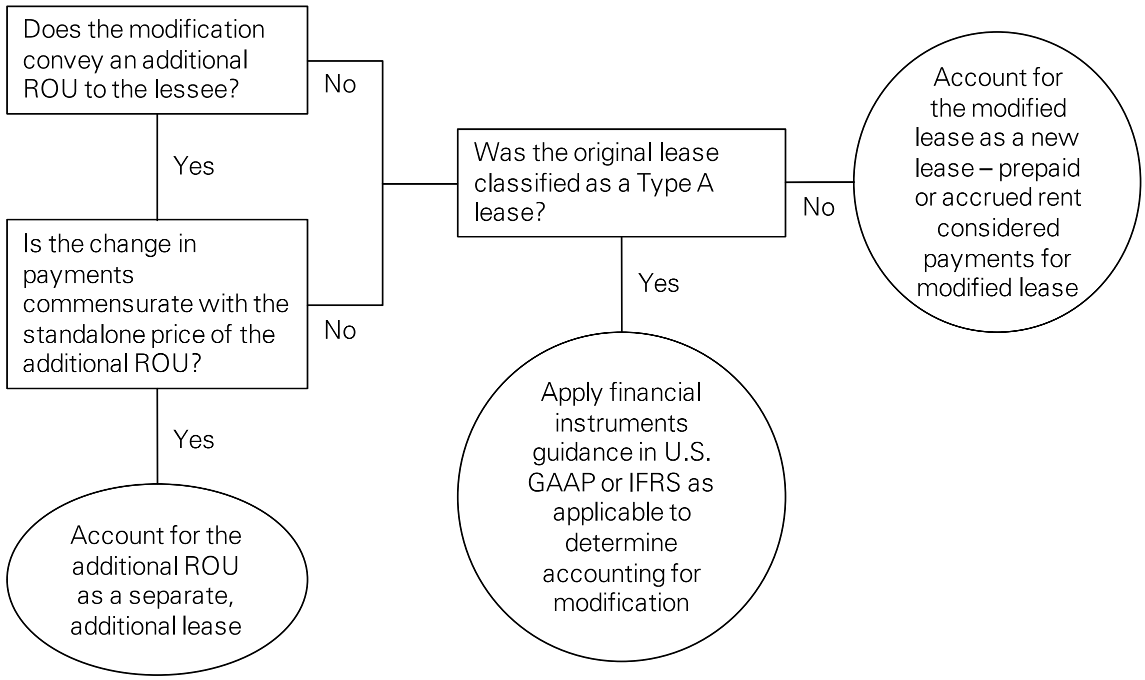
The Boards agreed to define a lease modification as *any* change to the contractual terms and conditions that wasn't part of the original terms and conditions of the lease. A modification would be accounted for as a separate, additional lease when it conveys an additional right-of-use (ROU) to the lessee and the price of that additional ROU within the lease is commensurate with its standalone price.

Modification Accounting by Lessees



If a lease modification does not meet the criteria to be considered a separate, additional lease, the treatment for lessees is based on the nature of the modification. For all modifications except those that decrease the lessee's ROU, the lessee would adjust the ROU asset by the amount of the change in the lease liability. A reduction in the lease payments would not, by itself, be considered a decrease in the lessee's ROU. Modifications that decrease the lessee's ROU would be treated as a full or partial early termination of the lease with the entry offsetting the decrease in the lease liability apportioned between an adjustment to the balance of the ROU asset and a gain or loss recognized in the income statement.

Modification Accounting by Lessors



For lessors, the treatment of lease modifications that do not meet the criteria to be considered a separate, additional lease would depend on the lease classification. For leases originally classified as Type B leases, any modified lease would be essentially treated as a new lease, which would not fundamentally change lessor accounting for these types of modifications compared with current accounting guidance. Any prepaid or accrued rent balance relating to the original lease would be considered part of the payments for the modified lease. If the modified lease remains a Type B lease, no gain or loss would be recognized. If the modified lease is classified as a Type A lease, selling profit or loss likely would be recognized at the modification date. For leases originally classified as Type A leases, modifications would be accounted for under current GAAP on financial instruments.[5] The Type A modification accounting wouldn't change existing IFRS requirements, but it would represent a change for U.S. GAAP. Under U.S. GAAP, existing modification guidance for sales-type and direct financing leases is contained within the requirements for lease accounting and is less likely to result in an income statement effect than the modification guidance that applies to financial instruments.[6]

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[5] FASB ASC Topic 310, Receivables, available at www.fasb.org, and IFRS 9, Financial Instruments.

[6] FASB ASC Topic 840, Leases, available at www.fasb.org.

KPMG Observations

The proposed lease modification accounting differs from the accounting for lease reassessments in situations where the modification decreases the lessee's ROU as illustrated in Scenarios C and D of Example 2. This may create an incentive for some lessees to enter into lease modifications to eliminate optional features in a lease because there is a difference between the accounting for a modification and the accounting for a reassessment. The proposed accounting for modifications that decrease the lessee's ROU also is inconsistent with the FASB's rationale for Type B lessee accounting – i.e., that the lease liability and ROU asset are inextricably linked – because the amount of the change in the lease liability would be different than the amount of the change in the ROU asset.

Example 2: Lease Modification Scenarios for a Lessee

Scenario A – Modification that is a separate, additional lease

A lessee enters into a lease for four floors of an office building for a 10-year period with an optional renewal period of two years. At lease commencement it is reasonably certain that the lessee will exercise the renewal option. After five years, the lessee and lessor modify the original lease to add another floor in the same building for a 5-year term with an optional renewal period of two years. The increase in total lease consideration corresponds to the current market rate for one floor in that building for that lease term (including the optional renewal period).

Result – Two leases. The original, unmodified lease would remain on the lessee's books and a new, separate lease would be recorded for the additional floor.

Scenario B – Modification that increases the lessee's ROU

Assume the same facts as Scenario A, except in this case the consideration for the additional office space is not at market rates.

Result – One lease. The lessee would remeasure the lease liability based on the remaining term (5 years or 7 years depending on whether exercise of the renewal option is considered reasonably certain at the modification date), the total, modified consideration, and the lessee's incremental borrowing rate at the effective date of the modification. The lessee would also adjust the ROU asset by the amount of the change in the lease liability.

Scenario C – Modification that decreases the lessee's ROU

Assume the same facts as Scenario A for the initial lease. For this scenario, the lease is modified after year 5 to eliminate the lessee renewal option. The pre-modification carrying amount of the lease liability is $420,000. The amount of the reduction in the lease liability as a result of the modification is $115,000. The pre-modification carrying amount of the ROU asset is $370,000.

Result – One lease. The lessee would remeasure the lease liability based on the consideration over the 5-year remaining term and the lessee's incremental borrowing rate in effect at the effective date of the modification. The amount of the remeasured lease liability would be $305,000 ($420,000 – $115,000). The lessee would decrease the ROU asset by the amount of the decrease in its ROU. One way to make this determination is using the proportion of the decrease in the lease liability or $101,310 ($115,000 ÷ $420,000 × $370,000). The difference between the decrease in the ROU asset and the decrease in the lease liability would be recognized as a gain or loss in the income statement at the effective date of the modification. In this case the difference results in a gain of $13,690 ($115,000 – $101,310).

Scenario D – Lease reassessment

Assume the same facts as Scenario A for the initial lease. For this scenario, assume a lease reassessment is required after year 5. In performing the reassessment, the lessee concludes that exercise of the renewal option is no longer reasonably certain. The pre-reassessment carrying amount of the lease liability is $420,000. The amount of the reduction in the lease liability as a result of the reassessment is $115,000. The pre-reassessment carrying amount of the ROU asset is $370,000.

Result – The lessee would remeasure the lease liability based on the consideration over the 5-year remaining term and the lessee's incremental borrowing rate in effect at the reassessment date. The amount of the remeasured lease liability would be $305,000 ($420,000 – $115,000). The lessee would decrease the ROU asset by the amount of the decrease in the lease liability or $115,000. The amount of the remeasured ROU asset would be $255,000 ($370,000 – $115,000). No gain or loss would be recognized in the income statement as a result of the reassessment.

Contract Combinations

The Boards also discussed when it is appropriate to combine contracts. They decided that two or more contracts should be combined if:

- 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 another contract.

KPMG Observations

The Boards' contract combination decisions are intended to be consistent with the new revenue recognition standard's guidance and serve as a deterrent to structuring contracts to obtain, or avoid, a particular accounting treatment.

Separating Lease and Non-lease Components

	Lessee	Lessor
When there is an observable standalone price for each component	Unless accounting policy elected (see below), separate and allocate based on relative standalone price of components – maximize the use of observable information	Always separate and allocate using the revenue recognition standard's guidance (i.e., on a relative standalone selling price basis)
When there is not an observable standalone price for some or all components		
Taxes and insurance on the property	Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract	
Accounting policy election by class of underlying asset	Account for lease and non-lease components together as a single lease component	

The Boards decided to retain the EDs' guidance for lessors to always separate lease and non-lease components and to allocate consideration to those components using the new revenue recognition standard's guidance (i.e., on a relative standalone selling price basis). The Boards also decided that lessors would reallocate consideration only when a modification occurs that is not accounted for as a separate, additional lease.

For lessees, the Boards decided to modify the EDs' proposed guidance to allow a policy election by class of underlying asset, to *not* separate lease components from non-lease components. If a lessee elects not to separate lease and non-lease components, the contract would be accounted for as a lease in its entirety.

If a lessee elects to separate lease and non-lease components, the lessee would allocate consideration to the components based on their relative standalone prices. Lessees would be required to maximize the use of observable inputs in determining standalone prices and to estimate standalone prices if observable prices are not available. Lessees also would be required to reallocate consideration when (a) there is a reassessment of either the lease term or whether it is reasonably certain that the lessee will exercise a purchase option, or (b) there is a contract modification that is not accounted for as a separate, additional lease.

The Boards also decided that activities or costs of the lessor that do not transfer a good or service to the lessee (e.g., reimbursement or payment of the lessor's taxes and insurance on the property) would not be considered separate components in a contract and, therefore, would not be accounted for separately or receive a separate allocation of consideration in the contract. This represents a change from current GAAP under which executory items such as taxes and insurance are explicitly excluded from lease accounting.

Leases with Multiple Underlying Assets

The Boards agreed to retain the EDs' proposals for an entity to account for the right to use an individual underlying asset (or group of underlying assets) as a separate lease when an arrangement includes the right to use multiple underlying assets only if:

- The lessee can benefit from use of the asset (or group of assets) either on its own or together with other resources that are readily available to the lessee; and

- The underlying asset (or group of assets) is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

KPMG Observations

It was important under the EDs' proposals to identify each lease component and assess the nature of the primary asset in order to determine classification as either a Type A or Type B lease. However, the Boards' decisions on lease classification in March (for lessees applying IFRS all leases would be Type A leases, and for all other leases under IFRS and U.S. GAAP classification would be based on IAS 17 criteria rather than the nature of the underlying asset) reduced the importance of separating out different lease components.

Nevertheless, the guidance on components has acquired a potential new significance for the IASB version of the proposals. Identifying separate lease components as the unit of account will establish a "floor" below which an entity will not be able to further disaggregate an asset when applying the final standard. This will be critical if the IASB proceeds with a small-ticket lease exemption for lessees, as it will limit the ability of lessees to break-down a lease of a large asset into smaller leases of separate parts in order to qualify for the exemption.

The decision to allow for lessees to use estimation techniques (e.g., a residual approach) in determining stand-alone selling prices of components (if observable prices are not available) for the allocation of contract consideration will eliminate the need for lessors to potentially provide proprietary pricing information to lessees. The use of estimation techniques will also help to reduce the costs and complexity of applying the proposals.

Providing lessees an alternative to not separate lease and non-lease components could lessen comparability between entities. However, the Boards believe that lessees will typically elect the alternative only for leases with insignificant non-lease components (to minimize their lease liabilities).

The Boards' decision that property tax and insurance obligations of the lessor are not separate components in a contract may result in different accounting by lessees depending on whether the lease is a gross lease or a net lease. For example, a lessee could enter into a gross lease in which it pays the lessor $5,000 per month and has no separate obligation with respect to the lessor's property taxes or insurance on the property. Alternatively, the lessee and lessor could enter into a net lease that obligates the lessee to (a) pay the lessor $4,500 per month, (b) separately obtain property insurance that includes the lessor as a named beneficiary, and (c) reimburse the lessor for its actual property tax assessments during the lease term. Under the gross lease, the amount of the lessee's lease liability and ROU asset would be determined using the payment of $5,000 per month whereas the lease liability and ROU asset under the net lease would be determined using the payment of $4,500 per month.

Variable Lease Payments

The Boards agreed to include variable lease payments (VLPs) that are in-substance fixed payments in the definition of lease payments used to initially measure lease assets and liabilities. In-substance fixed payments would include payments that do not create genuine variability and the minimum payments the lessee is required to make when it has alternative payments that it can select from under the lease (e.g., due to optional features within the lease). This is consistent with current practice and the EDs' proposals.

The Boards decided that the only other VLPs that would be included in the initial measurement of lease assets and liabilities are VLPs that depend on an index or rate, consistent with the proposals in the EDs. These VLPs would be measured using the index or rate at the lease commencement date. Lessors would not reassess VLPs during the lease term. Conversely, the Boards decided that lessees would be required to reassess VLPs based on an index or rate in some circumstances. However, they could not agree on the circumstances that would require reassessment.

The FASB decided that lessees would only reassess VLPs based on an index or rate when lease payments are remeasured for other reasons, such as a change in the lease term. The IASB decided that lessees would also reassess VLPs based on an index or rate when there is a contractual change in 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).

KPMG Observations

Although the Boards agreed on the principle that VLPs that are in-substance fixed payments would be included in the initial measurement of lease assets and liabilities, they had difficulty reaching agreement on the application of that principle to examples provided by their staff. The Boards acknowledged that the principle has been applied in practice and is well understood. As a result, they decided not to include examples addressing that principle in the standard.

One of the reasons for the Boards' divergence on when to reassess VLPs based on an index or rate could be the diverse geographical makeup of financial statement preparers applying IFRS. A key index that is often used in VLPs is the consumer price index (CPI) or its equivalent. In some countries that use IFRS, the periodic fluctuations in CPI can be extreme. The financial statement impact, particularly for the balance sheet, of reassessments when there are contractual changes in cash flows related to lease payments based on an index or rate is much more likely to be material in those economic environments than it is in the United States where CPI is fairly stable.

The difference in the Boards' lessee accounting models complicates the evaluation of the implications of their divergence on when to reassess VLPs based on an index or rate. Under the FASB approach, most leases will be accounted for as Type B leases. Reassessment of VLPs based on an index or rate for Type B leases will only impact the balance sheet – net income and lease expense will be unaffected. Under the IASB approach, all leases that don't qualify for a practical expedient (e.g., some short-term leases) will be accounted for as Type A leases. Reassessment of VLPs based on an index or rate for Type A leases will impact both the balance sheet and the income statement, although the income statement effect may often be immaterial. The differences in the balance sheet and income statement impact for Type A versus Type B leases may be significant without regard to the treatment of VLPs based on an index or rate. However, when combined with the Boards' non-converged lessee accounting models, the different approaches to reassessment of VLPs will not only further distort the comparability of the ROU asset but will also result in different subsequent measurement of the lessee's lease liability. VLPs based on an index or rate are a common feature in lease agreements, especially leases of property, and for a majority of these leases the subsequent measurements of both a lessee's ROU asset and lease liability will be accounted for differently under the Boards' respective proposals. Consequently, the differing triggers for reassessment of VLPs based on an index or rate will create additional effort and complexity for financial statement users attempting to compare lessees applying U.S. GAAP to lessees applying IFRS.

Example 3: In-Substance Fixed Payments

A lessee enters into a 10-year lease with a lessor for payments that are initially $20,000 per month in arrears. The payments increase by 1% annually for every 0.1% increase in CPI from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2% per year. Once VLPs increase they cannot decrease under the provisions of the lease. The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2% during the term of the lease.

Result – The facts in this example are such that the payments under the CPI escalation provision likely would be considered in-substance fixed payments rather than VLPs, given the remote likelihood that the change in CPI would be less than 0.2%. If so, the lessee and lessor would include a 2% annual increase in the measurement of lease payments.

Other Topics Discussed

The Boards' decisions on initial direct costs, discount rate, subleases, and financial statement presentation are included in the section, *Summary of Decisions Reached in Redeliberations*. With the exception of the decisions on subleases and cash flow presentation, the Boards' decisions on these topics were substantially converged, not significantly different than the proposals in the EDs, and would not result in a significant change from current GAAP.

The Boards did not agree on how a sublessor would determine the classification of a sublease. The FASB decided that a sublessor would consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease, which is consistent with current U.S. GAAP. Conversely, the IASB decided that a sublessor would consider the ROU asset to be the leased asset in determining the classification of the sublease, which is not consistent with current practice under IFRS.

The Boards reached decisions on cash flow presentation that were substantially converged and consistent with the EDs' proposals. Specifically, lessee principal payments for Type A leases would be classified as financing activities and lessee payments for Type B leases, VLPs, and payments for leases that are eligible for a practical expedient (such as some short-term leases) would be classified as operating activities. Lessees applying U.S. GAAP would classify interest payments on Type A leases as operating activities while lessees applying IFRS would classify interest payments on leases as either operating or financing activities based on the lessee's accounting policy choice under IAS 7.[7]

KPMG Observations

Subleases

The Boards' decisions on subleases are likely to result in Type B classification by the sublessor for most subleases under U.S. GAAP. Conversely, subleases are more likely to be classified as Type A leases by the sublessor under IFRS. Although the difference in the Boards' decisions is at least partly a result of their lack of convergence on lessee accounting, it will create additional effort and complexity for financial statement users attempting to compare lessee-sublessors applying U.S. GAAP to lessee-sublessors applying IFRS.

Cash Flow Presentation

The Boards' cash flow presentation decisions would not result in significant changes in operating and financing cash flows for lessees applying U.S. GAAP. However, they would likely significantly change the composition of operating and financing cash flows for lessees applying IFRS. Under current IFRS most leases are classified as operating leases and, therefore, most lease payments by lessees are classified as operating cash flows. Because all leases other than those that qualify for a practical expedient would be Type A leases, a substantial proportion of lease payments would be classified as financing cash flows by lessees applying IFRS under the IASB's proposed lessee accounting model. The IASB decided to require lessees to disclose total lease payments in the notes to the financial statements to mitigate the difficulty that financial statement users would otherwise encounter in comparing the cash flows from leasing activities for lessees applying IFRS to those for lessees applying U.S. GAAP.

[7] IAS 7, Statement of Cash Flows.

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[8]</td><td colspan="2">• A contract would 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</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 for which the lease term as determined under the revised proposals ≤ 12 months
• Portfolio-level accounting would be permitted if it does not differ materially from applying the requirements to individual leases</td></tr>
<tr><td>• No exemption for small-ticket leases</td><td>• Optional lessee exemption for small-ticket leases (e.g., leases of IT equipment and office furniture), even if material in aggregate</td></tr>
<tr><td>Lessee Accounting Model</td><td>• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria
• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability
– Type A leases would be treated as the purchase of an asset on a financed basis
– Type B leases generally would have straight-line recognition of total lease expense</td><td>• Single lease accounting model
• No lease classification test
• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability
– Treated as the purchase of an asset on a financed basis</td></tr>
<tr><td>Lessor Accounting Model</td><td colspan="2">• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria
• Type B accounting model based on IAS 17 operating lease accounting
• Type A accounting model based on IAS 17 finance lease accounting with recognition of net investment in lease comprising lease receivable and residual asset</td></tr>
</table>

[8] The IASB voted on this definition. The FASB expressed general support for the principle supporting the definition, but has not yet proceeded to a formal vote.

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	– Selling profit would not be recognized on commencement of leases that qualify for Type A classification only due to involvement by third parties other than the lessee	– There would be no restriction on recognizing selling profit on commencement of Type A leases
Lease Term and Purchase Options	• Optional (e.g., renewal) periods and purchase options would be included in lease accounting if it is *reasonably certain* that the lessee will exercise those options, consistent with the high threshold in current GAAP • Lessees would 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	
Initial Direct Costs	• Initial direct costs would include only incremental costs that an entity would not have incurred if it had not obtained the lease • Lessees would include initial direct costs in the initial measurement of the ROU asset and amortize the costs over the lease term • Initial direct costs would be included in determining the lessor's implicit rate unless the lease is a Type A lease for which selling profit would be recognized at lease commencement • Lessors would include initial direct costs for Type A leases – In the initial measurement of the lease receivable if no selling profit is recognized at lease commencement – In expense at lease commencement if selling profit is recognized at lease commencement • Lessors would capitalize initial direct costs for Type B leases and amortize the costs over the lease term in the same pattern as lease income	
Discount Rate	• The lessee's discount rate would 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 would be the cost of the ROU asset • Lessees would 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 • The lessor's discount rate would be the rate implicit in the lease (i.e., the	

<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">implicit rate)
– Initial direct costs would be included in determining the implicit rate unless the lease is a Type A lease for which selling profit will be recognized at lease commencement
• Lessors would reassess the discount rate when there is a lease modification</td></tr>
<tr><td rowspan="2">Variable Lease Payments</td><td colspan="2">• Lease payments used in the initial measurement of lease assets and liabilities would 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 would 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 would 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)</td><td>• Lessees would 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) would not be considered components in a contract
• Lessors would always separate lease and non-lease components and allocate consideration using the new revenue recognition standard’s guidance (i.e., on a relative standalone selling price basis)
– Reallocate consideration when there is a contract modification that is not accounted for as a separate, additional lease
• Lessees would choose an accounting policy by class of underlying asset</td></tr>
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<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">to either:
– Separate lease and non-lease components and allocate consideration based on relative standalone price 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
– Account for lease and non-lease components together as a single lease component
• Two or more contracts would be combined as 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</td></tr>
<tr><td>Lease Modifications</td><td colspan="2">• Lease modifications would be defined 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
• A modification would 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, the ROU asset would be adjusted by the amount of the adjustment to the lease liability
– If the modification reduces the lessee's ROU, the modification would 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:
– Type B lease modifications would be treated as a new lease with any prepaid or accrued rent on the original lease considered part of the lease payments for the new lease
– Type A lease modifications would be accounted for under the financial instruments requirements in U.S. GAAP or IFRS as applicable</td></tr>
</table>

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<tr><td rowspan="2">Subleases</td><td colspan="2">• A lessee-sublessor would account for the head lease and the sublease as two separate contracts unless those contracts meet the contract combinations guidance
– The head lease would be accounted for in accordance with the lessee accounting proposals
– The sublease would be accounted for in accordance with the lessor accounting proposals
• A lessee-sublessor would 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 would not offset lease income from a sublease and lease expense from a head lease unless it meets the requirements for offsetting in other U.S. GAAP or IFRS as applicable (e.g., the new revenue recognition standard)[9]</td></tr>
<tr><td>• A sublessor would 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 would consider the ROU asset to be the leased asset in determining the classification of the sublease</td></tr>
<tr><td rowspan="2">Lessee Presentation – Balance Sheet</td><td colspan="2">• Lessees would present Type A ROU assets and lease liabilities either as separate line items on the balance sheet or disclose separately in the notes to the financial statements
– If not separately presented on the balance sheet lessees would:
▪ Present Type A 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 Type A ROU assets and lease liabilities are included and their amounts</td></tr>
<tr><td>• Lessees would not include Type B ROU assets and lease liabilities in the same line items as Type A ROU assets and lease liabilities on the balance sheet
– If not separately presented on the balance sheet lessees would disclose in the notes the line items on the balance sheet in which Type B ROU assets and lease liabilities are included and their amounts</td><td>• N/A – no Type B lease classification</td></tr>
</table>

[9] Members of both Boards believe it is unlikely that sublease income and head lease expense would qualify to be offset if the sublease is classified as a Type B lease.

Lessee Presentation – Statement of Cash Flows	• Lessees would classify cash paid for: – Principal on Type A lease liabilities as financing activities – Interest on Type A lease liabilities as operating activities – Type B leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities	• Lessees would 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 IAS 7 – Variable lease payments and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities • Lessees would disclose total lease payments in the notes to the financial statements
Lessor Presentation	• Lessors would present lease assets and liabilities and income and expense consistent with the current guidance in IAS 17 • Lessors would classify all cash inflows from leases as operating activities in the statement of cash flows	

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Kimber K. Bascom and Catherine M. Creps. We would also like to thank the following reviewers for their input: Brian O'Donovan, Steve Hills, and Brandon Gardner.

Earlier editions are available at: http://www.kpmginstitutes.com/financial-reporting-network

cutting through complexity

Defining Issues®

March 2015, No. 15-8

Lease Accounting Discussions Near Completion

The FASB and IASB are ready to stop talking about lease accounting – at least for now.[1] With the completion of the IASB's March meeting, other than any minor clean-up issues, both say they are finished building their new lease accounting mousetraps. They have told their staff to begin writing the final standards. The standards will contain numerous points of divergence, the most significant of which relate to lessee accounting. Neither has decided when the new standards will become effective. However, they plan to issue their final standards by the end of this year.

This edition of *Defining Issues* discusses the Boards' significant decisions on lease accounting subsequent to October 2014 and provides KPMG's observations on their potential impacts. The complete highlights of the new lease accounting models are included in the Summary of Decisions Reached in Redeliberations.

Key Facts

- The Boards decided to require new lessee disclosures, but reached different conclusions on the specific disclosures and how they would be presented.
- Both Boards agreed to allow a modified retrospective transition approach. However, they had different views on whether to permit full retrospective transition and the details of modified retrospective transition.
- The Boards talked about changing the definition of a lease so that fewer transactions would qualify as leases. Ultimately, they decided not to.
- The FASB talked about aligning the reassessment requirements for variable lease payments based on an index or rate with the IASB's decisions, but decided not to.

Contents

[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org. For more information about the Boards' previous discussions see KPMG's Defining Issues Nos. 14-46, FASB and IASB Enter Home Stretch in Redeliberations on Lease Accounting – but on Different Tracks, 14-29, FASB and IASB Continue Discussions on Lease Accounting, and 14-17, FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting, all available at http://www.kpmg-institutes.com.

- The IASB decided to specify that leased assets that are dependent on, or highly interrelated with other leased assets do not qualify for the small-ticket lease exemption that will apply under IFRS. It also decided to indicate in the basis for conclusions to its standard that the exemption is intended to apply to assets with a value of $5,000 or less when new.

Key Impacts

Other than on-balance sheet recognition for lessees and the prospective elimination of leveraged lease accounting for lessors, the FASB's new lease accounting requirements will not represent a significant change from current U.S. GAAP.

- Lessees will be required to disclose more information about leases than they currently do.
- Transition alternatives may increase the difficulty for financial statement users trying to compare companies applying U.S. GAAP to those applying IFRS. For preparers, the transition alternatives will generally reduce the cost and effort of initially applying the new requirements.

Background

When the FASB and the IASB began their leases project, their primary objectives included:

- Reducing complexity in lease accounting;
- Eliminating arbitrary accounting distinctions for transactions that are economically similar;
- Requiring lessees to recognize all leases on-balance sheet; and
- Developing converged lease accounting requirements.

Although the project will meet the objective for lessees to recognize leases on-balance sheet, it will not achieve the other objectives. Other than lessees recognizing leases on the balance sheet, the project will result in modest changes to lease accounting under U.S. GAAP. While the changes to lessee accounting are more significant under IFRS, the changes to lessor accounting under IFRS are also minimal.

Last year, the Boards reached significantly different decisions about lessee accounting. The FASB opted for a dual model approach. Under that approach, a lessee will recognize a right-of-use (ROU) asset and a lease liability for its obligation to make lease payments for all leases other than short-term leases. Subsequent accounting for the ROU asset and presentation of lease expense, however, will depend on whether the lease is classified as Type A (most capital leases under current U.S. GAAP) or Type B (most operating leases under current U.S. GAAP). For Type A leases, the lessee generally will recognize a front-loaded pattern of total lease expense comprising interest on the lease liability and amortization of the ROU asset, similar to today's accounting for capital leases. For Type B leases, the lessee will recognize a single lease expense amount on a straight-line basis over the lease term, similar to today's accounting for operating leases. The carrying amount of the ROU asset for Type B leases will be determined as a "plug" to achieve straight-line total lease expense. Conversely, the IASB opted for a single model approach in which lessees will account for all leases other than short-term leases as Type A leases.

On lessor accounting, the Boards reached converged decisions to keep the key aspects of lessor accounting substantially unchanged from existing guidance. As a result, lessors will account for most leases as executory contracts (i.e., as operating leases).

The Boards also reached different conclusions on many issues in addition to the basic lessee accounting model. Additional areas in which the Boards' decisions diverged include lessee reassessments of variable lease payments, accounting for subleases and sale-leaseback transactions, accounting for small-ticket leases and leases between related parties, financial statement presentation for lessees, lessee disclosures, and transition.

The Boards' disparate approaches may cause significant differences in financial reporting by companies applying U.S. GAAP versus companies applying IFRS, complicating comparisons by financial statement users.

The Boards have now told their staff to begin writing the final standards. Nuances in the language of the different standards may produce divergence in application for areas where the Boards' decisions are converged. During the drafting process there likely will be questions that the Boards will be asked to resolve in one or more public meetings. However, those discussions are not likely to significantly change either Board's decisions. The Boards will decide later this year when the new standards will become effective. It could be that the standards have different effective dates. However, it's likely that the effective date of both standards will be aligned with the effective date of each Board's new revenue recognition standard.[2] Both Boards are expected to decide whether to defer the effective date of those standards later this year.

Lessee Disclosures

At their January meeting, the Boards agreed that the objective of lessee disclosures is to help users understand the amount, timing, and uncertainty of cash flows from leases. Lessees will use judgment to determine the appropriate level of disclosure aggregation. However, the Boards reached different decisions about both the qualitative and quantitative information lessees will have to disclose. Some of these differences are due to their divergence on lessee accounting.

Qualitative Disclosures. The FASB decided to require lessees to disclose:

- Information about the nature of leases (and subleases), 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;
  - The existence, and terms and conditions, of lessee residual value guarantees; and

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[2] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org, and IFRS 15, Revenue from Contracts with Customers.

  – Restrictions or covenants imposed by leases.

- Information about leases that have not yet commenced, but that create significant rights and obligations for lessees;
- Information about significant judgments and assumptions made in accounting for leases, including:
  – The determination of whether a contract contains a lease;
  – The allocation of the consideration in a contract between lease and non-lease components; and
  – The determination of the discount rate.
- Main terms and conditions of any sale-leaseback transactions; and
- Whether an accounting policy election was made to apply the short-term lease exemption.

The FASB decided not to include guidance about how to aggregate qualitative disclosures.

The IASB decided *not* to include a list of required qualitative disclosures in its final standard. Lessees will be required to provide qualitative disclosures in addition to the quantitative disclosures only if necessary to satisfy the lessee disclosure objective.

Quantitative Disclosures. Lessees will be required to disclose:

Disclosure	U.S. GAAP	IFRS
For Type A leases, amortization of right-of-use (ROU) assets and interest on lease liabilities (including capitalized interest)	✓	Amortization split by class of underlying asset
Additions to ROU assets		✓
The carrying amount of ROU assets, by class of underlying asset		✓
Type B lease expense (including capitalized costs)	✓	
Short-term lease expense, when the lease term exceeds 30 days	✓	✓
Small-ticket lease expense		✓
Variable lease expense	✓	✓
Sublease income	✓	✓
Gains and losses on sale-leaseback transactions	✓	✓

Disclosure	U.S. GAAP	IFRS
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 the undiscounted cash flows to lease liabilities on the balance sheet	✓	
A maturity analysis of lease liabilities in accordance with IFRS 7, separate from the maturity analysis for other financial liabilities[3]		✓
Cash paid for amounts included in the measurement of lease liabilities, segregated between Type A and Type B leases and between operating and financing cash flows	✓	
Total cash outflows for leases		✓
Supplemental noncash information on lease liabilities exchanged for ROU assets separately for Type A and Type B leases	✓	
The weighted-average remaining lease term, presented separately by Type A and Type B leases	✓	
The weighted-average discount rate for Type B leases as of the balance sheet date	✓	

Presentation. The IASB decided to require lessees to present quantitative disclosures in a tabular format (unless another format is more appropriate). Lessees applying IFRS will present all lessee disclosures in a single note or separate section in the financial statements. The FASB did not agree to the same presentation requirements, but agreed to include an example illustrating quantitative disclosure requirements in a tabular format in its final standard. Example 1 provides an illustration of the FASB's quantitative lessee disclosures, other than the maturity analysis of lease liabilities, in a tabular format.

Other Decisions Reached. The FASB decided to require the same lessee disclosures for public and nonpublic business entities. It decided not to require lessees to disclose:

- A reconciliation of the opening and closing balances of lease liabilities; or
- A maturity analysis of commitments for non-lease components (e.g., services provided by the lessor) related to a lease.

The IASB decided not to require lessees to disclose a reconciliation of the opening and closing balances of ROU assets.

[3] IFRS 7, Financial Instruments – Disclosures.

KPMG Observations

Based on the Boards' decisions, lessee disclosures will increase as compared to current GAAP. This increase is likely due in part to the Boards' divergent lessee accounting models.

The FASB's decision not to provide further guidance on the disaggregation of qualitative disclosures (e.g., by class of underlying asset, lease term, lease payment terms, geographical region, etc.) is different than the new revenue recognition standard, which includes disaggregation guidance in its qualitative disclosure requirements.

The FASB decided not to require a reconciliation of lease liabilities due to preparers' concerns about the costs and complexity of implementation. Some preparers cited the need for more robust IT systems and/or process capabilities to track and accumulate reconciling items that are not identified for disclosure today. Instead, the FASB agreed to require lessees to disclose key components of the reconciliation, including total lease expense and cash paid for amounts included in the measurement of lease liabilities. This decision is consistent with current U.S. GAAP on financial liabilities, which does not require a similar reconciliation.

The FASB expects lessees to be able to prepare the new quantitative disclosures using their existing systems and processes as many of requirements are similar to current U.S. GAAP.

Example 1: Selected Lessee Quantitative Disclosures in a Tabular Format (FASB)

For the years ended December 31, 20X8 and 20X7 (in thousands)	20X8	20X7
Lease expense		
Type A lease expense		
Amortization of ROU assets	600	525
Interest on lease liabilites	150	110
Type B lease expense	1,000	900
Short-term lease expense	50	40
Variable lease expense	75	60
Sublease income	(10)	(8)
Total lease expense	**1,865**	**1,627**
Other information		
(Gains) losses on sale-leaseback transactions, net	(8)	5
Cash paid for amounts included in the measurement of lease liabilities for Type A leases		
Operating cash flows	1,400	1,300
Financing cash flows	200	170
Cash paid for amounts included in the measurement of lease liabilities for Type B leases		
Operating cash flows	800	635
ROU assets obtained in exchange for lease liabilites	475	515
Weighted-average remaining lease term (in years)		
Type A leases	9.7	8.9
Type B leases	5.2	5.4
Weighted-average discount rate for Type B leases	6.1%	6.3%

Transition

The Boards separately discussed transition approaches, including transition disclosures, at their respective February meetings. The Boards reached notably different decisions about transition requirements for lessees, lessors, and subleases. The FASB also reached decisions about transition requirements for build-to-suit leasing transactions that are not applicable under IFRS.

Transition Requirement	U.S. GAAP	IFRS
Definition of a Lease		
Entities permitted to not reconsider whether a contract is or contains of a lease for all contracts that are ongoing at the date of initial application.[4] An entity that chooses not to apply the new definition of a lease will do so for all contracts that are ongoing at the date of initial application, and disclose that fact.	Only if elected with certain other specified reliefs (see below)	✓
Lessee Transition		
Modified retrospective transition required for all leases existing at, or entered into after, the date of initial application.[5] No transition accounting required for leases that expired prior to the date of initial application.	✓	
Lessees permitted to elect not to reconsider: • Whether any expired or existing contracts are or contain leases. • The lease classification for any expired or existing leases. • Whether existing capitalized initial direct costs would have qualified for capitalization under the new leases standard. These must be elected as a package and applied to all leases. They cannot be elected on a lease-by-lease or relief-by-relief basis.	✓	
Lessees permitted to use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This specified relief may be elected separately	✓	

[4] Under the IASB proposal, the first day of the annual reporting period in which a lessee first applies the requirements of the new standard.

[5] Under the FASB proposal, the beginning of the earliest comparative period presented in the financial statements.

Transition Requirement	U.S. GAAP	IFRS
from the other specified reliefs, but cannot be elected on a lease-by-lease basis.		
Lessees to choose either a fully retrospective approach or a modified retrospective approach on transition, to be applied consistently across their entire portfolio of operating leases. • Under the modified retrospective approach, a lessee will not restate comparative information. • At the date of initial application, recognize the cumulative effect of initial application as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate).		✓
Lessees 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. This approach will not require any transition accounting for build-to-suit leases that expired prior to the date of initial application. • Lessees that have recognized assets and liabilities solely as a result of a transaction's build-to-suit designation must derecognize those assets and liabilities at the later of (a) the date of initial application or (b) 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 must be recorded as an adjustment to equity at that date. A lessee will then follow the general lessee transition guidance for the lease itself. • For build-to-suit leases in which the construction period ends prior to the date of initial application, but the lease term has not expired as of that date, and the transaction qualified for sale-leaseback accounting under existing guidance prior to that date, the	✓	

Transition Requirement	U.S. GAAP	IFRS
entity will apply the lessee transition requirements.[6]		
Lessor Transition		
Modified retrospective transition required for all leases other than leveraged leases existing at, or entered into after, the date of initial application. No transition accounting required for leases that expired prior to the date of initial application.	✓	
Lessors permitted not to reconsider: • Whether any expired or existing contracts are or contain leases. • The lease classification for any expired or existing leases. • Whether existing capitalized initial direct costs would have qualified for capitalization under the new leases standard. These must be elected as a package and applied to all leases. They cannot be elected on a lease-by-lease or relief-by-relief basis.	✓	
Lessors permitted to use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This specified relief may be elected separately from the other specified reliefs, but cannot be elected on a lease-by-lease basis.	✓	
Specified relief elections must be consistently applied by an entity for all lessee and lessor transactions (i.e., an entity that is a lessee and a lessor must make the same relief elections for all of its leases).	✓	
Lessors required to continue to apply existing accounting for any leases that are ongoing at the date of initial application, except for intermediate lessors in a sublease.		✓

[6] FASB ASC Subtopic 840-40, Leases – Sale-Leaseback Transactions, available at www.fasb.org.

Transition Requirement	U.S. GAAP	IFRS
Subleases Transition		
Intermediate lessors to 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. This determination is based on the remaining contractual terms of the head lease and the sublease. For subleases that were classified as operating leases under IAS 17 but finance leases under the new standard, an intermediate lessor will be required to account for the sublease as a new finance lease entered into on the date of initial application.		✓
Sale-Leaseback Transactions		
Entities will not reassess whether a transaction previously accounted for as a sale-leaseback transaction would have qualified as a sale (or purchase) in accordance with the Boards' new revenue recognition standards.[7]	✓	✓
An entity will account for a leaseback in accordance with the lessee and lessor transition requirements.	✓	✓
For any transaction previously accounted for as a sale and capital (finance) leaseback, the seller-lessee will continue to amortize any deferred gain or loss.	✓	✓
For any transaction previously accounted for as a sale and operating leaseback: • The seller-lessee will recognize the portion of any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to equity at the later of the date of initial application or the date of sale. • The portion of any seller-lessee deferred gains or losses that resulted from off-market terms will be recognized as an adjustment to the leaseback ROU asset (if a deferred loss) or as a remaining financial liability (if a deferred gain) at the date of initial application.	✓	

[7] FASB ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org, and IFRS 15, Revenue from Contracts with Customers.

Transition Requirement	U.S. GAAP	IFRS
For any transaction previously accounted for as a sale and operating leaseback, account for deferred gains or losses as an adjustment to the leaseback ROU asset.		✓
Disclosures		
Lessees and a lessors will provide transition disclosures consistent with Topic 250, *Accounting Changes and Error Corrections*, except for the following disclosure requirements in paragraph 250-10-50-1(b)(2)): • 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 retrospectively adjusted.	✓	
Lessees will be required to disclose: • The weighted average incremental borrowing rate at the date of initial application, and • Explanation of any difference between: (a) The result of discounting the operating lease commitments reported under IAS 17 at the end of the annual reporting period preceding the date of initial application; and (b) Lease liabilities recognized on the balance sheet immediately after posting the cumulative catch up adjustment on the date of initial application.		✓

KPMG Observations

The FASB decided to not allow a full retrospective transition approach, and to limit how preparers can use transition reliefs. While this limits flexibility for preparers, it will result in transition that is more consistent across companies. The FASB also decided it was important to align transition options for entities that are both lessees and lessors.

In addition to the decisions above, the Boards also went into further detail on how lessees (and lessors for U.S. GAAP) will apply the respective approaches to remeasure existing leases. Those details will be included in a future KPMG publication, along with examples and implementation guidance.

The Boards' separate meetings to discuss transition led to significant differences in transition approaches. For lessee accounting, given the divergence in the Boards' lessee accounting models, this may not be as noteworthy. But it does represent additional divergence, at least for a period of time after initial application, for lessors under each standard. (Lessor accounting is much more converged under the Boards' respective standards.)

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Kimber K. Bascom, Daniel Amat, and Robin E. Van Voorhies. We also would like to thank the following reviewers for their input: Brian O'Donovan and Almudena Cossio.

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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 or to direct others to operate it in a manner the customer determines (and the supplier has no right to change those operating instructions); or
• The customer designed the asset, or caused it to be designed, in a way that predetermines during the period of use (a) how and for what purpose it will be used, or (b) how it will be operated</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 as determined under the revised proposals ≤ 12 months
• Portfolio-level accounting will be permitted if it does not differ materially from applying the requirements to individual leases</td></tr>
<tr><td>• No exemption for small-ticket leases</td><td>• Optional lessee exemption for small-ticket leases (i.e., 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 IAS 17 classification criteria[8]
• All leases on-balance sheet: lessee will recognize a right-of-use (ROU) asset and lease liability
– Type A leases will be treated as the purchase of an asset on a financed basis
– Type B leases generally will have straight-line recognition of total lease expense</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.

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="3">Lessor Accounting Model</td><td colspan="2">• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria
• Type B accounting model based on IAS 17 operating lease accounting
• Type A accounting model based on IAS 17 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 for Type A classification only due to involvement by third parties other than the lessee</td><td>– There will be no restriction on recognizing selling profit on commencement of Type A leases</td></tr>
<tr><td>• Existing leveraged leases will be grandfathered from application of 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</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 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>
<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
• 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 Type A lease for which selling profit is recognized at lease commencement
• Lessors will include initial direct costs for Type A leases
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• Lessors will capitalize initial direct costs for Type B 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 Type A lease for which selling profit will be recognized at lease commencement
• Lessors will reassess the discount rate when there is a lease modification</td></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</td><td>• Lessees will reassess variable lease payments based on an index or rate when:</td></tr>
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<tr><td></td><td>other reasons (e.g., a reassessment due to a change in the lease term)</td><td>– 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 recognition 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
– 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 as 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</td></tr>
<tr><td>Lease Modifications</td><td colspan="2">• 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 of the lease
• 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</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></td><td colspan="2">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, 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:
– Type B lease modifications will be treated as a new lease with any prepaid or accrued rent on the original lease considered part of the lease payments for the new lease
– Type A lease modifications will be accounted for under the financial instruments requirements in U.S. GAAP or IFRS as applicable</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 lessee accounting proposals
– The sublease will be accounted for in accordance with the lessor accounting proposals
• 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 expense from a head lease unless it meets the requirements for offsetting in other U.S. GAAP or IFRS as applicable (e.g., the new revenue recognition standard)[9]</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>

[9] Members of both Boards believe it is unlikely that sublease® income and head lease expense will qualify to be offset if the sublease is classified as a Type B 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="5">Sale-Leaseback Transactions</td><td colspan="2">Determining Whether a Sale has Occurred
• A sale and leaseback of the underlying asset will be recognized if the requirements for sale recognition in the new revenue recognition standard are met. The existence of the leaseback will not, on its own, result in a conclusion that control of the asset had not been conveyed to the buyer-lessor.</td></tr>
<tr><td>• If the leaseback would be classified as a Type A lease by the seller-lessee, then sale recognition will be precluded
• A repurchase option held by the seller-lessee in a sale and 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 Type A ROU assets and lease liabilities either as separate line items on the balance sheet or disclose separately in the notes to the financial statements
– If not separately presented on the balance sheet lessees will:
Present Type A 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 Type A ROU assets and lease liabilities are included and their amounts</td></tr>
<tr><td>Lessees will not include Type B ROU assets and lease liabilities in the same line items as Type A 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 Type B ROU assets and lease liabilities are included and their amounts</td><td>N/A – no Type B lease classification</td></tr>
</table>

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
Lessee Presentation – Statement of Cash Flows	• Lessees will classify cash paid for: – Principal on Type A lease liabilities as financing activities – Interest on Type A lease liabilities as operating activities – Type B leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities	• 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 IAS 7[10] – 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
Lessee Disclosures	• *Objective*: Enable financial statement users to understand the amount, timing, and uncertainty of cash flows arising from leases	
	• 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; and – Whether an accounting policy election was made for the short-term lease exemption	• Lessees will disclose other information, in addition to the quantitative disclosures, in sufficient detail to satisfy the lessee disclosure objective

[10] 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 Type A 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 expense (when lease term > 30 days) – Variable lease expense – Sublease income – Gains (losses) on sale-leaseback transactions	
	– Type B lease expense – N/A – Cash paid for lease payments, separately for Type A and Type B leases and segregated between operating and financing cash flows – Supplemental noncash information on lease liabilities exchanged for ROU assets, separately for Type A and Type B leases – Weighted-average remaining lease term, separately for Type A and Type B leases – Weighted-average discount rate for Type B leases as of the balance sheet date	– N/A – Small-ticket lease expense – Total cash outflow for leases – N/A
	– A maturity analysis of lease liabilities for each of the first 5 years after the balance sheet	– A maturity analysis of lease liabilities in accordance with IFRS 7, separate from the

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	date and in total thereafter, including a reconciliation of undiscounted cash flows to lease liabilities on the balance sheet	maturity analysis for other financial liabilities
Lessor Presentation	• Lessors will present lease assets and liabilities and income and expense consistent with the current guidance in IAS 17 • 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; and • 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 Type A leases) and b) the undiscounted future lease payments (for Type B leases) for each of the first five years and a total of the amounts thereafter. For Type A 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.	
	Type B Leases • General property, plant, and equipment disclosures for assets subject to Type B leases by significant class of underlying asset separately from those disclosures for the lessor's other owned assets	

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	Type A Lease	
	• An explanation of the significant changes in the components of net investment in Type A leases other than the lease receivable during the reporting period	• A qualitative and qualitative explanation of the significant changes in the net investment in Type A leases during the reporting period
Lessee 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	• Fully 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 component of equity, as appropriate)
	• Lessees may elect certain specified reliefs, which must be elected as a package and applied to all leases.	• N/A
	• 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.	• N/A
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

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
		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 IAS 17 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.	• N/A

KPMG
cutting through complexity

Defining Issues®

March 2014, No. 14-17

FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting

At their March 18-19 meeting to redeliberate the proposals in their 2013 exposure drafts (EDs) on lease accounting, the FASB and the IASB (Boards) could not agree on how lessees and lessors should depict their leasing activities for financial reporting purposes.[1] Because the Boards' redeliberations are not yet complete, their decisions from the meeting could change before a final standard is issued. However, the members of both Boards appeared entrenched in their views.

Key Facts

The Boards made dramatically different decisions about key aspects of their leases project.

Lessee Accounting

- The FASB decided to retain the EDs' proposed dual model for lessee accounting, but to change the lease classification test for all types of underlying assets to be similar to the existing requirements of IAS 17, which are similar to the classification requirements in existing U.S. GAAP but without explicit bright lines.[2] Under U.S. GAAP, most leases would qualify for the EDs' proposed Type B lessee model (which is described in the section on *Lessee Accounting*) with generally straight-line recognition of total non-contingent lease expense as a result.
- The IASB rejected the EDs' proposed dual model approach in favor of a single lessee accounting model based on the EDs' Type A lessee model (which is described in the section on *Lessee Accounting*). As a result, under IFRS, leases would only qualify for straight-line recognition of total non-contingent lease expense if they are eligible for one of the targeted reliefs such as the exceptions for short-term and small-ticket leases.

Contents

[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org. For more information about the Boards' 2013 proposals, see KPMG's Defining Issues No. 13-24, FASB and IASB Issue Revised Exposure Drafts on Lease Accounting, and Issues In-Depth No. 13-3, Implications of the Revised FASB and IASB Exposure Drafts on Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network.

[2] IAS 17, Leases.

Lessor Accounting

- The IASB decided to retain a version of the existing IAS 17 lease classification requirements for lessors for all types of underlying assets, rather than the EDs' proposed lessor lease classification guidance. Under IFRS, most leases would qualify for the EDs' proposed Type B lessor accounting with generally straight-line recognition of total non-contingent lease income as a result, similar to current operating lease accounting.
- The FASB decided to replace the EDs' proposed lessor lease classification guidance for all types of underlying assets with a classification test similar to that in IAS 17 (which is similar to the classification requirements in existing U.S. GAAP but without explicit bright lines), with one important twist. Under U.S. GAAP, recognition of selling profit at lease commencement would be precluded for any lease that meets the criteria for finance lease classification only as a result of involvement by a third party other than the lessee (e.g., a third-party residual value guarantor). The FASB believes this will substantially align the requirements for recognition of up-front profit in a lease with the requirements in the Boards' forthcoming revenue recognition standard.[3]
- Both Boards decided to replace the EDs' proposed Type A lessor receivable and residual accounting model (which is described in the section on *Lessor Accounting*) with the IAS 17 finance lease accounting model.

Targeted Reliefs

- The IASB decided to provide an explicit recognition and measurement exemption for leases of small-ticket items (e.g., office furniture, personal computers, etc.) but the FASB decided not to.
- The Boards agreed that leases could be accounted for on a portfolio basis in limited circumstances.
- The Boards agreed to expand the EDs' proposed short-term lease exemption to leases with a maximum lease term of 12 months for accounting purposes rather than a maximum contractual term of 12 months. This would allow some leases with renewal options to qualify for the short-term lease exemption.

Key Impacts

- Lessees applying IFRS will account for all property leases as Type A leases, which is significantly different than the accounting the EDs proposed.
- Most equipment leases will be accounted for as Type B leases under U.S. GAAP, which is significantly different than the accounting the EDs proposed.
- The decisions on lessee accounting in particular result in non-convergence for a critical aspect of this project.
- Lessor accounting will be similar to current practice in response to feedback from financial statement users indicating that current lessor accounting generally is useful without significant change.

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[3] FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers, November 14, 2011, available at www.fasb.org, and IASB ED/2011/6, Revenue from Contracts with Customers, November 2011, available at www.iasb.org.

- Lessors applying U.S. GAAP will be prohibited from recognizing selling profit at lease commencement in some cases, even if the fair value of the underlying asset exceeds its carrying amount and the criteria for finance lease classification are met at lease commencement.

Background

Since issuing the EDs, the Boards have received over 600 comment letters and have held subsequent outreach meetings to listen to the concerns of investors, analysts, regulators, and preparers. At their November 2013 meeting the Boards discussed plans for future redeliberations that focused on the following significant issues:

- The lessee model, lessor model, lease classification, and scope simplifications;
- Measurement, specifically the lease term, reassessment of variable lease payments, in-substance fixed payments, residual value guarantees, and discount rate;
- Scope, specifically the definition of a lease, separating lease and non-lease components, and scope exclusions;
- Sale and lease-back transactions;
- Presentation and disclosure; and
- Transition.

At the January 2014 meeting, the Boards were presented with alternative ways forward for:

- Lessee accounting;
- Lessor accounting, including lease classification and the lessor accounting model; and
- Small-ticket leases.

At the March 2014 meeting, the Boards made significant decisions on each of these issues. In addition, the Boards considered alternative ways forward for:

- Lease term; and
- Renewal and purchase option reassessments.

This edition of *Defining Issues* provides a summary of the Boards' decisions, including examples of their potential impacts.

Lessee Accounting

The discussions took as a given that leases should be on-balance sheet for lessees. The focus was on whether to retain a dual model for lessee accounting and, if so, the lease classification test.

The EDs proposed a dual model approach for lessee accounting, under which a lessee would classify each lease as either Type A or Type B. The proposed lease classification test was based on the nature of the underlying asset and the extent to which it was consumed during the lease term. Broadly, most leases in which the underlying asset was not property – i.e., not land or a building – would be classified as Type A; most property leases would be classified as Type B.

For all leases other than short-term leases, a lessee would recognize a right-of-use (ROU) asset for its right to use the underlying asset during the lease term and a lease liability for its obligation to make lease payments based on the present value of the lease payments. Subsequently, the lessee would measure the lease liability at amortized cost. However, subsequent accounting for the ROU asset and presentation of lease expense would depend on whether the lease was classified as Type A or Type B.

- For Type A leases, the lessee would measure the ROU asset at amortized cost and would typically amortize the ROU asset on a straight-line basis. The lessee would recognize amortization of the ROU asset and interest expense on the lease liability separately in profit or loss. Overall, the lessee would typically recognize a front-loaded pattern of total non-contingent lease expense.
- For Type B leases, the lessee would recognize total non-contingent lease expense generally on a straight-line basis over the lease term, and present this as a single expense in profit or loss. To achieve this accounting outcome, the lessee would plug the measurement of the ROU asset.

There was no consensus among constituents on the proposed dual model for lessees. Many favored the Type B lease accounting model because they believed that the straight-line profile of lease expense better reflected the economics of some leases – especially property leases. Some supporters of the Type B model wished to apply it to a wider range of leases. Other constituents questioned whether there was any conceptual basis for the Type B model. Many also raised concerns about the costs and complexity of the new proposed classification tests, noting that new accounting systems would be required and that applying the tests would require increased management judgment.

At the March 2014 meeting, the Boards discussed alternative approaches to lessee accounting and ultimately decided not to converge U.S. GAAP and IFRS. The IASB opted for a single model based on the EDs' proposed Type A model, in which lessees would recognize amortization of the ROU asset separately from interest on the lease liability.

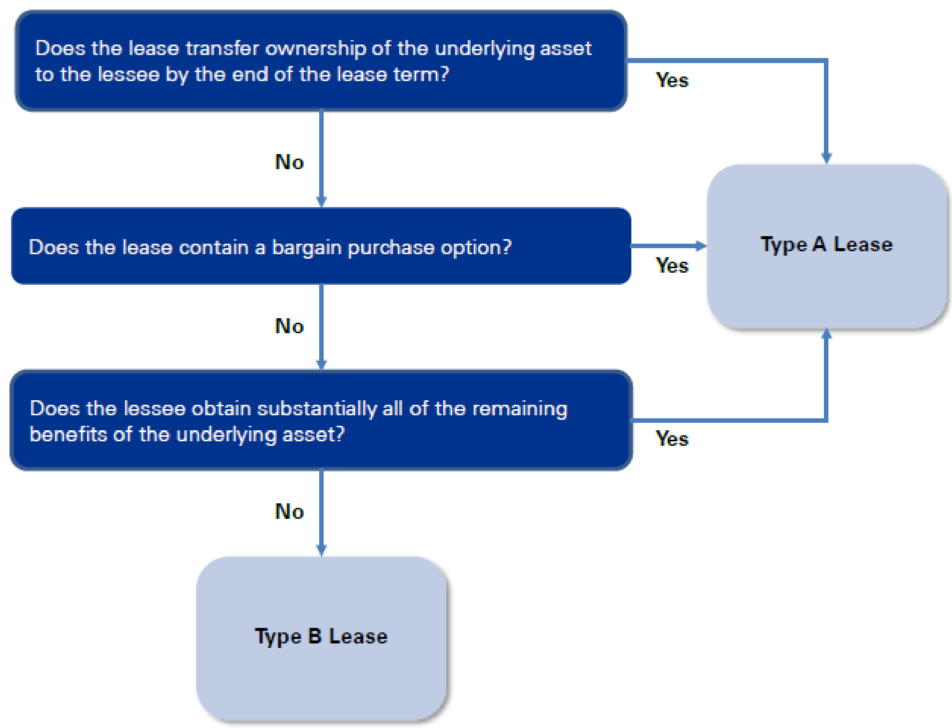
The FASB decided to retain the EDs' proposed dual model. However, the FASB decided to replace the EDs' proposed lease classification approach for all types of underlying assets with a classification test similar to that in IAS 17, which is similar to the classification requirements in existing U.S. GAAP but without explicit bright lines. Specifically, leases would be classified as Type B unless any of the following conditions are met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lessee has a purchase option that is reasonably certain to be exercised based on consideration of economic factors (i.e., a bargain purchase option);
- The lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease.

Factors that may indicate the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include:

- A lease term that is for a major part of the remaining economic life of the underlying asset;
- Lease payments with a present value that is substantially all of the fair value of the underlying asset;
- An underlying asset of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If it is clear that notwithstanding these indicators the lessee would not obtain substantially all of the remaining benefits of the underlying asset as a result of the lease (e.g., because the fair value of the asset is expected to appreciate over the lease term) this criterion would not be met.



Leases that include a land element would require separate classification of the land element unless it is clearly immaterial. Leases not classified as Type B leases would be classified as Type A leases. This approach is similar to determining whether a lease is effectively an installment purchase by the lessee. Under this approach, a lessee applying U.S. GAAP would account for the vast majority of existing capital leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

KPMG Observations

Under both U.S. GAAP and IFRS, the core results of the lessee ROU model – i.e. recognizing all leases on-balance sheet – will represent a consistent change from today's lease accounting. However, the Boards' differing approaches will cause significant differences in the measurement and presentation of lease expense, with consequential impacts on the balance sheet.

The Boards' divergence on fundamental aspects of lessee accounting is unfortunate after nearly 8 years of joint effort on the project. There are no jurisdictional differences in leasing transactions that the Boards have identified to justify differences in lessee accounting. The Boards' staff asserted that for organizations with large revolving portfolios of leases with differing terms, the results of applying the different lessee accounting models may be substantially the same, other than the presentation in the income statement. However, in light of the divergent decisions by the FASB and IASB, it appears that for financial statement users, performing comparisons of companies with significant leasing activities may become a rather messy exercise that is more difficult than it is under current accounting requirements if some of the companies apply U.S. GAAP and others apply IFRS.

The FASB approach would preserve the EDs' proposed straight-line recognition of total lease expense for Type B leases, and expand it to a wider population of leases because classification would not be based on the nature of the underlying asset as proposed in the EDs. Instead, the classification test would be similar to the existing IAS 17 classification tests, which are similar to the classification requirements in existing U.S. GAAP, but without explicit bright lines. This is likely to increase the level of judgment involved in evaluating lease classification as compared to current U.S. GAAP.

The IASB approach would not require the lease classification judgments that would be required under the FASB approach and therefore may be less susceptible to error. However, the IASB approach will not allow for the Type B straight-line recognition of total lease expense that many constituents asserted better reflects the economics of certain leases, notably many real estate leases. IASB members provided an example to FASB members similar to Example 1 in the Appendix illustrating the basis for their view that Type B lease accounting may not faithfully depict the economic result of a leasing transaction, depending on the timing of the rent payments in the lease contract.

Lessor Accounting

Classification Tests. The Boards discussed lease classification and lease accounting by lessors, including whether to retain key aspects of current accounting practice.

The EDs proposed that lessors would apply the same classification requirements as lessees, which would be based on the nature of the underlying asset and the extent to which the asset is consumed over the lease term. For Type A leases, the EDs proposed that the lessor would apply a new, complex model under which it would derecognize the underlying asset and recognize a lease receivable and a residual asset. For Type B leases, the lessor would account for the lease similar to operating lease accounting under current U.S. GAAP or IFRS.[4]

Most constituents, including financial statement users, indicated that they do not consider symmetry between lessee and lessor accounting to be a high priority. Some constituents felt that lessors should classify more leases as Type B – e.g., leases of ships and heavy equipment that would be classified as Type A under the proposals. In general, most users did not support the proposals, as they believed that lessor accounting works well in practice and do not adjust financial statement results for current lessor accounting requirements.

At the March 2014 meeting, the IASB decided on a dual model approach that would determine lessor lease classification (Type A versus Type B) based on whether the lease is effectively a financing or a sale, rather than an operating lease (i.e., an approach that would be generally consistent with the current requirements of IAS 17). A lessor would make that determination by assessing whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Specifically, leases would be classified as Type B unless any of the following conditions are met:

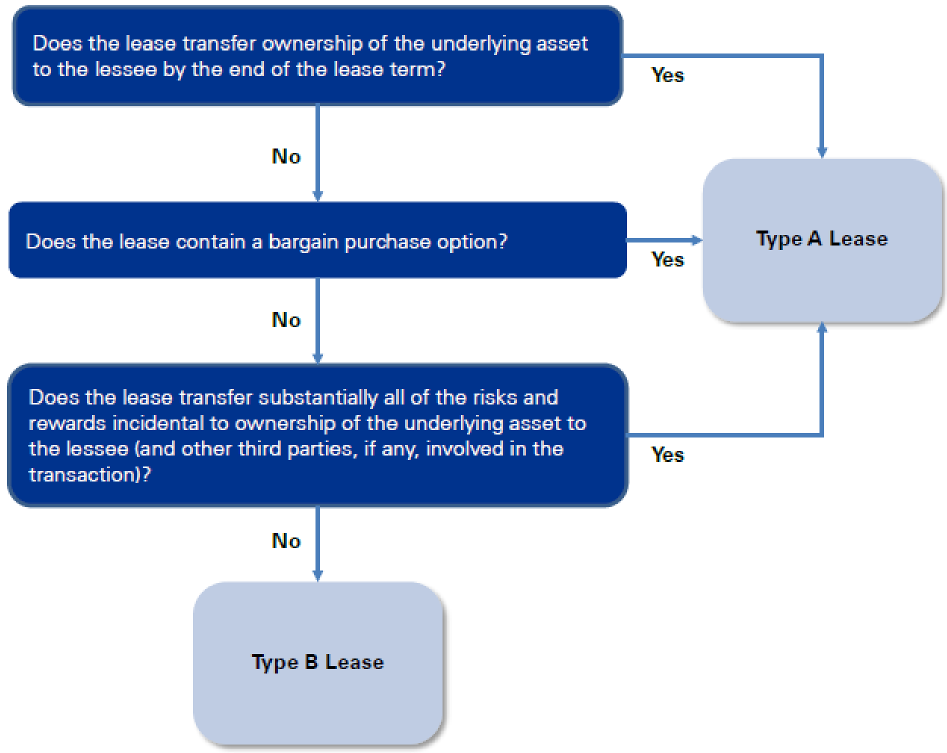
- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lessee has a purchase option that is reasonably certain to be exercised based on consideration of economic factors (i.e., a bargain purchase option);
- The lease otherwise transfers substantially all of the risks and rewards incidental to ownership of the underlying asset to the lessee (and other third parties, if any, involved in the transaction).

Factors that may indicate the lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset include:

- A lease term that is for a major part of the remaining economic life of the underlying asset;
- Lease payments and third-party residual value guarantees (if any) with a present value that is substantially all of the fair value of the underlying asset;
- An underlying asset of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term (e.g., when the lessor would incur significant economic losses to direct the asset to another use).

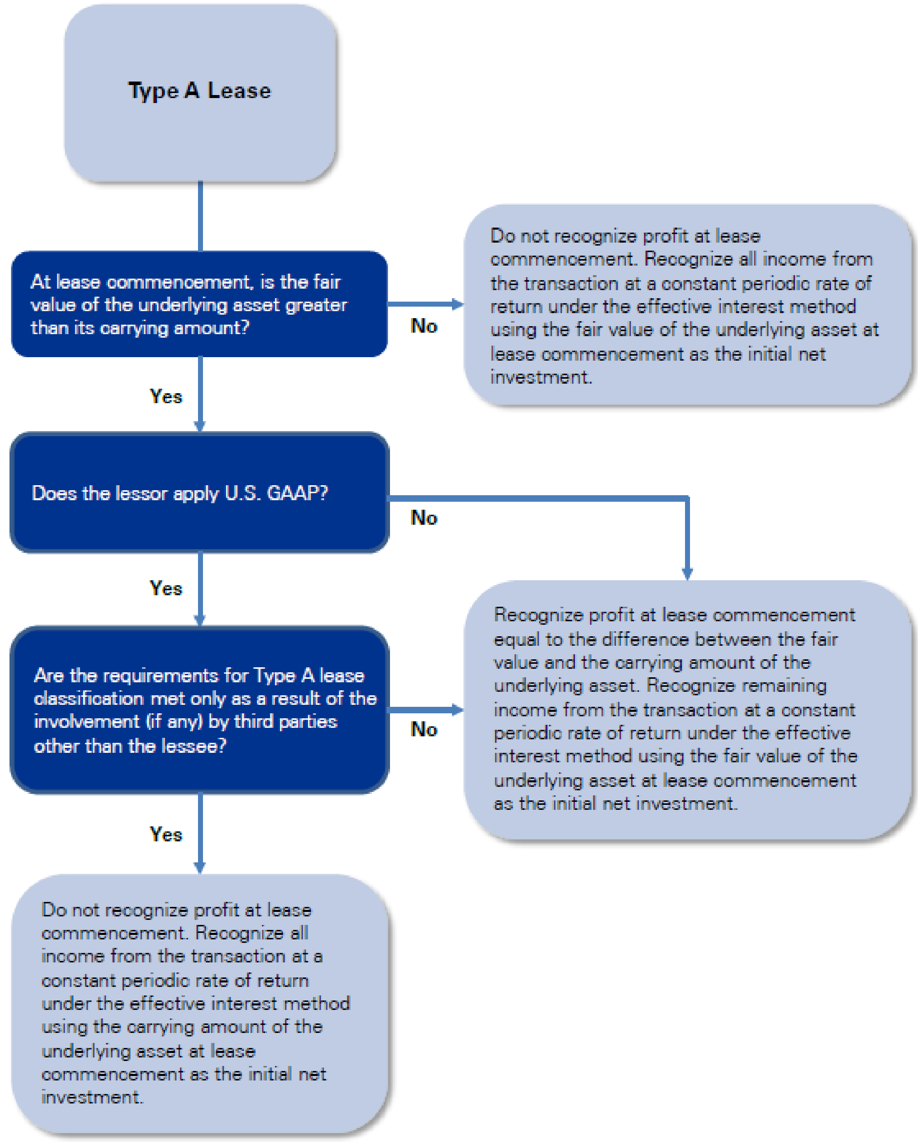
If it is clear that notwithstanding these indicators the lease does not transfer substantially all of the risks and rewards incidental to ownership of the underlying asset (e.g., because the fair value of the asset is expected to appreciate over the lease term) this criterion would not be met.

[4] FASB ASC Topic 840, Leases, available at www.fasb.org, and IAS 17, Leases.



Leases that include a land element would require separate classification of the land element unless it is clearly immaterial. Leases not classified as Type B leases would be classified as Type A leases. Under this approach, a lessor would account for the vast majority of existing finance leases as Type A leases, and the vast majority of existing operating leases as Type B leases.

The FASB decided on a similar approach, except that it decided to preclude recognition of selling profit at lease commencement for any lease that meets the criteria for Type A lease classification only as a result of involvement by a third party other than the lessee. Third-party residual value guarantees, buy-back arrangements, and similar features that result in a reduction of risk to the lessor are examples of features that would be considered for this purpose. This is intended to substantially align the requirements for recognition of up-front profit in a lease with the requirements in the Boards' forthcoming revenue recognition standard. The amount of profit that does not qualify for up-front recognition in such leases would be recognized as additional interest income using a constant effective yield over the lease term as illustrated in Example 2 in the Appendix.



KPMG Observations

The decision to base the lessor lease classification test on an approach generally consistent with the current requirements of IAS 17 will significantly reduce the cost and complexity of applying the proposals for lessors as it will limit the extent of necessary changes to systems and processes required to assess lease classification. In many cases, a lease that is currently classified as a direct financing or sales-type lease under U.S. GAAP (finance lease under IFRS) would be classified as a Type A lease, and a lease that is currently classified as an operating lease would be a Type B lease. However, as the existing classification bright lines in U.S. GAAP will be eliminated, additional judgment will be required to classify a lease and it will be important to assess whether there may be reclassifications on transition. Leveraged lease classification will be eliminated under U.S. GAAP and these leases will likely be classified as Type A leases.

The IASB decision to have a dual model for lessor accounting, but a single model for lessees will result in significant changes to the accounting by intermediate lessors – i.e., entities that lease an asset from a head lessor and lease the same asset to another party under a sublease – and to the accounting for lease-leaseback transactions. It will also increase the complexities associated with intra-group leases, especially when individual entities within a group are required to file separate financial statements and are taxed separately.

Lessor Accounting Model. The EDs proposed that lessors apply a complex new model to Type A leases. Under this model, a lessor would derecognize the underlying asset and recognize a:

- Lease receivable – representing its right to receive lease payments from the lessee; and
- Residual asset – representing its interest in the underlying asset at the end of the lease term.

Many constituents questioned whether a new lessor accounting model was necessary. Some expressed specific concerns about the cost and complexity of applying the proposed Type A model, including the:

- Judgment required to estimate the value of the residual asset and the sensitivity of income recognition to this estimate;
- Complexity involved in accounting for variable lease payments; and
- Different impairment tests for the lease receivable and the residual asset.

At the March 2014 meeting, the Boards decided to replace the EDs' proposed Type A lessor accounting model with the IAS 17 finance lease accounting model (modified for lessors applying U.S. GAAP as indicated in the discussion of lease classification). The Boards expect this will reduce cost and complexity. It also will significantly reduce the extent of change to lessor accounting generally, given the EDs' proposal for lessors to apply a model similar to IAS 17 operating lease accounting for Type B leases.

KPMG Observations

Retention of the IAS 17 lessor accounting model for Type A leases is consistent with the Boards' overall decision not to make significant changes to lessor accounting. Taken together with the Boards' decision that lessors should apply a lease classification test based on current IAS 17, and the similarity of the lessor accounting model for Type B leases to current operating lease accounting, the changes to lessor accounting will be modest. This reflects user feedback that lessor accounting under current GAAP works well in practice.

However, it would be inaccurate to characterize the project as a 'lessee-only' project. There are still various proposals that will affect lessor accounting, including the identification of a lease, sale-leaseback accounting, and disclosure requirements.

Lease Term and Purchase Options

The EDs proposed that the lease term would be the non-cancelable period of the lease, together with:

- The period(s) covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; or
- The period(s) covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

The EDs proposed that when making an assessment of whether the lessee has a significant economic incentive to either exercise an option to extend a lease, or not exercise an option to terminate a lease, an entity would consider contract-based, asset-based, entity-based, and market-based factors. The exercise price of purchase options would be included in lease payments when the lessee has a significant economic incentive to exercise the option based on the same factors that apply to the significant economic incentive for lease term options.

Many constituents noted that substantial judgment and effort would be required to apply the concept of *significant economic incentive*. Lessors were particularly concerned because they would be required to make the assessment from the perspective of the lessee. Constituents suggested that the Boards keep the "reasonably assured" or "reasonably certain" thresholds as currently used in Topic 840 and IAS 17, if the intent is the same.

At the March 2014 meeting, the Boards decided that the lease term should include optional periods when it is reasonably certain that the lessee will exercise its option to lease the asset during those periods based on consideration of the economic factors described in the EDs. The determination of whether to include purchase option exercise prices in lease payments will be evaluated using the same test. The Boards indicated that they will not use the term *significant economic incentive* as they do not intend to change the high threshold in existing U.S. GAAP and IFRS for inclusion of optional periods in the lease term and purchase option strike prices in lease payments. However, they will retain the EDs' clarifying guidance about the economic factors to be considered in evaluating the likelihood that lease term or purchase options will be exercised.

KPMG Observations

The IFRS reasonably certain threshold is applied in practice in a manner that is equivalent to the reasonably assured threshold in U.S. GAAP. Confirmation that the Boards do not intend to change the high threshold in existing GAAP for recognition of renewal and purchase options will reduce the cost and complexity for entities, including on transition. It is also likely to result in more consistent application of the threshold.

Reassessments. The EDs proposed that lessees and lessors would be required to reassess the lease term and likelihood of purchase option exercise if:

- There is a change in relevant factors that affect the assessment of whether the lessee has a significant economic incentive to exercise one or more options in the lease contract; or

- The lessee either (a) elects to exercise a renewal or termination option for which previously it was determined the lessee did not have a significant economic incentive to exercise; or (b) elects *not* to exercise a renewal or termination option for which previously it was determined the lessee had a significant economic incentive to exercise.

At the March 2014 meeting the Boards decided that lessees would be required to reassess the lease term and likelihood of purchase option exercise if there is a significant event or change in circumstances in relation to the lease as a result of actions that are taken by the lessee. Examples of such events or circumstances include:

- Construction of significant leasehold improvements;
- Making significant modifications or customizations of the underlying asset; and
- Subleasing the underlying asset for a period beyond the exercise date of a renewal option in the lease.

The Boards decided that lessors would not be required or permitted to perform reassessments of the likelihood of option exercise.

KPMG Observations

The Boards' decision to limit reassessments to lessee-controlled events will reduce the potentially significant changes in reported profits and losses which could have arisen under the EDs' reassessment proposals. The elimination of these requirements for lessors will further align the lessor proposals with current practice.

Small-Ticket Leases and Short-Term Leases

The Boards discussed a variety of options to simplify the EDs' application to small-ticket leases, ranging from revisions to the proposed exception for short-term leases, to new guidance on materiality and portfolios of leases. The staff described small-ticket leases as those that are small in value or secondary to an entity's business operations.

The EDs proposed that lessees and lessors could elect to apply a simplified approach to short-term leases (i.e., leases with a maximum contractual term, including renewal options, of 12 months or less). Any lease that contains a purchase option would not be a short-term lease. Under this simplified approach, the lessee/lessor would recognize lease payments as expense/ income in profit or loss, similar to current operating lease accounting.

Many constituents welcomed the proposed relief but noted that substantial effort would be required to identify and analyze the key terms of leases to assess whether they qualified for the simplified approach. Many also felt that the simplified approach should be available to a wider range of leases to reduce the costs of implementing the proposals. Constituents suggested a variety of ways to extend the simplified approach to more small-ticket leases. The Boards discussed alternative options for expanding the circumstances in which a lessee could apply the simplified approach to reduce the costs of implementing the proposals.

At the March 2014 meeting, the Boards:

- Agreed to expand the EDs' proposed short-term lease exemption to leases with a maximum lease term (as assessed at lease commencement) of 12 months for accounting purposes rather than a maximum contractual term of 12 months. This would allow leases with renewal options to qualify for the short-term lease exemption provided that:
  - There is not a purchase option that is reasonably certain to be exercised;
  - The minimum contractual lease term is not greater than 12 months; and
  - It is not reasonably certain, based on economic considerations, that the lessee will exercise options to extend the lease term beyond 12 months.
- Agreed that aspects of the proposals could be applied at a portfolio level when there is a reasonable expectation that portfolio-level accounting would not differ materially from applying the standard to individual leases, consistent with the guidance in the forthcoming revenue standard. The IASB decided to include application guidance to that effect in the standard, while the FASB decided to acknowledge it in the basis for conclusions.
- Agreed not to provide specific materiality guidance with respect to leasing transactions in the final standard.

The Boards also discussed whether to provide a scope exclusion for leases of assets with a small value (i.e., small-ticket items). The IASB decided to develop further a scope exception for leases of underlying assets that are individually small in value when new. The IASB indicated that this exception is intended to capture leases such as those of small IT equipment (e.g., laptops, desktops, tablets, mobile phones, individual printers, etc.) and office furniture. The exception would not be intended to capture underlying assets such as automobiles and most photocopiers. The exception would be applied without regard to the materiality – individually or in aggregate – of the leases to the reporting entity.

The FASB decided not to provide a scope exception for small-ticket leases because current guidance on materiality would permit entities to exclude from the scope of the proposed guidance any leases, including leases for small-ticket items, that would not be material to the financial statements. However, the FASB directed its staff to perform further research about the impact of small-ticket leases on reporting entities applying U.S. GAAP.

KPMG Observations

Short-Term Leases

The Boards' decision on the short-term lease exemption will expand the population of leases eligible for the exemption to include month-to-month, evergreen, and other leases for which it is not reasonably certain that the lessee will renew the lease beyond 12 months.

Aligning the definition of a short-term lease to be consistent with the guidance on lease term may increase the sensitivity of the judgment to be made in evaluating the lease term. Whereas the EDs proposed a bright-line test of a maximum contractual term of 12 months for a lease to qualify for the short-term exemption, entities will now need to analyze all relevant economic factors (e.g. contract-based, market-based, asset-based, and entity-based) to determine whether leases are eligible for the short-term exemption. As a result, the revised exemption may attract more structuring efforts.

The new disclosure requirements for short-term leases may reduce some of the benefits associated with the exemption, as entities will still be required to track such leases to compile the disclosures. In addition, due to the level of judgment required in determining the lease term for such leases, they may become subject to the same process and control requirements as all other leases, which may further reduce the benefits of applying the exemption.

The Boards did not discuss the short-term lease exemption for lessors. Many leases that qualify for the exemption for lessees would be classified as Type B leases by lessors, such that lessors would apply similar accounting whether or not they applied the exemption.

Small-Ticket Leases

It is currently unclear what factors an entity applying IFRS would consider to make the determination of whether an item is eligible for the small-ticket exemption, other than an item being "small" in nature – though the IASB does not seem inclined to provide a specific quantitative threshold. There is a risk that the relief may not be applied consistently, and that arrangements may be structured in order to take advantage of the exemption.

Some constituents may be surprised that an entity would not be required to assess whether items eligible for the exemption are material in the aggregate. This could have a significant effect on certain industries – e.g., a telemarketing firm that leases a large number of phones and low value IT equipment. In turn, this may complicate the comparison of financial statements of entities

in such industries reporting under IFRS and U.S. GAAP, given the FASB's decision not to provide the exemption.

Portfolio Approach

The decision to permit a portfolio approach aligns with the Boards' forthcoming revenue standard and may also help to reduce costs. For example, an entity may be able to use the same judgment to determine the discount rate and lease term for all similar items leased under a master lease agreement. However, judgment will be required in order to determine when a portfolio-level approach can be used. One practical question may be what level of analysis is necessary to demonstrate that there is a reasonable expectation that portfolio-level accounting would not differ materially to applying the requirements to individual lease contracts.

Appendix – Examples

Example 1: Simple Equipment Lease

This example reflects the EDs' proposals, updated for the Boards' March 2014 discussions.

Facts

- Lessee and Lessor enter into a transaction to lease an automobile for a non-cancelable 3-year lease term with no renewal options;
- The lease does not contain a purchase option or an automatic transfer of title;
- The automobile has a remaining economic life of 5 years and a fair value of $30,000 at lease commencement;
- The rate Lessor charges Lessee is 5% and can be readily determined by Lessee (if the rate Lessor charges Lessee cannot be readily determined, Lessee would use its incremental borrowing rate);
- There are no initial direct costs incurred by Lessee; and
- The lease payments have a present value of $24,000 when discounted at 5%.

Lease Classification

Under the IASB single-model approach, Lessee would not perform a lease classification test and would account for this lease as a Type A lease.

Under the FASB dual-model approach, Lessee would classify and account for this lease as a Type B lease. This is because there is no transfer of ownership at the end of the lease, there is no purchase option, the lease term is not for a major part of the remaining economic life of the underlying asset, the present value of the lease payments is not substantially all of the fair value of the underlying asset, and the underlying asset is expected to have alternative uses to Lessor at the end of the lease term.

Lessee Accounting – Type A Lease

Lessee would recognize a ROU asset and, if it has an obligation to make future lease payments (i.e., if all payments are not made at lease commencement), a lease liability. Lessee would initially measure the ROU asset at $24,000 (i.e., the present value of the lease payments discounted at 5%). Initial measurement of the lease liability would be equal to the present value of the lease payments (if any) to be made after lease commencement. Lessee would subsequently measure the lease liability (if any) at amortized cost using the effective interest method. Lessee would subsequently amortize the ROU asset each period on a straight-line basis, consistent with the amortization of other non-financial assets. As a result, the pattern of total lease expense would depend on the timing of the lease payments, consistent with the accounting for other non-financial assets that are acquired with the proceeds of debt financing.

Lessee Accounting – Type B Lease

Lessee would recognize a ROU asset and, if it has an obligation to make future lease payments (i.e., if all payments are not made at lease commencement), a lease liability. Lessee would initially measure the ROU asset at $24,000 (i.e., the present value of the lease payments discounted at 5%). Initial measurement of the lease liability would be equal to the present value of the lease payments (if any) to be made after lease commencement. Lessee would subsequently measure the lease liability (if any) at amortized cost using the effective interest method and would recognize total lease expense (including both interest and amortization of the ROU asset) on a straight-line basis in the statement of comprehensive income. Lessee would subsequently measure the amortization of the ROU asset each period as a balancing amount, which would be calculated as the greater of zero or the periodic straight-line lease expense minus interest on the lease liability for the period.

The following tables summarize the amounts arising in Lessee's statement of financial position and statement of comprehensive income under various payment scenarios based on whether the lease is accounted for as a Type A lease (IFRS) or a Type B lease (U.S. GAAP).

Scenario 1 – Lease Payments Fully Prepaid at Lease Commencement

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$ -	$ -	$ -	$ -
1	16,000	-	8,000	-	8,000
2	8,000	-	8,000	-	8,000
3	-	-	8,000	-	8,000
	Totals		**$24,000**	**$ -**	**$24,000**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$ -	$ -	$ -	$ -
1	16,000	-	8,000	-	8,000
2	8,000	-	8,000	-	8,000
3	-	-	8,000	-	8,000
Totals			**$24,000**	**$ -**	**$24,000**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

In Scenario 1 the total lease expense for each period is the same under Type A and Type B accounting because the lease payments are fully prepaid.

Scenario 2 – Single Payment at End of Year 2

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,000	25,200	8,000	1,200	9,200
2	8,000	-	8,000	1,260	9,260
3	-	-	8,000	-	8,000
Totals			**$24,000**	**$2,460**	**$26,460**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,380	25,200	7,620	1,200	8,820
2	8,820	-	7,560	1,260	8,820
3	-	-	8,820	-	8,820
Totals			**$24,000**	**$2,460**	**$26,460**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

Under Type B lease accounting, the ROU asset would be amortized each period by the straight-line lease expense amount minus interest on the lease liability for the period. For year 1, the amortization of the ROU asset would be calculated as $8,820 – $1,200 = $7,620. The ROU asset would then be adjusted by this amount to calculate the year 1 ROU asset closing balance ($24,000 – $7,620 = $16,380).

In Scenario 2 the periodic amortization expense is the same for Type A accounting as it is under Scenario 1. The additional cost that arises due to the timing of the payment is reported as a periodic expense related to the time value of money under Type A accounting.

Conversely, under Scenario 2, amortization expense for Type B accounting is lower in the first two years of the lease than it is under Scenario 1 and higher in the final year of the lease than it is under Scenario 1 because the total cost of the lease is allocated to the reporting periods on a straight-line basis.

Scenario 3 – Single Payment at End of Lease

Type A (IFRS)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,000	25,200	8,000	1,200	9,200
2	8,000	26,460	8,000	1,260	9,260
3	-	-	8,000	1,323	9,323
	Totals		**$24,000**	**$3,783**	**$27,783**

Type B (U.S. GAAP)

	Statement of financial position		Statement of comprehensive income		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$24,000	$ -	$ -	$ -
1	15,939	25,200	8,061	1,200	9,261
2	7,938	26,460	8,001	1,260	9,261
3	-	-	7,938	1,323	9,261
	Totals		**$24,000**	**$3,783**	**$27,783**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

In Scenario 3 the periodic amortization expense is the same for Type A accounting as it is under Scenario 1. The additional cost that arises due to the timing of the payment is reported as a periodic expense related to the time value of money under Type A accounting.

Conversely, under Scenario 3, amortization expense for Type B accounting is higher in the first two years of the lease than it is under Scenario 1 and lower in the final year of the lease than it is under Scenario 1 because the total cost of the lease is allocated to the reporting periods on a straight-line basis.

Scenario 4 – Equal Annual Payments at Beginning of Each Year

Type A (IFRS)

	Statement of financial position		**Statement of comprehensive income**		
End of year	ROU asset	Lease liability	Amortization expense	Interest expense	Total expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,000	16,387	8,000	780	8,780
2	8,000	8,394	8,000	400	8,400
3	-	-	8,000	-	8,000
Totals			**$24,000**	**$1,180**	**$25,180**

Type B (U.S. GAAP)

	Statement of financial position		**Statement of comprehensive income**		
End of year	ROU asset	Lease liability	Amortization expense*	Interest expense*	Total lease expense
0	$24,000	$24,000	$ -	$ -	$ -
1	16,387	16,387	7,613	780	8,393
2	8,394	8,394	7,993	400	8,393
3	-	-	8,394	-	8,394
Totals			**$24,000**	**$1,180**	**$25,180**

*Amortization and interest are shown solely for illustrative purposes; they would be combined and presented as a single lease expense in the statement of comprehensive income.

In Scenario 4 the periodic amortization expense is the same for Type A accounting as it is under Scenario 1. The additional cost that arises due to the timing of the payments is reported as a periodic expense related to the time value of money under Type A accounting.

Conversely, under Scenario 4, amortization expense for Type B accounting is lower in the first two years of the lease than it is under Scenario 1 and higher in the final year of the lease than it is under Scenario 1 because the total cost of the lease is allocated to the reporting periods on a straight-line basis.

IASB members expressed concerns about the results of applying Type B accounting in Scenarios 2–4 because the additional cost that arises due to the timing of the payments is allocated to the reporting periods on a basis that is unrelated to the time value of money. They expressed the view that Type B accounting results in a charge to the income statement that is too small in the first two years of the lease and too large in the final year of the lease under Scenarios 2 and 4, and a charge to the income statement that is too large in the first two years of the lease and too small in the final year of the lease under Scenario 3. Consequently, IASB members argued that the income statement does not faithfully depict the economic result of the lease under Type B accounting in Scenarios 2–4.

Example 2: Type A Lease With Third-Party Residual Value Guarantee

This example reflects the EDs' proposals, updated for the Boards' March 2014 discussions.

Facts

- Lessee and Lessor enter into a transaction to lease equipment for a non-cancelable 3-year lease term with no renewal options;
- The lease does not contain a purchase option;
- The equipment has an estimated remaining economic life of 5 years at lease commencement;
- The equipment has a fair value and a carrying amount of $40,000 and $36,000, respectively, at lease commencement;
- The equipment has an estimated residual value of $12,500;
- The lease payments are $10,500 per year (paid in arrears) and there are no variable lease payments;
- Lessor's implicit rate is 4.289% if the fair value of $40,000 is used as the initial investment and 9.314% if the carrying amount of $36,000 is used as the initial investment;
- Lessor obtains a residual value guarantee (RVG) from a third party with a net present value at lease commencement of $9,200;
- At lease commencement the present value of the lease payments is 95% of the initial fair value of the equipment with the RVG and 72% of the fair value of the equipment without the RVG (note that the full amount of the RVG is used for purposes of determining the present value of the lease payments with the RVG as required by the existing guidance in IAS 17); and

- There are no initial direct costs incurred by Lessor and no prepaid rent.

Lease Classification

Under the revised proposed lease classification tests, the lease would be classified as a Type A lease by Lessor because the present value of the lease payments, including the RVG, represents substantially all of the fair value of the equipment at commencement of the lease.

Lessor Accounting – Type A Lease with Selling Profit (FASB Approach)

In this transaction the fair value of the equipment exceeds its carrying amount at lease commencement. However, because the lease only qualifies for Type A classification as a result of the third-party RVG, any selling profit would be deferred at lease commencement and recognized as income over the lease term in a manner that produces, when combined with the interest income on the net investment in the lease, a constant periodic rate of return on the lease.

Lessor would recognize its net investment in the lease and would derecognize the underlying asset. Lessor would measure the net investment in the lease at the present value of the lease payments plus the present value of the residual value less deferred profit. Lessor also would recognize interest income on the net investment in the lease over the lease term using the effective interest method.

The table below summarizes the amounts arising in Lessor's statement of financial position and statement of comprehensive income under the FASB approach.

	Statement of financial position				**Statement of comprehensive income**			
End of year	Lease receivable	Residual asset	Deferred profit*	Net investment in lease	Interest on receivable†	Residual accretion†	Earned profit‡	Total income‡
0	$28,980	$11,020	$(4,000)	$36,000	$ -	$ -	$ -	$ -
1	19,722	11,493	(2,362)	28,853	1,242	473	1,638	3,353
2	10,068	11,986	(1,014)	21,040	846	493	1,348	2,687
3	-	12,500	-	12,500	432	514	1,014	1,960
	Totals				**$2,520**	**$1,480**	**$4,000**	**$8,000**

* Deferred profit is equal to the equipment's fair value minus its carrying amount ($40,000 - $36,000).

† Interest on the receivable and residual accretion are calculated using the rate implicit in the lease that is derived by using the equipment's fair value at lease commencement of $40,000 as the initial investment (i.e., 4.289%).

‡ Total income, including release of deferred profit, is allocated so that it is recognized at a constant rate equal to the rate implicit in the lease that is derived by using the equipment's carrying amount at lease commencement of $36,000 as the initial investment (i.e., 9.314%).

Lessor Accounting – Type A Lease with Selling Profit (IASB Approach)

The IASB approach is the same as the FASB approach except that there would be no deferral of the selling profit. The table below summarizes the amounts arising in Lessor's statement of financial position and statement of comprehensive income under the IASB approach.

	Statement of financial position			Statement of comprehensive income			
End of year	Lease receivable	Residual asset	Net investment in lease	Interest on receivable†	Residual accretion†	Earned profit**	Total income
0	$28,980	$11,020	$40,000	$ -	$ -	$4,000	$4,000
1	19,722	11,493	28,853	1,242	473	-	1,715
2	10,068	11,986	21,040	846	493	-	1,339
3	-	12,500	12,500	432	514	-	946
	Totals			**$2,520**	**$1,480**	**$4,000**	**$8,000**

** Earned profit recognized at lease commencement is equal to the equipment's fair value minus its carrying amount ($40,000 - $36,000).

† Interest on the receivable and residual accretion are calculated using the rate implicit in the lease that is derived by using the equipment's fair value at lease commencement of $40,000 as the initial investment (i.e., 4.289%).

As illustrated by this example, the timing of profit recognition and the periodic rate of return on the lessor's net investment in the lease may be significantly different for some Type A leases under the FASB approach than the IASB approach.

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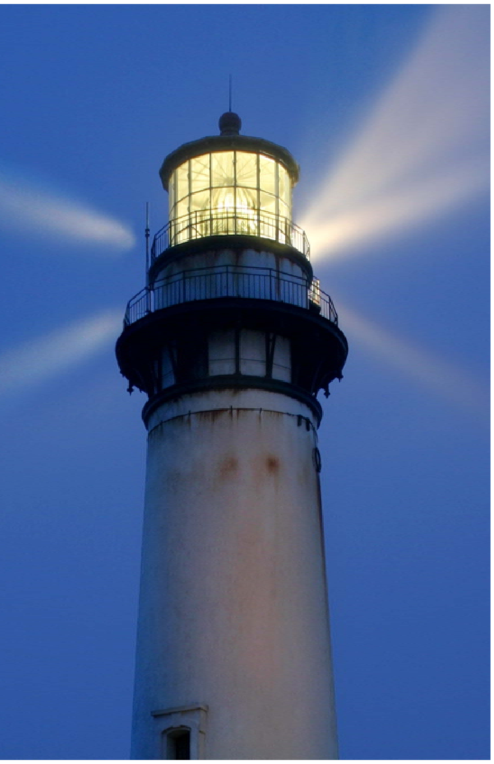

FASB and IASB Enter Home Stretch in Redeliberations on Lease Accounting – but on Different Tracks

At their July and October joint meetings, the FASB and the IASB (the Boards) continued redeliberations on the proposals in their 2013 exposure drafts (EDs) on lease accounting.[1] The FASB also met separately in August to discuss aspects of the proposals that are specific to U.S. GAAP.[2] As in each joint meeting since March 2014, while the Boards reached converged decisions in the reconsideration of some of their proposals, there were key areas on which they did not agree.

This edition of *Defining Issues* discusses the Boards' more significant decisions subsequent to the first half of 2014 and provides KPMG's observations on their potential impacts. The Boards' remaining decisions during redeliberations are included in the Summary of Decisions Reached in Redeliberations. The Boards expect to substantially complete their redeliberations by the end of this year.

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Key Facts

The Boards failed to reach converged decisions about:

- ***Sale-Leaseback Transactions.*** The Boards agreed that (a) a sale would be recognized in a sale-leaseback transaction that meets the requirements for

[1] FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org. The Boards met jointly to discuss the project on July 25 and October 22, 2014. For more information about the Boards' previous redeliberations on the EDs see KPMG's Defining Issues Nos. 14-29, FASB and IASB Continue Discussions on Lease Accounting, and 14-17, FASB and IASB Take Divergent Paths on Key Aspects of Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network. For more information about the EDs' proposals, see KPMG's Defining Issues No. 13-24, FASB and IASB Issue Revised Exposure Drafts on Lease Accounting, and Issues In-Depth No. 13-3, Implications of the Revised FASB and IASB Exposure Drafts on Lease Accounting, both available at www.kpmginstitutes.com/financial-reporting-network.

[2] FASB meeting on August 27, 2014.

sale recognition in the new revenue recognition standard, (b) the leaseback by itself would not preclude the transaction from qualifying for sale recognition, and (c) a lease in a sale-leaseback transaction would be accounted for in the same manner as any other lease when the transaction qualifies for sale accounting.[3] However, they did not agree on (a) the circumstances that would preclude sale accounting under the new revenue recognition standard's requirements, or (b) how to measure (1) any gain on the transaction or (2) the lessee's right-of-use asset, when the transaction is accounted for as a sale.

The Boards reached generally converged decisions about:

- ***Definition of a Lease.*** The Boards agreed to clarify that the definition of a lease generally requires a customer to have the right to direct how and for what purpose the underlying asset is used throughout the period of use. The Boards directed their staff to provide additional analysis about whether the definition of a lease also should require a customer to either have the capability to operate the asset itself or have access to other readily available operators other than the supplier who have the capability to operate the asset.
- ***Lessor Disclosures.*** The Boards agreed to retain substantially all of the existing lessor disclosure requirements under both U.S. GAAP and IFRS. In addition, they agreed to expand the existing lessor disclosures to provide financial statement users more information about the amount, timing, and uncertainty of cash flows arising from lessor's leases.

The FASB reached decisions about the following U.S. GAAP-specific proposals:

- ***Leveraged Leases.*** The FASB decided to eliminate leveraged lease accounting prospectively but to allow existing leveraged leases to be grandfathered from application of the new lease accounting requirements.
- ***Nonpublic Lessee Discount Rates.*** The FASB decided to retain the proposed accounting policy election in its ED that would permit nonpublic lessees to use a risk-free discount rate to determine the initial and subsequent measurement of all lease liabilities.
- ***Related Party Leasing Transactions.*** The FASB decided to retain the proposal in its ED that leases between related parties would be accounted for based on their contractual terms, even if those terms do not reflect the substance of the arrangement.

Key Impacts

- Purchase options retained by the seller-lessee generally will preclude sale accounting in sale-leaseback transactions, which may affect many equipment sale-leaseback transactions. Gains recognized on sale-leaseback transactions that qualify for sale accounting will be smaller (often significantly) under IFRS than under U.S. GAAP, with a corresponding reduction of the lessee's right-of-use asset and related amortization expense recognized over the lease term.

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[3] FASB Accounting Standards Update 2014-09, Revenue from Contracts with Customers, May 28, 2014, available at www.fasb.org, and IFRS 15, Revenue from Contracts with Customers.

- The definition of a lease will exclude some contracts in which the customer obtains all of the output or utility of an identified asset, regardless of the price the customer pays for the output, unlike current GAAP. Depending on the outcome of the Boards' future discussions about the impact of a customer's ability to derive the benefits from directing the use of an identified asset, the definition of a lease also may exclude arrangements in which the supplier provides operations services that the customer is not capable of performing on its own or purchasing separately.
- Lessor accounting will remain unconverged for existing leveraged leases that are grandfathered under U.S. GAAP, making it difficult for financial statement users to compare the financial statements of these lessors to those of other lessors prepared under U.S. GAAP and IFRS.
- While the alternative for nonpublic lessees to use a risk-free discount rate in measuring their lease liabilities should decrease costs and complexity for some reporting entities, when applied it will result in overstated lease liabilities that may not reflect the economics of these transactions and may increase the costs of analysis for financial statement users.
- Lessors and lessees applying U.S. GAAP will no longer be required to evaluate whether the contractual terms of related party leases are consistent with the substance of the arrangements to determine the appropriate accounting.

Background

When the FASB and the IASB began the leases project their primary objectives included reducing complexity in lease accounting, eliminating arbitrary accounting distinctions for transactions that are economically similar, requiring lessees to recognize all leases on-balance sheet, and developing converged lease accounting requirements. Based on the current state of the Boards' decisions, the project will meet the objective for lessees to recognize leases on-balance sheet. However, it appears unlikely that the Boards will achieve their other objectives.

Earlier this year, the Boards reached significantly different decisions about lessee accounting. The FASB decided to retain a dual model approach similar to that proposed in the EDs. Under the dual model approach, a lessee would recognize a right-of-use (ROU) asset and a lease liability for its obligation to make lease payments for all leases other than short-term leases. Subsequent accounting for the ROU asset and presentation of lease expense, however, would depend on whether the lease is classified as Type A (most capital leases under current U.S. GAAP) or Type B (most operating leases under current U.S. GAAP). For Type A leases, the lessee generally would recognize a front-loaded pattern of total lease expense comprising interest on the lease liability and amortization of the ROU asset, similar to today's accounting for capital leases. For Type B leases, the lessee would recognize a single lease expense amount on a straight-line basis over the lease term, similar to today's accounting for operating leases. The amortization of the ROU asset for Type B leases would be determined as a "plug" to achieve straight-line total lease expense. Conversely,

Leases Project Timeline

- **2009 – Discussion Paper**
- **2010 – Exposure Draft**
- **May 2013 – Revised Exposure Draft**
- **Sept 2013 – Comment Period Ended (>630 comment letters received)**
- **2013-Present – Joint Redeliberations**

the IASB decided on a single model approach in which lessees would account for all leases other than short-term leases as Type A leases.

On lessor accounting, the Boards reached a converged decision to abandon the proposals in their EDs. Specifically, the Boards decided there was no need for lessors to characterize leasing transactions in the same way as lessees for financial reporting purposes. Instead, the Boards decided to keep the key aspects of lessor accounting substantially unchanged from existing guidance. As a result, lessors will account for most leases as executory contracts (i.e., as operating leases).

Although the Boards have publicly expressed an intention to minimize further divergence between their respective final lease accounting standards, they have reached different conclusions on a number of issues in addition to the basic lessee accounting model. Additional areas in which the Boards' proposals have diverged include lessee reassessments of variable lease payments, accounting for subleases, accounting for leases between related parties, financial statement presentation for lessees, and sale-leaseback transactions. In addition, discussion to date suggests that their proposals will also diverge on the accounting for "small-ticket" leases (i.e., leases of assets that are small in value). These disparate approaches may cause significant differences between the financial reporting by companies applying U.S. GAAP and companies applying IFRS, making comparisons by their financial statement users more difficult than under current GAAP. This may compel some financial statement users to reverse the impacts of lease accounting so that the users can perform an analysis using their own models. Although it is possible that the Boards may yet be able to converge their decisions in some of these areas, their plan for the remaining redeliberations does not include revisiting their divergent decisions on the fundamental aspects of lessee accounting.

The Boards expect to discuss other remaining issues before finalizing their respective standards, including:

- The impact, if any, of a customer's ability to derive the benefits from directing the use of an identified asset on the definition of a lease;
- Small-ticket leases;
- Lessee disclosure requirements;
- Transition and effective date;
- Cost-benefit considerations; and
- Consequential amendments.

Sale-Leaseback Transactions

The Boards jointly discussed the accounting for sale-leaseback transactions at their July meeting. The FASB also separately discussed the accounting for sale-leaseback transactions at its August meeting.

Determining whether a Sale has Occurred. The Boards agreed that a sale would be recognized in a sale-leaseback transaction that meets the requirements for sale recognition in the new revenue recognition standard. They also agreed that the leaseback itself would not automatically preclude the transaction from qualifying for sale recognition under the new revenue recognition standard. Examples of circumstances that would preclude sale accounting under the new revenue recognition standard include a repurchase option held by the seller and a put option that the buyer has a significant economic incentive to exercise. The Boards agreed that sale-leaseback transactions that do not qualify for sale accounting would be accounted for as financing transactions by the seller-lessee and the buyer-lessor.

The Boards did not agree on whether certain repurchase options held by the seller-lessee would preclude sale accounting under the new revenue recognition standard's requirements. The FASB decided that a repurchase option with a strike price that is the fair value of the underlying asset at the option exercise date would *not* preclude sale accounting in a sale-leaseback transaction if the underlying asset is non-specialized and readily available in the marketplace. The FASB concluded that in this situation the buyer-lessor would be entitled to obtain substantially all of the remaining benefits of the underlying asset and/or obtain a substantially equivalent asset with its repurchase option proceeds. Therefore, these repurchase options would not prevent the buyer-lessor from obtaining control of the underlying asset under the new revenue recognition standard's transfer of control requirements. Conversely, the IASB decided that any substantive repurchase option held by the seller-lessee would preclude sale accounting in a sale-leaseback transaction, and that a strike price that is the fair value of the underlying asset at the option exercise date would not cause the option to be non-substantive.

The FASB also decided to preclude recognition of a sale in a sale-leaseback transaction if the leaseback would be classified as a Type A lease by the seller-lessee. The FASB concluded that in a Type A leaseback the seller-lessee would be essentially retaining control of the underlying asset under the new revenue recognition standard's provisions. The IASB decided that Type A lease classification by the seller-lessee would not preclude sale accounting as lessees would account for all leases as Type A leases under the IASB's proposals.

Accounting for a Sale/Purchase. The Boards disagreed on how to measure a gain in a sale-leaseback transaction that qualifies for sale accounting. The FASB decided that a seller-lessee would measure a gain on sale as the amount by which the selling price of the underlying asset exceeds its carrying amount, consistent with the guidance that would apply to any other sale (i.e., recognize the full gain). This is because the FASB concluded that in a sale-leaseback transaction the seller-lessee transfers control of the entire underlying asset and obtains a different asset (the ROU asset) as a consequence of the leaseback. The IASB decided that the seller-lessee would limit the measurement of any gain on sale to the amount of the difference between the selling price and the carrying amount of the underlying asset that relates to the buyer-lessor's residual interest in the underlying asset at the end of the leaseback. In essence, the IASB concluded that the seller-lessee retains the portion of the underlying asset represented by its ROU asset and, therefore, only sells the portion of the underlying asset represented by the buyer-lessor's residual interest, rather than the entire underlying asset. Accordingly, the IASB concluded that it would be inappropriate for the seller-lessee to recognize the portion of the total gain related to the ROU asset. Both Boards decided that the total gain should be subject to revision when the transaction contains off-market terms as discussed in further detail below.

KPMG Observations

Because the Boards have decided that the leaseback in a sale-leaseback transaction does not by itself preclude sale accounting under their new revenue recognition guidance, it will continue to be possible to structure sales as sale-leaseback transactions to recognize revenue earlier than the new revenue recognition standard would otherwise permit. Consider the following example:

> Seller A sells machines with a five-year remaining economic life to Customer B. Seller A and Customer B agree that Seller A will not deliver the machines for two years. Until delivery of the machines, Seller A is free to use them if it wants to, and Customer B will receive a refund of part of the purchase price from Seller A during the two-year period. The present value of the refund is equal to half the sales price.

Under the guidance in the revenue recognition standard, Customer B must obtain control of the machines (including the ability to receive substantially all of their remaining benefits) for Seller A to recognize a sale. In this example, Customer B does not meet that requirement at the date of the sale because (among other reasons) Customer B does not obtain substantially all of the remaining benefits from the machines. However, if the arrangement was structured as a sale-leaseback rather than a bill-and-hold transaction, Seller A would be *required* to recognize a sale and a leaseback upon entering into the transaction because Seller A does not retain substantially all of the remaining benefits from the machines. The Boards' decisions on sale-leaseback accounting along with their decision not to exclude leases of inventory from the scope of the leases standard offer companies flexibility to determine the timing of revenue recognition without actually delivering goods to customers simply by structuring transactions that will be in the scope of the leases standard. Moreover, companies will be able to structure the lease term to achieve off-balance sheet accounting for the leaseback.

Sale Recognition

Under current U.S. GAAP, repurchase options held by the seller-lessee do not preclude recognition of a sale in a sale-leaseback transaction involving assets other than real estate. Under current IFRS, repurchase options held by the seller-lessee do not preclude recognition of a sale in a sale-leaseback involving any type of asset (including real estate). The Boards' decision to require sale-leaseback transactions to qualify for sale accounting under their new revenue recognition standard means that repurchase options retained by the seller-lessee generally will preclude sale accounting. This could be a major change for many equipment sale-leaseback transactions for companies applying U.S. GAAP and more generally for companies applying IFRS.

Gain Measurement

The differences in the Boards' decisions on measurement of a gain to be recognized in a sale-leaseback transaction will affect not only the income statement at the date of the transaction, but also the measurement of the seller-lessee's ROU asset and the subsequent expense recognized over the term of the leaseback. Gains recognized on sale-leaseback transactions that qualify for sale accounting will be smaller (often significantly) under IFRS than under U.S. GAAP, with a corresponding reduction of the seller-lessee's ROU asset and related amortization expense recognized over the lease term.

It is important to note that the IASB has not proposed any adjustment to the buyer-lessor's accounting due to the restriction on the measurement of the seller-lessee's gain in a sale-leaseback transaction that qualifies for sale accounting. The buyer-lessor would recognize the entire underlying asset at its purchase price (subject to revision when the transaction contains off-market terms as discussed in further detail below).

Example 1 and the diagram that follows illustrate the Boards' differing decisions on the seller-lessee's accounting for a sale-leaseback transaction that qualifies for sale accounting.

Example 1: Gain Recognized By a Seller-Lessee in a Sale-Leaseback Transaction

A seller-lessee sells a building with a carrying amount of $1,500,000 for $2,500,000, which is the observable market value of the building on the date of the sale (i.e., "at-market" terms). The seller-lessee leases the building for 4 years at $325,000 per year (paid in arrears) and the seller-lessee's incremental borrowing rate is 10%. The seller-lessee would account for the transaction as follows:

	FASB	**IASB**
	Dr. (Cr.)	Dr. (Cr.)
Cash	2,500,000	2,500,000
Building	(1,500,000)	(1,500,000)
Gain on sale	(1,000,000)	(588,000)[A]
ROU asset	1,030,000[C]	618,000[B]
Lease liability	(1,030,000)[D]	(1,030,000)

Under U.S. GAAP, the seller-lessee would recognize a gain on the sale of $1,000,000, consistent with any other gain resulting from the sale of a nonfinancial asset. The seller-lessee would recognize a ROU asset and lease liability of $1,030,000, consistent with the measurement of a lease in a non-sale-leaseback transaction.

Conversely, under IFRS the gain recognized by the seller-lessee would be limited to $588,000, which is the portion of the gain related to the buyer-lessor's residual interest in the underlying asset. The seller-lessee would measure its ROU asset at $618,000, which is the portion of the previous carrying amount of the building ($1,500,000) related to the ROU asset.

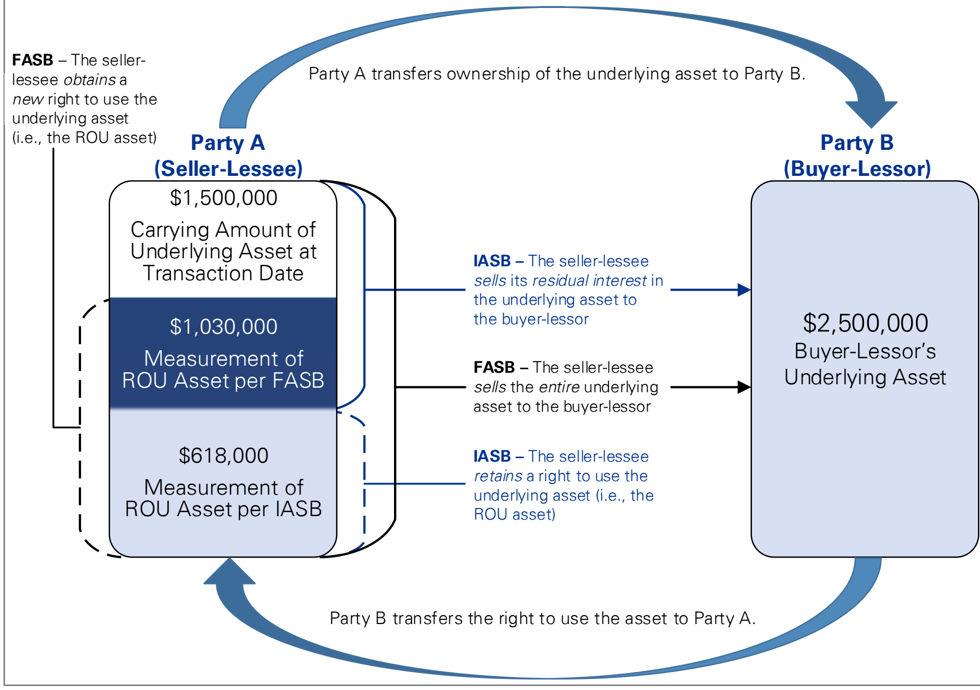
Example 1: Gain Recognized By a Seller-Lessee in a Sale-Leaseback Transaction

[A] Portion of gain related to buyer-lessor's residual interest in underlying asset = total gain × (fair value of underlying asset – present value of lease payments) ÷ fair value of underlying asset = $1,000,000 × ($2,500,000 - $1,030,000) ÷ $2,500,000 = $588,000

[B] ROU asset under IFRS = present value of lease payments – total gain + gain recognized = $1,030,000 – $1,000,000 + $588,000 = $618,000

[C] ROU asset = lease liability + prepaid rent + initial direct costs – lease incentives = $1,030,000

[D] Lease liability = 4 payments of $325,000 discounted at 10% = $1,030,000

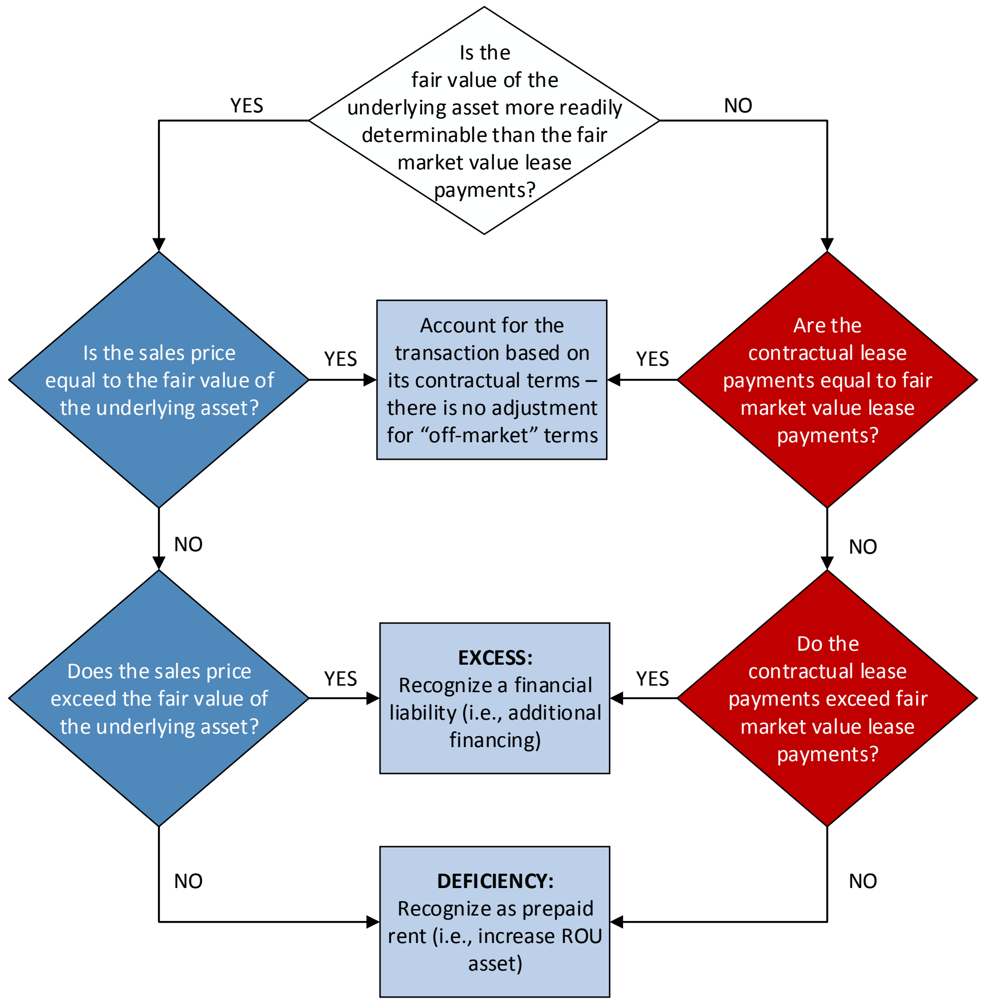


Accounting for "Off-Market" Terms. The Boards agreed that the accounting for a sale-leaseback transaction would be adjusted when the terms of the transaction are not at market. The amount of the "off-market" adjustment would be the more readily determinable of:

- The difference between the sales price and the fair value of the underlying asset, or
- The difference between the present value of the contractual lease payments and the present value of fair market value lease payments.

The Boards agreed that if the terms of the transaction are below market (e.g., the sales price of the underlying asset is less than its fair value), the deficiency would be accounted for as a prepayment of rent from the seller-lessee to the buyer-lessor. If the terms of the transaction are above market (e.g., the sales price of the underlying asset is greater than its fair value), the excess would be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

Accounting for "Off-Market" Terms



KPMG Observations

In a sale-leaseback transaction, the difference between the sales price and fair value of the underlying asset may not necessarily equal the difference between the present value of the contractual lease payments and the present value of fair market value lease payments. The Boards decided that either comparison would be an acceptable way to identify whether the accounting for the transaction needs to be adjusted due to the presence of off-market terms.

Example 2 illustrates the accounting for a sale-leaseback transaction with above market terms using both a comparison of the sales price to the fair value of the underlying asset and a comparison of the contractual lease payments to the fair market value lease payments.

Example 2: Accounting for a Sale-Leaseback Transaction with "Off-Market" Terms

Assume the same facts as Example 1 except that the building's observable market value on the date of the sale is $2,000,000 (i.e., the sales price exceeds the building's fair value by $500,000), and fair market value lease payments are $198,800 per year (i.e., the present value of the contractual lease payments exceeds the present value of fair market value lease payments by $400,000). (Note that although both a comparison of the sales price to the underlying asset's fair value and the contractual lease payments to fair market value lease payments are provided for illustrative purposes, only the more readily determinable comparison would be required under the Boards' decisions.) For ease of illustration, the buyer-lessor's discount rate is assumed to be 10%.

As the terms of the transaction are above market, both parties would need to record an adjustment to recognize the transaction at fair value as follows:

	FASB		IASB	
	More Readily Determinable		More Readily Determinable	
	Fair Value of Underlying Asset	Fair Market Value Lease Payments	Fair Value of Underlying Asset	Fair Market Value Lease Payments
	Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)
Seller-Lessee				
Cash	2,500,000	2,500,000	2,500,000	2,500,000
Building	(1,500,000)	(1,500,000)	(1,500,000)	(1,500,000)
Gain on sale	(500,000)[A]	(600,000)	(367,500)[F]	(420,000)[H]
ROU asset	530,000	630,000	397,500[G]	450,000[I]
Lease liability	(530,000)[B]	(630,000)[D]	(530,000)[B]	(630,000)[D]
Financial liability	(500,000)[C]	(400,000)[E]	(500,000)[C]	(400,000)[E]

	Converged	
	More Readily Determinable	
	Fair Value of Underlying Asset	Fair Market Value Lease Payments
	Dr. (Cr.)	Dr. (Cr.)
Buyer-Lessor		
Building	2,000,000[J]	2,100,000[L]
Financial Asset	500,000[K]	400,000[E]
Cash	(2,500,000)	(2,500,000)

[A] $2,000,000 (fair value of underlying asset) – $1,500,000 (carrying amount of underlying asset)

[B] Present value of contractual lease payments (4 annual payments of $325,000, discounted at 10%) – $500,000 ("off-market" adjustment)

[C] "Off-market" adjustment: $2,500,000 (sales price) – $2,000,000 (fair value of underlying asset)

Example 2: Accounting for a Sale-Leaseback Transaction with "Off-Market" Terms

[D] Present value of contractual lease payments at market (4 annual payments of $198,800, discounted at 10%)

[E] "Off-market" adjustment: present value of 4 annual payments of $126,200 ($325,000 – $198,800), discounted at 10%

[F] Portion of gain related to buyer-lessor's residual interest in underlying asset = total gain × (fair value of underlying asset – present value of lease payments) ÷ fair value of underlying asset = ($2,000,000 - $1,500,000) × ($2,000,000 - $530,000) ÷ $2,000,000 = $367,500

[G] ROU asset under IFRS = present value of lease payments – total gain + gain recognized = $530,000 – $500,000 + $367,500 = $397,500

[H] Portion of gain related to buyer-lessor's residual interest in underlying asset = total gain × (fair value of underlying asset – present value of lease payments) ÷ fair value of underlying asset = ($2,100,000 - $1,500,000) × ($2,100,000 - $630,000) ÷ $2,100,000 = $420,000

[I] ROU asset under IFRS = present value of lease payments – total gain + gain recognized = $630,000 – $600,000 + $420,000 = $450,000

[J] Fair value of underlying asset

[K] "Off-market" adjustment: $2,500,000 (purchase price) – $2,000,000 (fair value of underlying asset)

[L] $2,500,000 (purchase price) – $400,000 ("off-market" adjustment)

Definition of a Lease

The Boards agreed to retain the EDs' proposals that a contract would 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. To control the use of an identified asset a customer must obtain the right to:

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

The Boards agreed to clarify that for a customer to have the right to direct the use of an identified asset it must have the right to direct (including the right to *change*) how and for what purpose the asset is used throughout the period of use. The Boards also agreed that if neither the customer nor the supplier controls how and for what purpose the asset is used throughout the period of use, the customer would nevertheless have the right to control the use of the asset if:

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

KPMG Observations

The clarifications of the definition of a lease do not represent a significant change from the proposals in the EDs. The new definition will exclude some contracts in which the customer obtains all of the output or utility of an identified asset, regardless of the price the customer pays for the output, unlike current GAAP as illustrated in Example 3.

Example 3: Outsourcing Arrangement

Auto Manufacturer enters into a 25-year agreement for Parts Supplier to build a parts facility adjacent to Auto Manufacturer's manufacturing plant. Auto Manufacturer will make an equity investment in the entity formed by Parts Supplier to own the facility but does not participate in the design of the facility.

Auto Manufacturer and Parts Supplier agree that the parts facility will produce constant-velocity (CV) joints for Auto Manufacturer. The initial capacity of the facility will be used to produce only CV joints and Auto Manufacturer will purchase all of the CV joints produced by the facility. The price paid by Auto Manufacturer will be determined based on Parts Supplier's actual operating costs plus a profit margin. Parts Supplier has the right to expand the facility in the future if it wishes to produce other parts (but does not expect to do so) and has the right to make all operating decisions for the facility.

Based on the Boards' decisions, the arrangement would not contain a lease. Auto Manufacturer does not have a right to direct the use of the facility during the 25-year term of the agreement because it cannot direct how and for what purpose the facility is used throughout the term. Even though Parts Supplier built the facility for the express purpose of supplying parts to Auto Manufacturer, Auto Manufacturer has no right to *change* how the facility is used or what it produces. In addition, Auto Manufacturer does not have the right to operate the facility or direct Parts Supplier to operate it in a manner that Auto Manufacturer determines. Auto Manufacturer also did not design the facility or cause it to be designed in a way that predetermines during the period of use (a) how and for what purpose the facility will be used, or (b) how the facility will be operated. Consequently, Auto Manufacturer would account for the arrangement as the acquisition of inventory as CV joints are delivered. Auto Manufacturer would be required to separately evaluate whether to consolidate the entity that owns the facility and, if it is required to consolidate the entity, the inventory acquisition accounting would be eliminated in Auto Manufacturer's consolidated financial statements.

Alternatively, if Auto Manufacturer had the right to change the parts produced by Parts Supplier during the term of the agreement (e.g., to require that Parts Supplier produce axles rather than, or in addition to, CV joints), then Auto Manufacturer would have the right to direct the use of the facility based on the Boards' decisions because it could *change* what the facility produces and the arrangement would contain a lease.

Under current GAAP the arrangement would contain a lease because Auto Manufacturer is expected to obtain substantially all of the facility's output during the term of the arrangement for a price that is not fixed per unit of output or equal to the market price per unit of output at the time it is delivered.

The Boards also discussed whether the right to obtain substantially all of the economic benefits from directing the use of an identified asset requires a customer to have the ability, using its own resources or other readily available resources, to derive the benefits from directing the use of the asset. This additional condition would exclude from the definition of a lease arrangements in which the supplier operates the identified asset if the customer does not have the requisite skills to operate the asset on its own and there are no other readily available operators with that skill. The Boards directed their staff to provide additional analysis about this issue for consideration at a future meeting.

KPMG Observations

The Boards' staff did not identify any examples of arrangements in which the customer does not have the requisite skills to operate the asset on its own and there are no other readily available operators with that skill. Although the staff suggested that there should be very few such arrangements, most FASB members seemed inclined to include the condition in the definition of a lease because they viewed it as an important aspect of determining whether the customer controls the use of an identified asset. Most IASB members seemed inclined to exclude the condition from the definition of a lease either because they considered it irrelevant or because they thought it would create additional complexity and invite inappropriate transaction structuring to achieve off-balance sheet accounting. Members of both Boards expressed concern that the term "readily available" was not sufficiently clear to be applied consistently in practice.

Lessor Disclosures

The Boards agreed to retain substantially all of the existing lessor disclosure requirements under U.S. GAAP and IFRS. They also agreed that a lessor would be required to disclose for all leases:

- Information about the nature of its leases and significant judgments and assumptions made in accounting for leases;
- A table of lease income during the reporting period; and
- Information about how it manages risks of the residual interests in its leased assets.

For Type A leases, the Boards decided that a lessor would be required to disclose:

- A maturity analysis of the undiscounted cash flows comprising the lessor's lease receivables for each of the first five years following the reporting date and in total for years thereafter that is reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes (both Boards agreed);
- An explanation of significant changes in the components of the lessor's net investment in Type A leases other than lease receivables during the reporting period (FASB only – the FASB decided to consider disclosures

related to Type A lease receivables in its project on accounting for impairment of financial instruments);

- A qualitative and quantitative explanation of the significant changes in the lessor's net investment in Type A leases during the reporting period (IASB only).

For Type B leases, the Boards agreed that a lessor would be required to disclose:

- General property, plant, and equipment disclosures for assets subject to Type B leases by significant class of underlying asset separately from those disclosures for the lessor's other owned assets; and
- A maturity analysis of the undiscounted future lease payments to be received for each of the first five years following the reporting date and in total for years thereafter.

KPMG Observations

Although the Boards decided not to substantially change lessor accounting, their decision to expand the required lessor disclosures is intended to provide financial statement users more information about the risks to which the lessor is exposed (e.g., collectibility of lease receivables and risks related to the lessor's residual interest in its leased assets). In response to feedback from financial statement users, the Boards also decided to require lessors to provide a table of lease income recognized during the period. Example 4 provides an illustration of this reconciliation.

Example 4: Lessor Table of Lease Income	
Lease income – Type A leases	
Profit at lease commencement	XXX
Interest income on lease receivables	XX
Interest income from accretion of residual assets	XX[1]
Subtotal	**XXXX**
Lease income – Type B leases	XXX
Lease income from variable lease payments	X
Total lease income	**XXXX**

[1] Interest income on the lessor's net investment in Type A leases may be presented either in aggregate or separately (as shown) for each component of the net investment in the lease.

U.S. GAAP-Specific Proposals

The FASB reached decisions about U.S. GAAP-specific proposals on leveraged leases, nonpublic lessee discount rates, and related party leasing transactions. Refer to the Summary of Decisions Reached in Redeliberations for a description of the FASB's decisions on nonpublic lessee discount rates and related party leasing transactions.

The FASB decided to eliminate leveraged lease accounting under U.S. GAAP for leases that commence after the effective date of the new lease accounting standard. A lessor would account for all leases subject to the requirements of the new standard as either Type A (financing) or Type B (operating) leases. The Board decided that leveraged leases in existence at the effective date of the new lease accounting standard would not be subject to its requirements (i.e., leveraged lease accounting would continue for those transactions).

KPMG Observations

Leveraged leasing transactions typically provide significant tax and financial reporting benefits for lessors applying U.S. GAAP. Leveraged leases usually involve capital intensive assets such as airplanes and power plants that are leased for extended periods (e.g., 25 years or more). However, these transactions have become more infrequent in recent years due to changes in interest rates and investment tax incentives. The FASB's decision to eliminate leveraged lease accounting is intended to reduce complexity in the lessor accounting requirements and to converge with IFRS, which has no specialized accounting for leveraged leases. The FASB decided to grandfather existing leveraged leases from the requirements of the new lease accounting standard because it determined that there are relatively few existing leveraged leases and the cost for lessors to "unwind" the accounting for those transactions would exceed the benefit to financial statement users. This decision will require lessors with leveraged leases to retain their existing systems and controls for those transactions until the leases are terminated, which may be several decades. Lessor accounting will remain unconverged for grandfathered leveraged leases, making it difficult for financial statement users to compare the financial statements of these lessors to those of other lessors prepared under U.S. GAAP and IFRS.

"We prefer a single measurement approach [for lessee accounting] which would be consistent with the theme around reducing complexity and creating more simple financial statements that users can understand."

– Jonathan Nus, IAC Member

Other Developments

FASB Investor Advisory Committee Feedback. On August 26, 2014, the FASB met with its Investor Advisory Committee (IAC) to discuss the leases project.[4]

- The IAC expressed support for on-balance sheet accounting by lessees, noting that it would benefit the majority of financial statement users.
- A majority of the IAC members expressed a preference for the IASB single Type A lessee accounting model rather than the FASB dual model because in their view the single Type A model better represents the economics of leasing transactions and increases financial statement comparability.
- The IAC emphasized the importance of disclosures and recommended that the FASB focus on relevance, rather than volume. The committee expressed

[4] The IAC is a standing committee that works closely with the FASB in an advisory capacity to ensure that investor perspectives are effectively communicated to the FASB on a timely basis in connection with the development of financial accounting standards.

a desire for disclosures that would explain management's critical judgments and assumptions (e.g., when determining whether to include renewal or purchase options in the measurement of lease payments). The committee also highlighted the need for disclosures that would enable users to reconcile between the lessee accounting under U.S. GAAP and IFRS.

EFRAG and European Standard Setters Leases Consultation. During July and August, the European Financial Reporting Advisory Group (EFRAG)[5] and the National Standard Setters of France, Germany, Italy, and the UK jointly solicited public comment on two aspects of the proposals in the leases project:

a) Examples of transactions that would be considered leases under the Boards' proposed definition but that respondents believe are in-substance services for which off-balance sheet accounting should apply; and

b) Which approach to lessee accounting (the FASB dual model approach or the IASB single model approach) respondents considered more appropriate and/or less costly to apply.

Examples of transactions preparers identified that they believe are in-substance services for which off-balance sheet accounting should apply included:

a) Time charters of vessels;

b) IT storage contracts; and

c) "Wet" leases of aircraft in which the supplier of the aircraft also provides the personnel, maintenance, and insurance needed to operate it.

A majority of preparers that participated in the outreach expressed a preference to keep or improve existing lease accounting requirements as compared to either the FASB or IASB proposals. In addition, of those preparers that responded, more preferred the IASB single model approach to lessee accounting than the FASB dual model approach.

Most financial statement users that participated in the outreach expressed support for on-balance sheet recognition of leases by lessees. In addition, a majority of financial statement users indicated a preference for the IASB single model approach to lessee accounting rather than the FASB dual model approach.

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[5] EFRAG provides advice to the European Commission (EC) on all issues relating to the application of IFRS in the European Union (EU). Its primary objective is to influence the international debate on accounting matters from a European perspective. EFRAG is the primary technical advisor to the EC with respect to the EC's consideration of whether to endorse IFRS for use in the EU. Additional information is available at www.efrag.org.

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 would 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 or to direct others to operate it in a manner the customer determines (and the supplier has no right to change those operating instructions); or
▪ The customer designed the asset, or caused it to be designed, in a way that predetermines during the period of use (a) how and for what purpose it will be used, or (b) how it will be operated
</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 as determined under the revised proposals ≤ 12 months
• Portfolio-level accounting would be permitted if it does not differ materially from applying the requirements to individual leases
</td></tr>
<tr><td>• No exemption for small-ticket leases</td><td>• Optional lessee exemption for small-ticket leases (e.g., leases of IT equipment and office furniture), even if material in aggregate</td></tr>
<tr><td>Lessee Accounting Model</td><td>
• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria[6]
• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability
– Type A leases would be treated as the purchase of an asset on a financed basis
– Type B leases generally would have straight-line recognition of total lease expense
</td><td>
• Single lease accounting model
• No lease classification test
• All leases on-balance sheet: lessee would recognize a right-of-use (ROU) asset and lease liability
– Treated as the purchase of an asset on a financed basis
</td></tr>
</table>

[6] IAS 17, Leases.

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
Lessor Accounting Model	• Dual lease accounting model • Lease classification test based on IAS 17 classification criteria • Type B accounting model based on IAS 17 operating lease accounting • Type A accounting model based on IAS 17 finance lease accounting with recognition of net investment in lease comprising lease receivable and residual asset	
	– Selling profit would not be recognized on commencement of leases that qualify for Type A classification solely due to involvement by third parties other than the lessee	– There would be no restriction on recognizing selling profit on commencement of Type A leases
	• Existing leveraged leases would be grandfathered from application of the new standard	• N/A – leveraged lease accounting does not exist under IFRS
Related Party Leasing Transactions	• Account for leases between related parties based on their contractual terms, even if they differ from the substance of the arrangement	• N/A – the IASB did not address related party leasing transactions in its proposals
Lease Term and Purchase Options	• Optional (e.g., renewal) periods and purchase options would be included in lease accounting if it is *reasonably certain* that the lessee will exercise those options, consistent with the high threshold in current GAAP • Lessees would 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	
Initial Direct Costs	• Initial direct costs would include only incremental costs that an entity would not have incurred if it had not obtained the lease • Lessees would include initial direct costs in the initial measurement of the ROU asset and amortize the costs over the lease term • Initial direct costs would be included in determining the lessor's implicit rate unless the lease is a Type A lease for which selling profit would be recognized at lease commencement • Lessors would include initial direct costs for Type A leases – In the initial measurement of the lease receivable if no selling profit is recognized at lease commencement	

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	– In expense at lease commencement if selling profit is recognized at lease commencement • Lessors would capitalize initial direct costs for Type B leases and amortize the costs over the lease term in the same pattern as lease income	
Discount Rate	• The lessee's discount rate would 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 would be the cost of the ROU asset • Lessees would 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	
	• Nonpublic business entity lessees would be permitted to elect as an accounting policy to use a risk-free discount rate	• N/A – no unique guidance for nonpublic business entities
	• The lessor's discount rate would be the rate implicit in the lease (i.e., the implicit rate) – Initial direct costs would be included in determining the implicit rate unless the lease is a Type A lease for which selling profit will be recognized at lease commencement • Lessors would reassess the discount rate when there is a lease modification	
Variable Lease Payments	• Lease payments used in the initial measurement of lease assets and liabilities would 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 would be excluded from the measurement of lease assets and liabilities and recognized as expense as incurred or income as earned	
	• Lessees would reassess variable lease payments based on an index or rate only when lease	• Lessees would reassess variable lease payments based on an

<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>payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)</td><td>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) would not be considered components in a contract
Lessors would always separate lease and non-lease components and allocate consideration using the new revenue recognition standard’s guidance (i.e., on a relative standalone selling price basis)
Reallocate consideration when there is a contract modification that is not accounted for as a separate, additional lease
Lessees would choose an accounting policy by class of underlying asset to either:
Separate lease and non-lease components and allocate consideration based on relative standalone 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
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 would be combined as 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</td></tr>
<tr><td>Lease Modifications</td><td colspan="2">Lease modifications would be defined 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
A modification would be considered a separate lease when it grants the lessee an additional ROU that was not included in the original lease and</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></td><td colspan="2">that ROU is priced commensurate with its standalone 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, the ROU asset would be adjusted by the amount of the adjustment to the lease liability
– If the modification reduces the lessee’s ROU, the modification would 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:
– Type B lease modifications would be treated as a new lease with any prepaid or accrued rent on the original lease considered part of the lease payments for the new lease
– Type A lease modifications would be accounted for under the financial instruments requirements in U.S. GAAP or IFRS as applicable</td></tr>
<tr><td rowspan="2">Subleases</td><td colspan="2">• A lessee-sublessor would account for the head lease and the sublease as two separate contracts unless those contracts meet the contract combinations guidance
– The head lease would be accounted for in accordance with the lessee accounting proposals
– The sublease would be accounted for in accordance with the lessor accounting proposals
• A lessee-sublessor would 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 would not offset lease income from a sublease and lease expense from a head lease unless it meets the requirements for offsetting in other U.S. GAAP or IFRS as applicable (e.g., the new revenue recognition standard)[7]</td></tr>
<tr><td>• A sublessor would 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 would consider the ROU asset to be the leased asset in determining the classification of the sublease</td></tr>
</table>

[7] Members of both Boards believe it is unlikely that sublease income and head lease expense would qualify to be offset if the sublease is classified as a Type B 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="5">Sale-Leaseback Transactions</td><td colspan="2">Determining Whether a Sale has Occurred
• A sale and leaseback of the underlying asset would be recognized if the requirements for sale recognition in the new revenue recognition standard are met. The existence of the leaseback would not, on its own, result in a conclusion that control of the asset had not been conveyed to the buyer-lessor.</td></tr>
<tr><td>• If the leaseback would be classified as a Type A lease by the seller-lessee, then sale recognition would be precluded
• A repurchase option held by the seller-lessee in a sale and leaseback transaction would 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 would be precluded</td></tr>
<tr><td colspan="2">• Both the seller-lessee and the buyer-lessor would 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 would account for the purchase of an asset in a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that would apply to the purchase of a nonfinancial asset
• A seller-lessee would 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 would 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 would 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></td><td colspan="2">Accounting for the Leaseback
• If a sale-leaseback transaction qualifies for sale accounting, the leaseback would be accounted for in the same manner as any other lease</td></tr>
<tr><td></td><td colspan="2">Accounting for “Off-Market” Terms
• Any potential “off-market” adjustment would 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 would be accounted for as a prepayment of rent
• An excess in the transaction terms versus market terms would 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 would present Type A ROU assets and lease liabilities either as separate line items on the balance sheet or disclose separately in the notes to the financial statements
– If not separately presented on the balance sheet lessees would:
▪ Present Type A 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 Type A ROU assets and lease liabilities are included and their amounts</td></tr>
<tr><td>• Lessees would not include Type B ROU assets and lease liabilities in the same line items as Type A ROU assets and lease liabilities on the balance sheet
– If not separately presented on the balance sheet lessees would disclose in the notes the line items on the balance sheet in which Type B ROU assets and lease liabilities are included and their amounts</td><td>• N/A – no Type B 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 would classify cash paid for:
– Principal on Type A lease liabilities as financing activities
– Interest on Type A lease liabilities as operating activities
– Type B 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 would 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 IAS 7[8]
– Variable lease payments and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities
• Lessees would disclose total lease payments in the notes to the financial statements</td></tr>
<tr><td>Lessor Presentation</td><td colspan="2">• Lessors would present lease assets and liabilities and income and expense consistent with the current guidance in IAS 17
• Lessors would classify all cash inflows from leases as operating activities in the statement of cash flows</td></tr>
<tr><td>Lessor Disclosures</td><td colspan="2">General
• A lessor would 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; and</td></tr>
</table>

[8] IAS 7, Statement of Cash Flows.

<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">
▪ 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 Type A leases) and b) the undiscounted future lease payments (for Type B leases) for each of the first five years and a total of the amounts thereafter. For Type A leases, the amounts included in the maturity analysis would be reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes.
Type B Leases
• General property, plant, and equipment disclosures for assets subject to Type B leases by significant class of underlying asset separately from those disclosures for the lessor's other owned assets
Type A Leases
</td></tr>
<tr><td>• An explanation of the significant changes in the components of net investment in Type A leases other than the lease receivable during the reporting period</td><td>• A qualitative and quantitative explanation of the significant changes in the net investment in Type A leases during the reporting period</td></tr>
</table>

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Contributing authors: Kimber K. Bascom, Halie Creps, and Robin E. Dunn. We would also like to thank the following reviewers for their input: Brian O'Donovan, and Almudena Cossio Capdevila.

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IFRS AND U.S. GAAP

Issues In-Depth

Revenue from Contracts with Customers

September 2014

kpmg.com

Contents

A new global framework for revenue

In May 2014, the IASB and the FASB published their new joint standard on revenue recognition. This replaces most of the guidance on revenue recognition that currently exists under IFRS and U.S. GAAP.

The 2017 effective date might seem a long way off but already many companies are analyzing the implications – for both external financial reporting and the core systems used to produce the numbers. Most companies are finding that they are impacted in some way, although the impacts vary widely depending on the nature of their business and how they contract with their customers.

In this publication, we have pooled the insights and experience of our revenue recognition teams in the United States and globally to guide you through the requirements of the new standard. We have illustrated the main points with examples and explained our emerging thinking on key interpretative issues. We know that one of the first questions companies ask is "how does this compare with my current accounting?" and have included comparisons with current IFRS and U.S. GAAP requirements.

Proud as we are to present this publication, we realize that it is a work in progress. Every day brings new questions and new insights, which we will share in future publications.

Whether you are beginning your analysis of the new standard or deep into your implementation project, we hope this publication will help you move forward.

Brian K. Allen
Mark M. Bielstein
Prabhakar Kalavacherla (PK)
Paul H. Munter

**Department of Professional Practice,
KPMG LLP, United States**

Phil Dowad
Catherine Morley
Brian O'Donovan
Thomas Schmid

KPMG International Standards Group

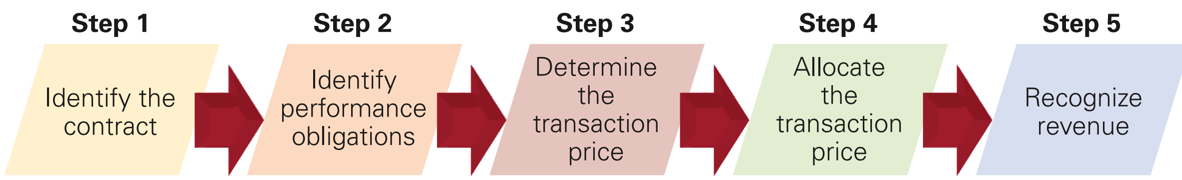
1 Key facts

The new standard provides a framework that replaces existing revenue guidance in U.S. GAAP and IFRS. It moves away from the industry- and transaction-specific requirements under U.S. GAAP, which are also used by some IFRS preparers in the absence of specific IFRS guidance.

New qualitative and quantitative disclosure requirements aim to enable financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

Entities will apply a five-step model to determine when to recognize revenue, and at what amount. The model specifies that revenue should be recognized when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled. Depending on whether certain criteria are met, revenue is recognized:

- over time, in a manner that best reflects the entity's performance; or
- at a point in time, when control of the goods or services is transferred to the customer.



The new standard provides application guidance on numerous related topics, including warranties and licenses. It also provides guidance on when to capitalize the costs of obtaining a contract and some costs of fulfilling a contract (specifically those that are not addressed in other relevant authoritative guidance – e.g., for inventory).

For some entities, there may be little change in the timing and amount of revenue recognized. However, arriving at this conclusion will require an understanding of the new model and an analysis of its application to particular transactions. In addition, all entities will be subject to extensive new disclosure requirements.

The new standard is effective for annual periods beginning on or after January 1, 2017 for entities applying IFRS, and for annual periods beginning after December 15, 2016 for public business entities and certain not-for-profit entities applying U.S. GAAP.[1] Early adoption is permitted only under IFRS.[2]

The impact of the new standard will vary by industry. Those steps of the model that are most likely to affect the current practice of certain industries are summarized below.

	Step				
	1	2	3	4	5
Aerospace and defense	✓	✓	✓		✓
Asset managers			✓		
Building and construction			✓		✓
Contract manufacturers					✓
Health care (U.S.)	✓		✓		
Licensors (media, life sciences, franchisors)	✓*	✓	✓		✓
Real estate	✓	✓			✓
Software		✓	✓	✓	✓
Telecommunications (mobile networks, cable)		✓		✓	

* In particular, life sciences.

1 'Public business entity' is defined in ASU 2013-12, *Definition of a Public Business Entity – An Addition to the Master Glossary*, available at www.fasb.org. 'Certain not-for-profit entities' are those that have issued or are a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market. All other entities applying U.S. GAAP have the option to defer application of the new guidance for one year for annual reporting purposes.

2 All other entities applying U.S. GAAP may adopt at the same time as public business entities.

2 Key impacts

- **Revenue may be recognized at a point in time or over time.** Entities that currently use the stage-of-completion/percentage-of-completion or proportional performance method will need to reassess whether to recognize revenue over time or at a point in time. If they recognize it over time, the manner in which progress toward completion is measured may change. Other entities that currently recognize revenue at a point in time may now need to recognize it over time. To apply the new criteria, an entity will need to evaluate the nature of its performance obligations and review its contract terms, considering what is legally enforceable in its jurisdiction.
- **Revenue recognition may be accelerated or deferred.** Compared with current accounting, revenue recognition may be accelerated or deferred for transactions with multiple components, variable consideration, or licenses. Key financial measures and ratios may be impacted, affecting analyst expectations, earn-outs, compensation arrangements, and contractual covenants.
- **Revisions may be needed to tax planning, covenant compliance, and sales incentive plans.** The timing of tax payments, the ability to pay dividends in some jurisdictions, and covenant compliance may all be affected. Tax changes caused by adjustments to the timing and amounts of revenue, expenses, and capitalized costs may require revised tax planning. Entities may need to revisit staff bonuses and incentive plans to ensure that they remain aligned with corporate goals.
- **Sales and contracting processes may be reconsidered.** Some entities may wish to reconsider current contract terms and business practices – e.g., distribution channels – to achieve or maintain a particular revenue profile.

- **IT systems may need to be updated.** Entities may need to capture additional data required under the new standard – e.g., data used to make revenue transaction estimates and to support disclosures. Applying the new standard retrospectively could mean the early introduction of new systems and processes, and potentially a need to maintain parallel records during the transition period.
- **New estimates and judgments will be required.** The new standard introduces new estimates and judgmental thresholds that will affect the amount or timing of revenue recognized. Judgments and estimates will need updating, potentially leading to more financial statement adjustments for changes in estimates in subsequent periods.
- **Accounting processes and internal controls will need to be revised.** Entities will need processes to capture new information at its source – e.g., executive management, sales operations, marketing, and business development – and to document it appropriately, particularly as it relates to estimates and judgments. Entities will also need to consider the internal controls required to ensure the completeness and accuracy of this information – especially if it was not previously collected.
- **Extensive new disclosures will be required.** Preparing new disclosures may be time-consuming, and capturing the required information may require incremental effort or system changes. There are no exemptions for commercially sensitive information. In addition, IFRS and SEC guidance require entities to disclose the potential effects that recently issued accounting standards will have on the financial statements when adopted.
- **Entities will need to communicate with stakeholders.** Investors and other stakeholders will want to understand the impact of the new standard on the overall business – probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, expected changes to business practices, the transition approach selected, and, for IFRS preparers and entities other than public business entities and certain not-for-profit entities reporting under U.S. GAAP, whether they intend to early adopt.

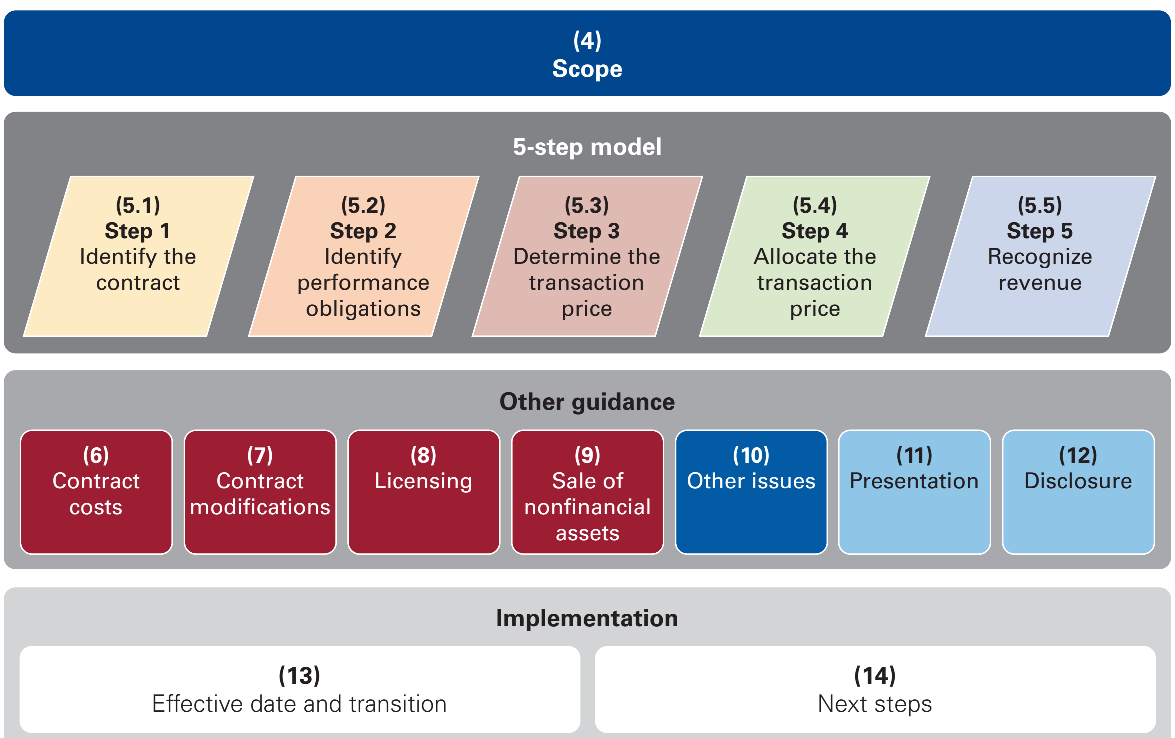
3 Putting the new standard into context

This publication provides a detailed analysis of the new standard, including a discussion of the elements of the new requirements and the areas that may result in a change in practice. Examples have also been provided to help assess the impact of implementation. In many cases, further analysis and interpretation may be needed for an entity to apply the requirements to its own facts, circumstances, and individual transactions. Furthermore, some of the information contained in this publication is based on our initial observations, which may change as issues from the implementation of the new guidance arise, and as practice develops.

This section provides important context to the rest of the publication, including whether particular guidance in the new standard is authoritative, and the interaction with existing guidance.

Organization of the text

The following diagram highlights the layout of the new standard and provides the corresponding sections in this publication. Within each section we generally provide an overview, the requirements of the new standard, examples, our observations, and comparisons with current IFRS and U.S. GAAP guidance.



Guidance referenced in this publication

This publication considers the requirements of IFRS 15 *Revenue from Contracts with Customers* and FASB ASU 2014-09, *Revenue from Contracts with Customers*, published jointly in May 2014.

For specific provisions of the revenue recognition guidance, KPMG *summarizes* the requirements, *identifies* differences between IFRS and U.S. GAAP, and *identifies* KPMG's observations. Neither this publication nor any of KPMG's publications should be used as a substitute for reading the standards and interpretations themselves.

References in the left hand margin of this publication relate to guidance issued as at August 31, 2014. A list of the guidance referenced in this publication is available in the appendix 'Guidance referenced in this publication'.

Authoritative portions of the new standard

The new standard includes:

- core requirements, including scope, recognition, measurement, disclosure, and presentation;
- additional guidance that is labeled 'application guidance' in the IFRS version of the new standard and 'implementation guidance' in the U.S. GAAP version (referred to as application guidance in this publication);
- illustrative examples;
- consequential amendments to other guidance (other standards in IFRS and other Codification Topics in U.S. GAAP); and
- a basis for conclusions.

Both the IFRS and U.S. GAAP versions of the new standard include a mapping of the paragraphs in each version of the new standard to the other. The following table provides an overview of which portions of the new standard are authoritative in IFRS and U.S. GAAP.

Portion of the new standard	IFRS	U.S. GAAP
Core requirements (e.g. 606-10-05-1 to 606-10-50-23 IFRS 15.1 – 15.129)	✓	✓
Application/implementation guidance	✓	✓
Illustrative examples	✗	✓
Consequential amendments to other guidance	✓	✓
Basis for conclusions	✗	✗

✓ Authoritative ✗ Nonauthoritative

Guidance replaced by the new standard

The new standard contains a single model that is applied when accounting for contracts with customers across all industries. The new standard replaces substantially all of the current revenue recognition guidance in both IFRS and U.S. GAAP, excluding contracts that are out of scope – e.g., leases and insurance.

For entities applying IFRS, the new standard replaces IAS 11 *Construction Contracts*; IAS 18 *Revenue*; IFRIC 13 *Customer Loyalty Programmes*; IFRIC 15 *Agreements for the Construction of Real Estate*; IFRIC 18 *Transfer of Assets to Customers*; and SIC-31 *Revenue-Barter Transactions Involving Advertising Services*.

For entities applying U.S. GAAP, the new standard replaces substantially all revenue guidance, including the general revenue guidance in FASB ASC Topic 605 (e.g., FASB ASC Subtopics 605-15, *Revenue Recognition—Products*; and 605-20, *Revenue Recognition—Services*) and specialized industry guidance (e.g., FASB ASC Subtopics 360-20, *Property, Plant, and Equipment—Real Estate Sales*; 928-605, *Entertainment—Music—Revenue Recognition*; 954-605, *Health Care Entities—Revenue Recognition*; and 985-605, *Software—Revenue Recognition*).

Summary of key differences between IFRS and U.S. GAAP

While the new revenue recognition standards are substantially converged, the following key differences exist between the two standards.

		IFRS	U.S. GAAP
606-10-25-1(e) *[IFRS 15.9(e)]*	**Collectibility threshold (see 5.1.1)**	'Probable' means 'more likely than not'	'Probable' means 'likely'
340-40-35-6 *[IFRS 15.104]*	**Reversal of previously impaired contract acquisition and contract fulfillment costs for a change in facts and circumstances (see 6.4)**	Required (limited to the carrying amount, net of amortization, that would have been determined if no impairment loss had been recognized)	Prohibited
270-10-50-1A *[IAS 34.16A]*	**Interim disclosures (see 12.2)**	Only disclosure on disaggregated revenue added to required interim disclosures	Disclosures on disaggregated revenue, contract balances, and remaining performance obligations added to required interim disclosures
606-10-50-7, 50-11, 50-16, 50-21; 340-40-50-4	**Reduction of disclosure requirements for 'all other entities' (see 12.3)**	Not applicable	Some relief on disclosures for entities other than public business entities and certain not-for-profit entities
606-10-65-1 *[IFRS 15.C1]*	**Effective date (see 13.1)**	Annual periods beginning on or after January 1, 2017	Fiscal years beginning after December 15, 2016 for public business entities and certain not-for-profit entities; one-year deferral available for all other entities
		Early adoption permitted	Early adoption prohibited, except that all other entities can adopt at the same time as public business entities

Home

SEC guidance

This publication contains comparisons to current U.S. GAAP, including the SEC's guidance on revenue recognition.[3] Although the new standard supersedes substantially all of the existing revenue recognition guidance issued by the FASB and included in the Codification, it does not supersede the SEC's guidance for registrants. At the time of this publication, it is unknown whether, and if so when, the SEC will revise or rescind its revenue guidance.

Transition Resource Group for revenue recognition

The IASB and the FASB have formed a Joint Transition Resource Group for Revenue Recognition (TRG) for the purpose of:

- soliciting, analyzing, and discussing stakeholder issues arising from the implementation of the new standard;
- informing the IASB and the FASB about implementation issues that will help the Boards determine what action, if any, will be needed to address them; and
- providing a forum for stakeholders to learn about the new guidance from others involved with implementation.

The TRG advises the Boards, but does not have standard-setting authority. The 19 members of the TRG include auditors, financial statement preparers, and users from various industries and geographies (both United States and international), and both public and private companies and organizations. Others who attend and participate in the meeting as observers include the IASB and FASB Board members and staff, the PCAOB, the SEC, AICPA, and IOSCO. The TRG had its first meeting in July 2014 and is expected to meet approximately four times annually until the new standard becomes effective.

Any stakeholder can submit an issue to the Boards for potential consideration by the TRG. The issues should relate to the new standard, be pervasive, and involve guidance that can be interpreted in different ways that would potentially result in diversity in practice. The IASB and FASB staff will decide which issues the TRG will discuss. For discussion purposes, the staff will analyze the various interpretations in issue papers and post those papers to the IASB and FASB websites before the TRG meeting. The TRG members will discuss the issues in a public setting but will not issue authoritative guidance. After each meeting, the Boards will determine what the next step should be for each issue, including whether standard setting is necessary.

In addition to the TRG, there are various other industry groups – including the Revenue Recognition Task Forces formed by the AICPA – that are discussing how to apply the new standard. An entity should actively monitor these activities and consider adjusting its implementation plan if new guidance is developed.

Criteria versus indicators

Throughout the new standard, there are several assessments that include either explicit criteria or indicators for an entity to evaluate. Indicators are provided as a non-exhaustive list of factors for an entity to consider when applying the guidance to the specific facts and circumstances of a contract, whereas an entity is required to evaluate some or all of the specified criteria.

3 SEC Staff Accounting Bulletin Topic 13, *Revenue Recognition*, available at www.sec.gov.

4 Scope

Overview

The new standard applies to contracts to deliver goods or services to a customer. The guidance is applied to contracts with customers in all industries. A contract with a customer is outside the scope of the new standard if it comes under the scope of other specific requirements.

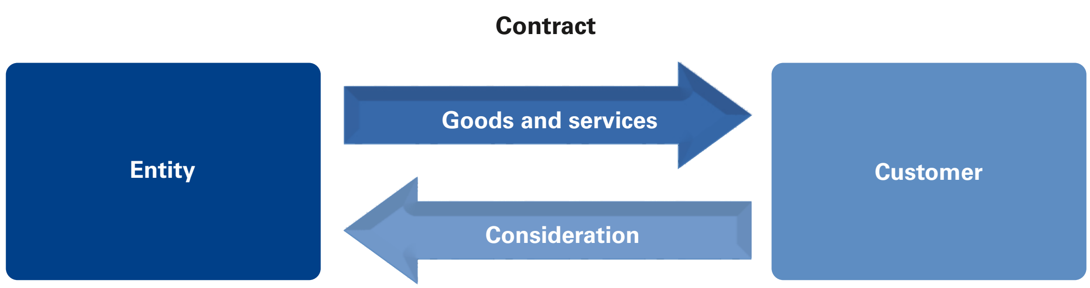
In some cases, the new standard will be applied to part of a contract or, in certain circumstances, to a portfolio of contracts. The new standard provides guidance on when it should or may be applied to these circumstances and how it is applied.

4.1 In scope

Requirements of the new standard

606-10-15-3
[IFRS 15.6]

A customer is 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.



Example 1

Identifying in-scope contracts

Company X is in the business of buying and selling commercial property. It sells a property to Purchaser Y. This transaction is in the scope of the new standard, because Purchaser Y has entered into a contract to purchase an output of Company X's ordinary activities and is therefore considered a customer of Company X.

Conversely, if Company X was instead a manufacturing entity selling its corporate headquarters to Purchaser Y, the transaction would not be a contract with a customer because selling real estate is not an ordinary activity of Company X. For further discussion on which parts of the model apply to contracts with a non-customer see Section 9.

Observations

Customer defined but no definition of ordinary activities given

ASU 2014-09 BC52 to BC53
[IFRS 15.BC52 to BC53]

The definition of a customer focuses on an entity's ordinary activities. The Boards did not define 'ordinary activities' but referred to the definitions of revenue in the Boards' respective conceptual frameworks. The IASB's *Conceptual Framework for Financial Reporting* specifically includes 'ordinary activities of an entity', while the FASB's *Statements of Financial Accounting Concepts* refer to the notion of an entity's 'ongoing major or central operations'.

4.2 Out of scope

Requirements of the new standard

606-10-15-2
[IFRS 15.5]

The new standard does not apply to:

- lease contracts;
- insurance contracts (for U.S. GAAP, insurance contracts in the scope of ASC Topic 944);
- contractual rights or obligations in the scope of certain financial instruments guidance – e.g., receivables, debt and equity securities, liabilities, debt, derivative contracts, and transfers of financial assets;
- guarantees (other than product or service warranties); and
- non-monetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

Differences between IFRS and U.S. GAAP

Insurance contracts

Topic 944
[IFRS 4]

There is a difference between what is scoped out for U.S. GAAP (contracts issued by insurance entities) compared with IFRS (insurance contracts).

The new standard only excludes insurance contracts for entities that apply current insurance industry guidance under U.S. GAAP. Contracts that meet the definition of insurance contracts but are issued by entities that do not apply insurance entity-specific guidance – e.g., an entity that issues a warranty contract to a third party – are in the scope of the new standard under U.S. GAAP. Therefore, the new standard is applied more broadly under U.S. GAAP.

Under IFRS, insurance contracts are scoped out regardless of the type of entity that issues them. In addition, some warranty contracts are considered to be insurance contracts under IFRS, and are scoped out of the new standard.

Guarantees

Topic 460
[IFRS 9; IAS 39]

The new standard scopes out guarantees. The U.S. GAAP version of the new standard specifically references guarantees as being scoped out because they are covered in a stand-alone ASC Topic; however, the IFRS version of the new standard scopes out rights and obligations that are in the scope of the financial instruments guidance in IFRS, which includes guidance on guarantees.

Observations

Guidance included for product and service warranties

606-10-55-30 to 55-35
[IFRS 15.B28 to B33]

Entities with product or service warranties apply the guidance in the new standard (see 10.2) to determine whether to account for them under the new standard or under other accounting guidance.

Comparison with current IFRS

Similar scope despite some differences in explicit exemptions

[IAS 18.6]

IAS 18 includes specific scope exceptions relating to changes in the fair value of biological assets, the initial recognition of agricultural produce, the extraction of mineral ores, and changes in the value of other current assets. The new standard does not explicitly include these scope exemptions, but because these items do not arise from contracts with customers they are also out of scope of the new standard.

Guidance on dividends moved to financial instruments standard

[IAS 18.30(c); IFRS 9; IAS 39.55A]

The new standard does not include guidance on the accounting for dividend income. Instead, guidance that is consistent with existing requirements has been incorporated into the financial instruments standards.

Comparison with current U.S. GAAP

Transaction- and industry-specific guidance is eliminated

The new standard eliminates substantially all transaction- and industry-specific guidance and applies to all contracts with customers other than those scoped out as described above. Therefore, some entities currently applying transaction- or industry-specific guidance may find that their revenue recognition policies will change under the new standard.

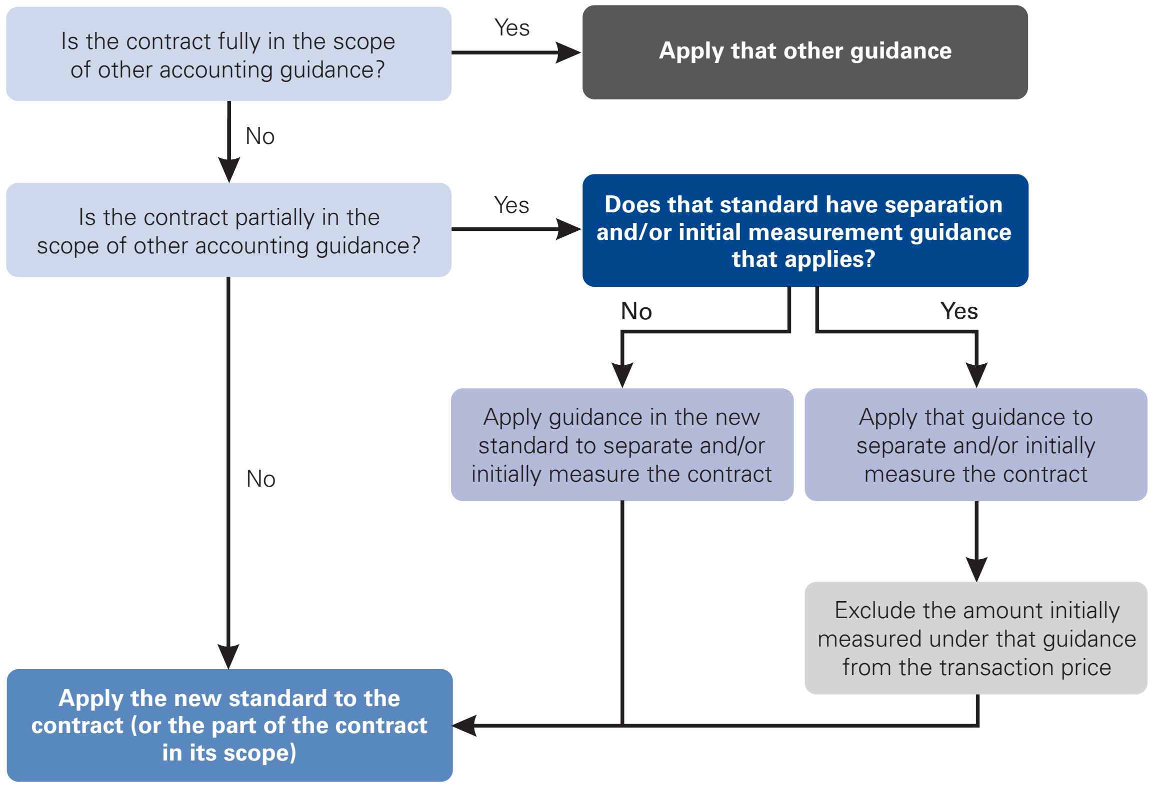
4.3 Partially in scope

Requirements of the new standard

606-10-15-4
[IFRS 15.7]

A contract with a customer may be partially in the scope of the new standard and partially in the scope of other accounting guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, then an entity first applies those requirements. Otherwise, the entity applies the new standard to separate and/or initially measure the separately identified parts of the contract.

The following flow chart highlights the key considerations when determining the accounting for a contract that is partially in the scope of the new standard.



606-10-15-3; Topic 808
[IFRS 15.6]

The new standard excludes from its scope contracts with a collaborator or a partner that are not customers, but rather share with the entity the risks and rewards of participating in an activity or process. However, a contract with a collaborator or a partner is in the scope of the new standard if the counterparty meets the definition of a customer for part or all of the arrangement. Accordingly, a contract with a customer may be part of an overall collaborative arrangement.

Example 2

Zero residual amount after applying other accounting requirements

Bank A enters into a contract with a customer in which it receives a cash deposit and provides treasury services for no additional charge. The cash deposit is a liability in the scope of financial instruments guidance. Bank A first applies the initial recognition and measurement requirements in the financial instruments guidance to measure the cash deposit. The residual amount is then allocated to the treasury services and accounted for under the new standard. Because the amount received for the cash deposit is recognized as a deposit liability, there are no remaining amounts to allocate to the treasury services. This conclusion may change if Bank A also charged a monthly fee.

Example 3

Collaborative agreement

Biotech X has an arrangement with Pharma Y to research, develop, and commercialize a drug candidate. Biotech X is responsible for the research and development (R&D) activities, while Pharma Y is responsible for the commercialization of the drug candidate. Both Biotech X and Pharma Y agree to participate equally in the results of the R&D and commercialization activities. Because the parties are active participants and share in the risks and rewards of the end product – i.e., the drug – this is a collaborative arrangement. However, there may be a revenue contract within the overall collaborative arrangement (see 'Observations' and 'Comparison with current U.S. GAAP', below).

Observations

In some cases, there will be little or no residual amount remaining to allocate

For some arrangements, as illustrated in Example 2 of this publication, after applying the other accounting guidance on separation and/or initial measurement, there may be little or no amount left to allocate to components of the contract that are in the scope of the new standard.

An entity may be both a collaborator and customer

ASU 2014-09 BC55
[IFRS 15.BC55]

The counterparty may be a collaborator for certain parts of the arrangement and a customer for other parts of the arrangement. It will be important for an entity that engages in collaborative arrangements to analyze whether the other parties to such arrangements are customers for some activities, and therefore lead to revenue-generating activities. Making this assessment will require judgment and consideration of all applicable facts and circumstances of the arrangement.

Rate-regulated entities continue to apply existing standards applicable to alternative revenue programs

980-605-25-1 to 25-4

The new standard applies to the normal operations of rate-regulated entities (e.g., the sale of electricity, gas, or water to customers in the course of an entity's ordinary activities that are not subject to rate regulation). However, some regulators have alternative revenue programs that allow for an adjustment (increase or decrease) to rates charged to customers in the future based on changes in demand (e.g., weather abnormalities or other external factors) and/or if certain objectives are met (e.g., reducing costs, reaching milestones, or improving customer service).

In cases where other guidance permits or requires an entity to recognize assets, liabilities, or other balances arising as a result of such programs, changes in these items are generally recognized in applying those other standards. For further discussion, see 'Comparison with current IFRS' and 'Comparison with current U.S. GAAP', below.

Parts of the new standard apply to sales of nonfinancial assets

ASU 2014-09 BC57
[IFRS 15.BC57]

Parts of the new standard also apply to sales of intangible assets and property, plant and equipment, including real estate in transactions outside the ordinary course of business. For further discussion on sales of nonfinancial assets outside the ordinary course of business, see Section 9.

Comparison with current IFRS

Guidance on financial services fees that are retained

[IAS 18.5; IFRS 9; IAS 39.AG8A to AG8C]

IAS 18 includes illustrative examples that address a variety of financial services fees. This guidance is not included in the new standard, but has been transferred to the financial instruments standards as part of the consequential amendments. Therefore, it will still be used when determining the financial services fees that are included in the measurement of the financial instrument, and those fees that will be accounted for under the new standard.

Movements in regulatory deferral account balances remain out of scope

[IFRS 14]

Currently, the only specific guidance on the accounting for the effects of rate regulation under IFRS is IFRS 14, an interim standard, which permits – but does not require – first-time adopters of IFRS to continue using previous GAAP to account for regulatory deferral account balances. An entity that applies IFRS 14 will therefore measure movements in regulatory deferral account balances using its previous GAAP. The interim standard requires such movements, as well as the regulatory deferral account balances, to be presented as separate line items in the financial statements, distinguished from assets, liabilities, income, and expenses that are recognized under other IFRSs. This is consistent with the new standard's requirement to disclose revenue arising from contracts with customers separately from the entity's other sources of revenue. Consistent with current IFRS, regardless of whether an entity is eligible to apply IFRS 14, revenue arising from contracts with customers is recognized and measured under the new standard.

Comparison with current U.S. GAAP

Separation and initial measurement

605-25-15-3 to 15-3A; Topic 825; Topic 460

The guidance on separation and measurement for contracts that are partially in the scope of the new standard is consistent with the current guidance on multiple-element arrangements. Examples of guidance in current U.S. GAAP in which an entity first applies that specific separation and measurement guidance before applying the new standard include financial instruments and guarantees.

Gas-balancing agreements

932-10-S99-5

Under current SEC staff guidance for a natural gas arrangement, an entity may present the participants' share of net revenue as revenue regardless of which partner has actually made the sale and invoiced the production (commonly known as the entitlement method). The new standard does not seem to be consistent with current SEC staff guidance relating to the entitlement method of accounting for gas-balancing arrangements.

Under the new standard, the gas-balancing arrangement may be considered to comprise:

- the actual sale of product to a third party, which is accounted for as revenue from a contract with a customer; and
- the accounting for imbalances between the partners, which is accounted for outside of the new standard's scope.

Collaborative arrangements

808-10

Current U.S. GAAP provides some limited income statement presentation guidance for a collaborative arrangement, which is defined as an arrangement that meets the following two criteria:

- the parties are active participants in the arrangement; and
- the participants are exposed to significant risks and rewards that depend on the endeavor's ultimate commercial success.

This guidance is not superseded or amended by the new standard. However, the guidance on presentation refers entities to other authoritative literature, or if there is no appropriate analogy, suggests that they apply a reasonable, rational, and consistently applied accounting policy election. The guidance does not address the recognition and measurement of collaborative arrangements. Collaborative arrangements with parties that are not customers are excluded from the scope of the new standard. Therefore, an entity may continue to evaluate whether the counterparty is a customer consistent with current practice and, if so, apply the new standard to the aspect of the arrangement for which the other party is a customer.

Alternative revenue programs

980-605-25-1 to 25-4

Current U.S. GAAP requirements on the recognition of regulatory assets and liabilities from alternative revenue programs are not in the scope of the new standard. However, the new standard requires revenue arising from regulatory assets and liabilities to be presented separately from revenue arising from contracts with customers in the statement of comprehensive income.

Entities will continue to follow current U.S. GAAP requirements to account for such programs, because these contracts are considered to be contracts with a regulator and not with a customer. This may result in a difference for rate-regulated entities with similar alternative revenue programs if they apply IFRS but are not eligible to apply the interim standard on regulatory deferral accounts.

4.4 Portfolio approach

Requirements of the new standard

606-10-10-4
[IFRS 15.4]

The new standard is generally applied to an individual contract with a customer. However, as a practical expedient, an entity may apply the revenue model to a portfolio of contracts with similar characteristics if the entity reasonably expects that the financial statement effects of applying the new standard to the portfolio or to individual contracts within that portfolio would not differ materially.

Observations

Entities need to consider costs versus benefits of portfolio approach

While the portfolio approach may be more cost effective than applying the new standard on an individual contract basis, it is not clear how much effort may be needed to:

- evaluate what similar characteristics constitute a portfolio – e.g., the impact of different offerings, periods of time, or geographic locations;
- assess when the portfolio approach may be appropriate; and
- develop the process and controls needed in accounting for the portfolio.

No specific guidance on assessing whether portfolio approach can be used

606-10-55-202 to 55-207, 55-353 to 55-356
[IFRS 15.IE110 to IE115, IE267 to IE270]

The new standard includes illustrative examples where the portfolio approach is applied, including for rights of return and breakage. However, the new standard provides no specific guidance on how an entity should assess whether the results of a portfolio approach would differ materially from applying the new standard on a contract-by-contract basis.

5 The model

5.1 Step 1: Identify the contract with a customer

Overview

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and certain criteria are met. If the criteria are not met, the contract is not in the scope of the new standard and any consideration received from the customer is generally recognized as a liability. Contracts entered into at or near the same time with the same customer (or a related party of the customer) are combined and treated as a single contract when certain criteria are met.

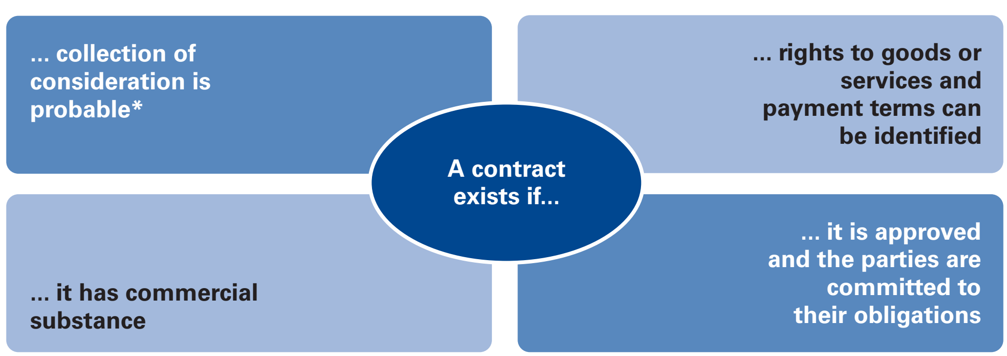
5.1.1 Criteria to determine whether a contract exists

Requirements of the new standard

606-10-25-2 [IFRS 15.10] The new standard defines a contract as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices.

606-10-25-4 [IFRS 15.12] A contract does not exist when each party has the unilateral right to terminate a wholly unperformed contract without compensation.

606-10-25-1 [IFRS 15.9] A contract with a customer is in the scope of the new standard when it is legally enforceable and it meets all of the following criteria.



* The threshold differs under IFRS and U.S. GAAP due to different meanings of the term 'probable'.

606-10-25-1(e) [IFRS 15.9(e)] In making the collectibility assessment, an entity considers the customer's ability and intention (which includes assessing its creditworthiness) to pay the amount of consideration when it is due. This assessment is made after taking into account any price concessions the entity may offer to the customer (see 5.3.1).

606-10-25-6
[IFRS 15.14]

If the criteria are not initially met, an entity continually reassesses the contract against the criteria and applies the requirements of the new standard to the contract from the date on which the criteria are met. Any consideration received for a contract that does not meet the criteria is accounted for under the requirements set out in 5.1.2.

606-10-25-5
[IFRS 15.13]

If a contract meets all of the above criteria at contract inception, an entity does not reassess those criteria unless there is an indication of a significant change in the facts and circumstances. If on reassessment an entity determines that the criteria are no longer met, it ceases to apply the new standard to the contract, but does not reverse any revenue previously recognized.

Example 4

Existence of a contract

In an agreement to sell real estate, Seller X assesses the existence of a contract, considering factors such as:

- the buyer's available financial resources;
- the buyer's commitment to the contract, which may be determined based on the importance of the property to the buyer's operations;
- Seller X's prior experience with similar contracts and buyers under similar circumstances;
- Seller X's intention to enforce its contractual rights; and
- the payment terms of the arrangement.

If Seller X concludes that it is not probable that it will collect the amount to which it expects to be entitled, then a contract does not exist. Instead, Seller X applies the guidance on consideration received before concluding that a contract exists (see 5.1.2) and will initially account for any cash collected as a deposit.

Observations

Assessment focuses on enforceability not form of the contract

ASU 2014-09 BC32
[IFRS 15.BC32]

The assessment of whether a contract exists for the purposes of applying the new standard focuses on the enforceability of rights and obligations rather than the form of the contract (oral, implied, or written). The assessment focuses on whether enforceable rights and obligations have been established, based on the relevant laws and regulations. This may require significant judgment in some jurisdictions or for some arrangements. In cases of significant uncertainty about enforceability, a written contract and legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to perform under the contract.

However, although the contract has to create enforceable rights and obligations, not all of the promises in the contract to deliver a good or service to the customer need to be legally enforceable to be considered performance obligations (see 5.2).

Collectibility is only a gating question

Under current requirements, an entity assesses collectibility when determining whether to recognize revenue. Under the new standard, the collectibility criterion is included as a gating question designed to prevent entities from applying the revenue model to problematic contracts and recognizing revenue and a large impairment loss at the same time. This change is unlikely to have a significant effect for most industries. However, the criterion will replace specific U.S. GAAP guidance for health care entities and real estate transactions (see 'Comparison with current U.S. GAAP', below).

Judgment required to differentiate between collectibility issue and price concession

606-10-55-99 to 55-105; ASU 2014-09 BC45
[IFRS 15.IE7 to IE13, BC45]

Judgment will be required in evaluating whether the likelihood that an entity will not receive the full amount of stated consideration in a contract gives rise to a collectibility issue or a price concession. The new standard includes two examples of implicit price concessions: a life science prescription drug sale (Example 2 in the new standard) and a transaction to provide health care services to an uninsured (self-pay) patient (Example 3 in the new standard). In both examples, the entity concludes that the transaction price is not the stated price or standard rate and that the promised consideration is therefore variable. Consequently, an entity may need to determine the transaction price in Step 3 of the model, including any price concessions, before concluding on the collectibility criterion in Step 1 of the model.

Fiscal funding clauses may affect assessment of whether a contract exists

When the customer in a contract is a government, there may be a fiscal funding clause in the contract stating that the contract is cancelable if the funding authority does not appropriate the funds necessary for the government to pay. Judgment will need to be applied in those contracts to determine whether a contract exists when delivery of goods or services commences before funding has been formally approved.

Comparison with current IFRS

Two definitions of a contract exist in IFRS

[IAS 32.13]

The definition of a contract in the new standard focuses on legal enforceability. Although the term 'contract' is also defined in IAS 32, the IAS 32 definition is different and stops short of requiring that a contract be enforceable by law. The IASB did not amend the definition of a contract in IAS 32, on the grounds that this may have unintended consequences on the accounting for financial instruments. As a result, there are two definitions of a contract in IFRS – one in IFRS 15 and another in IAS 32.

Comparison with current U.S. GAAP

Collectibility criterion replaces specific guidance for health care entities and real estate transactions

954-605-45-4

Under the new standard, if a health care provider expects to accept a lower amount of consideration than the amount billed for a patient class – e.g., those with uninsured, self-pay obligations – in exchange for services provided, then the provider estimates the transaction price based on historical collections for that patient class. This may be a change for health care providers currently recognizing significant amounts of patient service revenue and related bad debt when services are rendered even though they do not expect the patient to pay the full amount.

360-20

To recognize full profit on a real estate sale under current U.S. GAAP, the buyer has to provide a specified amount of initial and continuing investment and the seller cannot have significant continuing involvement in the property. Under the new standard, the bright lines that currently exist, as well as the specific criteria about significant continuing involvement, are eliminated, and collectibility is only considered in determining whether a contract exists and a sale has occurred. This may result in some transactions being treated as a sale under the new standard that would not qualify for full profit recognition under current U.S. GAAP.

Customary business practices versus legally enforceable

SEC SAB Topic 13

Under current SEC guidance, if an entity's customary business practice is to have, in addition to meeting the other criteria, a contract signed by both parties before it concludes that persuasive evidence of an arrangement exists, the entity does not recognize revenue until a written sales agreement is finalized – including being signed by both the customer and the entity. Under the new standard, if the placement of the customer order and shipment of the goods constitute a legally enforceable contract, the guidance in the new revenue model is applied even if that differs from an entity's customary business practices. Similar arrangements in different jurisdictions may be treated differently if the determination of a legally enforceable contract varies.

Consideration not required to be fixed or determinable

SEC SAB Topic 13; 985-605-25-3

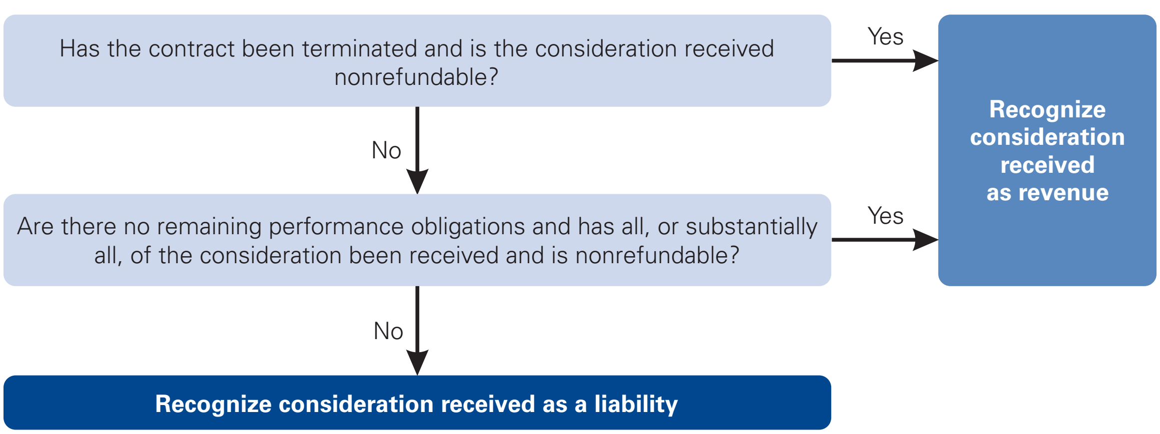
Under current SEC guidance and U.S. GAAP for software entities, consideration in a contract has to be fixed or determinable in order for the entity to recognize revenue. Under the new standard, the payment terms need to be identified for a contract to exist under the model, but do not need to be fixed or determinable. Instead, an entity estimates variable consideration in Step 3 of the model (see 5.3.1).

5.1.2 Consideration received before concluding that a contract exists

Requirements of the new standard

606-10-25-7 to 25-8 [IFRS 15.15 to 16]

The following flow chart outlines when consideration received from a contract that is not yet in the scope of the new standard can be recognized.



The entity is, however, required to reassess the arrangement and, if Step 1 of the model is subsequently met, begin applying the revenue model to the arrangement.

Observations

Guidance also applies to the sale of nonfinancial assets

ASU 2014-09 BC495
[IFRS 15.BC495]

Under U.S. GAAP, the new standard's guidance also applies to the sales of nonfinancial assets to parties other than a customer, because an entity is required to apply the requirements of Step 1 of the model to sales of nonfinancial assets. For further discussion on sales of nonfinancial assets, see Section 9.

Revenue recognition may be deferred for a significant period

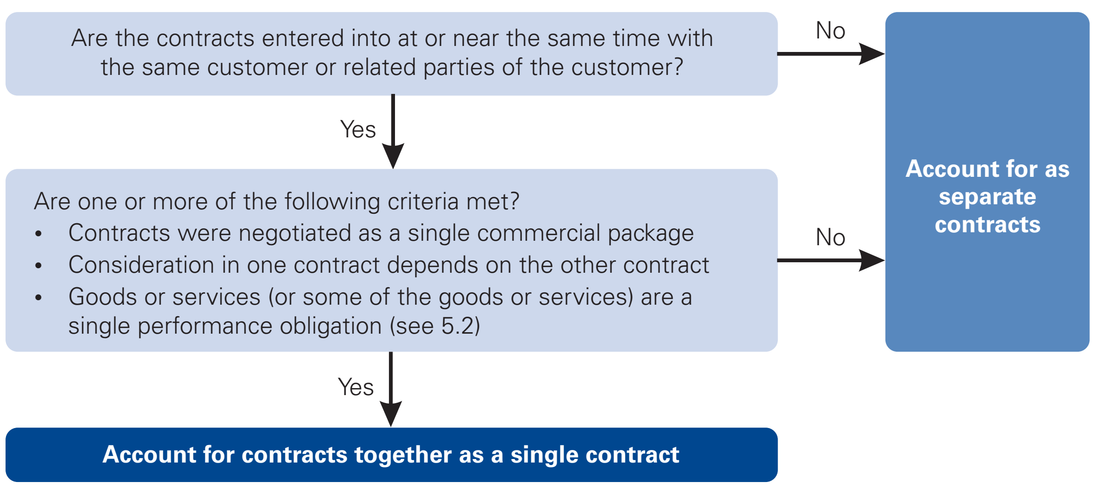
If an entity cannot conclude that a legally enforceable contract exists, it may be difficult to evaluate when all or substantially all of the promised consideration has been received and is nonrefundable. In some cases, an entity may have a deposit recognized for a significant period of time until it can conclude that a contract exists in the model or that the criteria above for recognizing the consideration are met.

5.1.3 Combination of contracts

Requirements of the new standard

606-10-25-9
[IFRS 15.17]

The following flow chart outlines the criteria in the new standard for determining when an entity combines two or more contracts and accounts for them as a single contract.



Example 5

Combination of contracts for related services

Software Company A enters into a contract to license its customer relationship management software to Customer B. Three days later, in a separate contract, Software Company A agrees to provide consulting services to significantly customize the licensed software to function in Customer B's IT environment. Customer B is unable to use the software until the customization services are complete.

Software Company A determines that the two contracts are combined because they were entered into at nearly the same time with the same customer, and the goods or services in the contracts are a single performance obligation. Software Company A is providing a significant service of integrating the license and consulting services into the combined item for which the customer has contracted. In addition, the software will be significantly customized by the consulting services. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see 5.2.

Observations

Definition of related parties acquires new significance

ASU 2014-09 BC74; 850-10-20
[IFRS 15.BC74; IAS 24]

The new standard specifies that for two or more contracts to be combined, they should be with the same customer or related parties of the customer. The Boards state that the term 'related parties' as used in the new standard has the same meaning as the definition in current related party guidance. This means that the definition originally developed in U.S. GAAP and IFRS for disclosure purposes acquires a new significance, as it can affect the recognition and measurement of revenue transactions.

Combining contracts criteria similar but not identical to current guidance

605-35
[IAS 11.8 to 9]

Both U.S. GAAP and IFRS contain explicit guidance on combining construction contracts, which is sometimes applied by analogy to other contracts to identify different components of a transaction. The new standard's guidance on combining contracts applies to all contracts in its scope. The approach to combining contracts in the new standard is similar but not identical to that in current U.S. GAAP and IFRS, which may result in different outcomes under the new standard than under current practice.

Additional complexities for sales through distribution channels

When applying the guidance on combining contracts, an entity needs to determine who the customer is under the contract. Contracts entered into by an entity with various parties in the distribution channel that are not customers of the entity are not combined. For example, for automotive manufacturers, the customer for the sale of a vehicle is typically a dealer, while the customer for a lease of a vehicle is typically the end consumer. Because the dealer and the end consumer are not related parties, these contracts (the initial sales contract for the vehicle to the dealer and the subsequent lease contract with the end consumer) are not evaluated for the purpose of combining them, and are treated as separate contracts.

ASU 2014-09 BC92
[IFRS 15.BC92]

However, performance obligations that an entity implicitly or explicitly promises to an end consumer in a distribution channel – e.g., free services to the end customer when the entity's sale is to an intermediary party – are evaluated as part of the contract. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see 5.2.

Comparison with current U.S. GAAP

Elimination of rebuttable presumption

605-25-25-3

Current U.S. GAAP on multiple-element arrangements contains a rebuttable presumption that contracts entered into at or near the same time with the same entity or related parties are a single contract. The new standard does not include a similar rebuttable presumption, although it is unclear whether that will affect the analysis in practice.

Software-specific indicators versus specified criteria

985-605-55-4

Existing software guidance provides six indicators that an entity considers to determine whether multiple contracts with the same customer are combined and accounted for as a single multiple-element arrangement. Although one of the indicators is that contracts are negotiated or executed within a short time frame of each other, it is only an indicator to be considered along with the other five indicators.

Under the new standard, entities are required to combine contracts if the contracts are entered into at or near the same time with the same customer (or related parties) and any one of the three specified criteria is met. Although this is similar in concept to the current guidance, it may result in some different conclusions about whether multiple contracts are combined because there are specified criteria instead of indicators to consider.

5.2 Step 2: Identify the performance obligations in the contract

Overview

The process of identifying performance obligations requires an entity to determine whether it promises to transfer either goods or services that are distinct, or a series of distinct goods or services that meet certain conditions. These promises may not be limited to those explicitly included in written contracts. The new standard provides indicators to help determine when the distinct criteria are met.

Requirements of the new standard

606-10-25-14, 25-18
[IFRS 15.22, 26]

A performance obligation is the unit of account for revenue recognition. An entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation either:

- a good or service (or a bundle or goods or services) that is distinct (see 5.2.1); or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see 5.2.3).

This will include an assessment of implied promises and administrative tasks (see 5.2.2).

5.2.1 Distinct goods or services

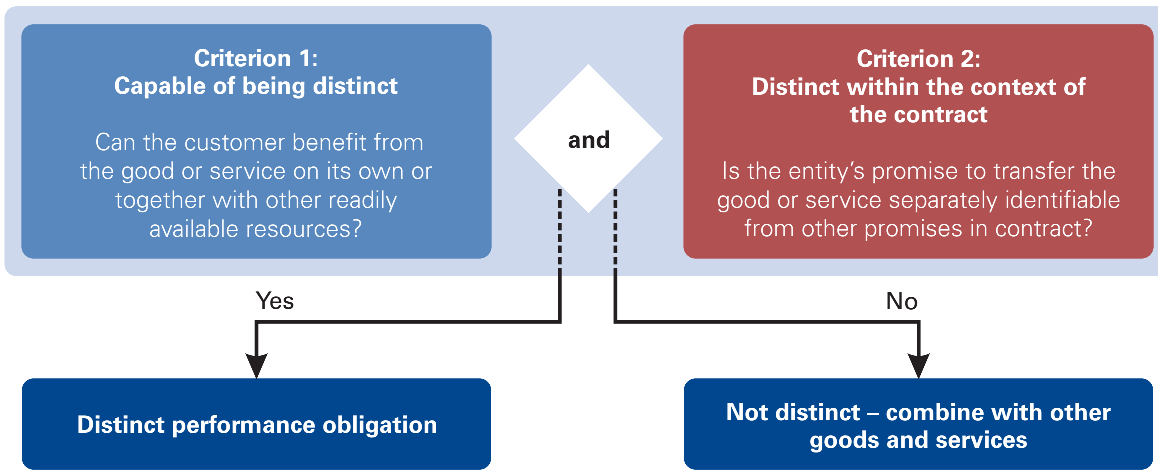
Requirements of the new standard

606-10-25-14
[IFRS 15.22]

A single contract may contain promises to deliver more than one good or service. At contract inception, an entity evaluates the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore constitute performance obligations.

A good or service is distinct if both of the following criteria are met.

606-10-25-19
[IFRS 15.27]



606-10-25-20
[IFRS 15.28]

Criterion 1

Good or service is capable of being distinct

A customer can benefit from a good or service if it can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits.

A customer can benefit from a good or service on its own or in conjunction with:

- other readily available resources that are sold separately by the entity, or by another entity; or
- resources that the customer has already obtained from the entity – e.g., a good or service delivered up-front – or from other transactions or events.

The fact that a good or service is regularly sold separately by the entity is an indicator that the customer can benefit from a good or service on its own or with other readily available resources.

606-10-25-21
[IFRS 15.29]

Criterion 2

Distinct within the context of the contract

The new standard provides indicators to evaluate whether a promised good or service is distinct within the context of the contract, which include, but are not limited to, the following.

- The entity does not provide a significant service of integrating the good or service (or bundle of goods or services) with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted – i.e., the entity is not using the good or service as an input to produce or deliver the output specified in the contract.
- The good or service does not significantly modify or customize another good or service promised in the contract.
- The good or service is not highly dependent on or highly interrelated with other goods or services promised in the contract – e.g., if a customer could decide not to purchase the good or service without significantly affecting the other promised goods or services in the contract.

606-10-25-22
[IFRS 15.30]

If a promised good or service is determined not to be distinct, an entity continues to combine that good or service with other goods or services until the combined bundle is a distinct performance obligation, or until all of the goods or services in the contract have been combined into a single performance obligation.

Example 6

Single performance obligation in a contract

606-10-55-137 to 55-140
[IFRS 15.IE45 to IE48]

Construction Company C enters into a contract with Customer D to design and build a hospital. Construction Company C is responsible for the overall management of the project and identifies goods and services to be provided – including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

Construction Company C identifies various goods and services that will be provided during the hospital construction that might otherwise benefit Customer D. Customer D could benefit from various goods or services on their own – e.g., if each construction material is sold separately by numerous entities, could be resold for more than scrap value by Customer D, or is sold together with other readily available resources such as additional materials or the services of another contractor.

However, Construction Company C notes that the goods and services to be provided under the contract are not separately identifiable from the other promises in the contract. Instead, Construction Company C is providing a significant integration service by combining all of the goods and services in the contract into the combined item for which Customer D has contracted – i.e., the hospital.

Therefore, Construction Company C concludes that the second criterion is not met and that the individual activities do not represent distinct performance obligations. Accordingly, it accounts for the bundle of goods and services to construct the hospital as a single performance obligation.

Example 7

Multiple performance obligations in a contract

Telco T has a contract with Customer R that includes the delivery of a handset and 24 months of voice and data services.

The handset is locked to Telco T's network and cannot be used on a third-party network without modification – i.e., through an unlock code – but can be used by a customer to perform certain functions – e.g., calendar, contacts list, email, internet access, and accessing apps via Wi-Fi and to play music or games.

However, there is evidence of customers reselling the handset on an online auction site and recapturing a portion of the selling price of the phone. Telco T regularly sells its voice and data services separately to customers, through renewals and sales to customers who acquire their handset from an alternative vendor – e.g., a retailer.

In this example, Telco T concludes that the handset and the wireless services are two separate performance obligations based on the following evaluation.

Criterion 1	**Handset is capable of being distinct** • Customer R can benefit from the handset either on its own – i.e., because the handset can be resold for more than scrap value and has substantive, although diminished, functionality that is separate from Telco T's network – or together with its wireless services that are readily available to Customer R, because Telco T sells those services separately. • Customer R can benefit from the wireless services in conjunction with readily available resources – i.e., either the handset is already delivered at the time of contract set-up or is purchased from alternative retail vendors.
Criterion 2	**Distinct within the context of the contract** • The handset and the wireless services are separable in this contract because they are not inputs to a single asset – i.e., a combined output – which indicates that Telco T is not providing a significant integration service. • Neither the handset nor the wireless services significantly modifies or customizes the other. • Customer R could purchase the handset and the voice/data services from different parties – i.e., Customer R could purchase the handset from a retailer – therefore providing evidence that the handset and voice/data services are not highly dependent on, or highly interrelated with, each other.

Telco T concludes that it does not need to evaluate whether the voice and data services are distinct from each other because the services will be provided over the same concurrent period and have the same pattern of transfer to Customer R.

Observations

Applying the indicators will require judgment

The new standard does not include a hierarchy or weighting of the indicators of whether a good or service is separately identifiable from other promised goods or services within the context of the contract. An entity evaluates the specific facts and circumstances of the contract to determine how much emphasis to place on each indicator.

Certain indicators may provide more compelling evidence to the separability analysis than others in different scenarios or types of contracts. In addition, there are some instances where the relative strength of an indicator, in light of the specific facts and circumstances of that contract, may lead an entity to conclude that two or more promised goods or services are not separable from each other within the context of the contract. This may occur even if the other two indicators might suggest separation.

For example, a software entity may conclude that in some cases its off-the-shelf software is separable from its non-complex implementation services because the core software code itself will not be significantly modified or customized by implementation-type services, and because the process itself may not be complex or significant. In other cases, the entity may conclude that its implementation services are not separable from the software license due to their complex interfacing or other specialized requirements, because they are significant to the customer's ability to obtain its intended benefit from the license. In the latter case, the fact that certain services are available from another provider, or that the core software code will not be significantly modified or customized by these implementation services, may have less relevance.

A potential change in practice for the software industry

606-10-55-141 to 55-150
[IFRS 15.IE49 to IE58]

In Example 11 of the new standard, post-contract customer support (PCS) that includes both technical support and unspecified software upgrades provided on a when-and-if available basis comprises two separate performance obligations. Additionally, in that example the two performance obligations are distinct from the software license itself, which is also a separate performance obligation. Current IFRS does not provide any specific guidance on revenue recognition for software-related transactions and the substance of each transaction needs to be considered to determine whether the various components are linked.

985-605-25-67

Under current U.S. GAAP, PCS is treated as a single element when it is separable from the license – i.e., when the entity has vendor-specific objective evidence (VSOE) of the fair value of the PCS. Because that example separates the PCS into two performance obligations, their treatment may differ as the model is applied to each of these two performance obligations.

Contractual restrictions may not be determinative

Contracts between an entity and a customer often include contractual limitations or prohibitions. These may include prohibitions on reselling a good in the contract to another third party, or restrictions on using certain readily available resources – e.g., the contract may require a customer to purchase complementary services from the entity in conjunction with its purchase of a good or license.

ASU 2014-09 BC100
[IFRS 15.BC100]

A contractual restriction on the customer's ability to resell a good – e.g., to protect an entity's intellectual property – may prohibit an entity from concluding that the customer can benefit from a good or service, on the basis of the customer not being able to resell the good for more than scrap value in an available market. However, if the customer can benefit from the good – e.g., a license – together with other readily available resources, even if the contract restricts the customer's access to those resources – e.g., by requiring the customer to use the entity's products or services – then the entity may conclude that the good has benefits to the customer and that the customer could purchase or not purchase the entity's products or services without significantly affecting that good.

Multiple units of a new product may be a single performance obligation

ASU 2014-09 BC111 to BC112
[IFRS 15.BC111 to BC112]

The Boards believe that promised goods or services may not be separately identifiable from the other promised goods or services when they are highly dependent on, or highly interrelated with each other – even when there is not a significant integration service or the goods or services do not significantly modify or customize other goods or services in the contract. In these cases, the Boards believe that it will be difficult for a customer to purchase one good or service without having a significant effect on the other promised goods or services in the contract.

For example, if an entity agrees to design a new product for a customer and then manufactures a limited number of prototype units, the entity should consider whether each promise is highly dependent on, and highly interrelated with, the other promises in the contract. If some or all of the initial units produced require rework because of design changes in the production process, it might be difficult to determine whether the customer could choose to purchase only the design service or manufacturing service without having a significant effect on the other. Although the entity may be able to benefit from each unit on its own, the units may not be separately identifiable, because each promise may be highly dependent on, or highly interrelated with, the other promised goods or services in the contract.

Systems and processes may be needed to allocate revenue to individual products or services

SEC Regulation S-X, Rule 5-03(b)

Under the new standard, a single performance obligation may be a combination of two or more goods and services. Although an entity may have one performance obligation, it may need systems and processes in place to allocate revenue between the individual products and services to meet voluntary or regulatory disclosures – e.g., the SEC requirement to present tangible product sales and sales from services separately.

Comparison with current IFRS

Separately identifiable components

[IAS 18.13; IFRIC 13; IFRIC 15; IFRIC 18]

Current IFRS includes limited guidance on identifying whether a transaction contains separately identifiable components. However, our view is that based on analogy to the test in IFRIC 18, an entity should consider whether a component has stand-alone value to the customer and whether the fair value of the component can be reliably measured (see 4.2.50.60 in *Insights into IFRS*, 11th Edition).

The new standard introduces comprehensive guidance on identifying separate components that applies to all revenue-generating transactions, which could result in goods or services being unbundled or bundled more frequently than under current practice.

Comparison with current U.S. GAAP

Benefit to the customer versus stand-alone value

605-25-25-5

For a promised good or service to be distinct under the new standard, it has to be:

- capable of being distinct (Criterion 1); and
- distinct within the context of the contract (Criterion 2).

Criterion 1 (capable of being distinct) is similar, but not identical, to the stand-alone value criterion required under current U.S. GAAP. Specifically, under current U.S. GAAP a delivered item has value on a stand-alone basis if it is sold separately by any entity or if the customer could resell the delivered item on a stand-alone basis (even in a hypothetical market).

Under the new standard, an entity evaluates whether the customer can benefit from the good or service on its own or together with other readily available resources. This evaluation no longer depends entirely on whether the entity or another entity sells an identical or largely interchangeable good or service separately, or whether the delivered item can be resold by the customer, to support a conclusion that a good or service is distinct. Rather, in evaluating whether the customer can benefit from the good or service on its own, an entity determines whether the good or service is sold separately (by the entity or another entity) or could be resold for more than scrap value. An entity also considers factors such as a product's stand-alone functional utility. Therefore, potentially more goods can qualify as distinct under Criterion 1 than under current U.S. GAAP. However, an entity also has to evaluate Criterion 2.

Promised goods or services versus deliverables

There may not be an exact correlation in all cases between what is considered a 'deliverable' under current U.S. GAAP and what is considered a 'promised good or service' under the new standard. The term 'deliverable' is not defined in current U.S. GAAP. However, in a 2007 speech,[4] the SEC staff noted that the following criteria are a helpful starting point in determining whether an item is a deliverable in the arrangement:

- the item is explicitly referred to as an obligation of the entity in a contractual arrangement;
- the item requires a distinct action by the entity;
- if the item is not completed, the entity will incur a significant contractual penalty; or
- inclusion or exclusion of the item from the arrangement will cause the arrangement fee to vary by more than an insignificant amount.

Under the new standard, a promised good or service is embedded within the guidance on identifying a contract. Specifically, promised goods or services are the promised obligations within the contract.

Essential to functionality versus separately identifiable

985-605-25-76 to 25-85

When determining whether software and services in a contract should be accounted for separately under current U.S. GAAP, an entity considers whether the service element is essential to the functionality of the other elements in the arrangement, including the software license.

However, under the new standard an entity considers whether the software and the related services are separately identifiable, which includes evaluating whether there is a significant integration service, whether one good or service significantly modifies or customizes the other, or whether the goods or services are highly dependent on, or highly interrelated with, each other. Although significant judgment may be required, some entities may conclude that services and software will be combined under the new standard, even though the services do not meet the currently required level of being essential to the software's functionality.

4 SEC Speech, "*Remarks Before the 2007 AICPA National Conference on Current SEC and PCAOB Developments*," by Mark Barrysmith, Professional Accounting Fellow at the SEC, available at www.sec.gov.

No perfunctory or inconsequential concept

SEC SAB Topic 13; ASU 2014-09 BC89 to BC90

Current SEC guidance permits revenue from sales arrangements to be recognized in its entirety if the seller's remaining obligation(s) was perfunctory or inconsequential. The new standard does not exempt an entity from accounting for promised goods or services that the entity might regard as being perfunctory or inconsequential. The Boards believe that it would be difficult and subjective for an entity to determine what goods or services promised in a contract were perfunctory or inconsequential to other goods or services in the contract and that different entities would likely apply the minor or inconsequential concept inconsistently. Therefore, an entity needs to consider all promised goods or services in a contract, subject to general materiality considerations.

Potential change for life sciences

In the pharmaceutical industry, entities do not typically sell technology licenses because the technology is proprietary. Therefore, entities that license unique technology together with proprietary R&D services are currently often required to combine the license with the R&D services in the contract.[5] However, under the new standard a customer may be able to benefit from the license with other readily available resources. An entity also considers whether the good or service is distinct within the context of the contract in order to separate the goods or services in the contract. This could result in a change in practice for some pharmaceutical companies.

5.2.2 Implied promises and administrative tasks

Requirements of the new standard

606-10-25-16 to 25-17 [IFRS 15.24 to 25]

Promises to transfer a good or service can be explicitly stated in the contract, or implicit based on an entity's established business practices or published policies if they create a valid expectation that the entity will transfer the good or service to the customer.

Conversely, administrative tasks do not transfer a good or service to the customer and are not performance obligations – e.g., administrative tasks to set up a contract.

Example 8

Implied promise to reseller's customers

Software Company K enters into a contract with Reseller D, who then sells those software products to end users. Software Company K has a customary business practice of providing free telephone support to end users without involving the reseller, and both expect Software Company K to continue to provide this support.

In evaluating whether the telephone support is a separate performance obligation, Software Company K notes that:

- Reseller D and the end customers are not related parties – and as such, these contracts will not be combined; and

5 SEC Speech, "*Remarks Before the 2009 AICPA National Conference on Current SEC and PCAOB Developments*," by Arie Wilgenburg, Professional Accounting Fellow at the SEC, available at www.sec.gov.

- the promise to provide telephone support free of charge to end users is considered a service that meets the definition of a performance obligation when control of the software product transfers to Reseller D.

As a result, Software Company K accounts for the telephone support as a separate performance obligation in the transaction with the reseller.

Example 9

Implied performance obligation – Pre- and post-sale incentives

Car Manufacturer N has an historical practice of offering free maintenance services – e.g., oil changes and tire rotation – for two years to the end customers of dealers who purchase its vehicles. Although not explicitly stated in the contract with its dealers, Car Manufacturer N has a customary business practice of offering the two-year maintenance incentive; therefore, the maintenance is treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle is recognized when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognized as the maintenance services are provided to the retail customer.

606-10-55-156 to 55-157
[IFRS 15.IE64 to IE65]

However, if Car Manufacturer N does not have a customary business practice of offering free maintenance, and instead announces the maintenance program as a limited-period sales incentive after control of the vehicle has transferred to the dealer, then the free maintenance is not a separate performance obligation in the sale of the vehicle to the dealer. In this case, Car Manufacturer N recognizes the full amount of revenue when control of the vehicle is transferred to the dealer. If Car Manufacturer N subsequently creates an obligation by announcing that it will provide incentives, Car Manufacturer N will accrue as an expense its expected cost of providing maintenance services on the vehicles in the distribution channel – i.e., controlled by dealers – when the program is announced.

Determining whether a sales incentive to end customers was offered pre- or post-sale to the dealer will be challenging for some entities, especially for implied sales incentives where the entity has a customary business practice of offering incentives. The entity will need to assess whether the dealer and customer have an expectation that the entity will provide a free service.

Example 10

Administrative task – Registration of software keys

Software Company B licenses and transfers operating system software to Customer L. The operating system software will not function on Customer L's computer hardware without a key provided by Software Company B. Customer L has to provide Software Company B with the serial number from the hardware to receive the key. If Customer L orders hardware from a different supplier and has not received the hardware when the operating system software is delivered, it is still obligated to pay for the operating system software because payment is not contingent on delivery of the key.

In this example, delivery of the key is contingent only on Customer L's actions, and the delivery of the key is an administrative task. Therefore, that activity is not considered to be a promised service in the contract. Assuming that all other revenue recognition criteria have been met – including Customer L obtaining control of the operating system software – Software Company B recognizes revenue on delivery of the operating system software because delivery of the key is an administrative activity that does not transfer a promised good or service.

Observations

Only promises that transfer goods or services to the customer can be performance obligations

ASU 2014-09 BC93, BC411(b)
[IFRS 15.BC93, BC411(b)]

An entity does not account for a promise that does not transfer goods or services to the customer. For example, an entity's promise to defend its patent, copyright, or trademark is not a performance obligation.

Comparison with current U.S. GAAP

Administrative tasks

SEC SAB Topic 13

The notion of an administrative task exists in current SEC guidance and refers to activities that do not represent discrete earnings events – i.e., selling a membership, signing a contract, enrolling a customer, activating telecommunications services, or providing initial set-up services. Current SEC guidance distinguishes between deliverables and these activities. It states that activities that do not represent discrete earnings events are typically negotiated in conjunction with the pricing of the deliverables to the contract, and that the customer generally views these types of non-deliverable activities as having significantly lower or no value separate from the entity's overall performance under the contract.

In general, entities are unlikely to reach a substantially different conclusion under the new standard in attempting to identify administrative tasks than they have reached under current SEC guidance in identifying activities that do not represent discrete earnings events.

5.2.3 Series of distinct goods or services

Requirements of the new standard

606-10-25-14(b)
[IFRS 15.22(b)]

A contract may contain promises to deliver a distinct series of goods or services that are substantially the same. At contract inception, an entity assesses the goods or services promised in the contract and determines whether the series of goods or services are a single performance obligation. This is the case when they are substantially the same and meet both of the following criteria.

606-10-25-15
[IFRS 15.23]

Each distinct good or service in the series is a performance obligation satisfied over time (see 5.5.2) + **The same method would be used to measure progress toward satisfaction of each distinct good or service in the series (see 5.5.3)** = **A single performance obligation**

Example 11

Series of distinct goods or services treated as a single performance obligation

Contract Manufacturer X agrees to produce 1,000 customized widgets for use by Customer A in its products. Contract Manufacturer X concludes that the widgets will transfer to Customer A over time because:

- they have no alternative use to Contract Manufacturer X; and
- Customer A is contractually obligated to pay Contract Manufacturer X for any finished or in-process widgets, including a reasonable margin, if Customer A terminates the contract for convenience.

Contract Manufacturer X already has the process in place to produce the widgets and is given the design by Customer A, such that Contract Manufacturer X does not expect to incur any significant learning curve or design and development costs. Contract Manufacturer X uses a method of measuring progress toward complete satisfaction of its manufacturing contracts that takes into account work in progress and finished goods controlled by Customer A.

Based on this fact pattern, Contract Manufacturer X concludes that each of the 1,000 widgets is distinct, because:

- Customer A can use each widget on its own; and
- each widget is separately identifiable from the others because one does not significantly affect, modify, or customize another.

Despite the fact that each widget is distinct, Contract Manufacturer X concludes that the 1,000 units are a single performance obligation because:

- each widget will transfer to Customer A over time; and
- Contract Manufacturer X uses the same method to measure progress toward complete satisfaction of the obligation to transfer each widget to Customer A.

Example 12

Distinct service periods within a long-term service contract

Cable Company R enters into a two-year service contract with Customer M to provide cable television services for a fixed fee of 100 per month. Cable Company R has concluded that its cable television services are satisfied over time because Customer M consumes and receives the benefit from the services as they are provided – e.g., customers generally benefit from each day that they have access to Cable Company R's services.

Cable Company R determines that each increment of its services – e.g., day or month – is distinct because Customer M benefits from that period of service on its own and each increment of service is separable from those preceding and following it – i.e., one service period does not significantly affect, modify, or customize another. However, Cable Company R concludes that its contract with Customer M is a single performance obligation to provide two years of cable television service because each of the distinct increments of services is satisfied over time and Cable Company R uses the same measure of progress to recognize revenue on its cable television services regardless of the contract's time period.

Observations

Accounting for a series provides a simplification of the model

ASU 2014-09 BC113 to BC114
[IFRS 15.BC113 to BC114]

The Boards believe that accounting for a series of distinct goods or services as a single performance obligation if they are substantially the same and meet certain criteria simplifies the application of the model and promotes consistency in identifying performance obligations in a repetitive service arrangement. For example, without the guidance on the series of goods or services, an entity may need to allocate consideration to each hour or day of service in a cleaning service contract. The Boards also gave transaction processing and the delivery of electricity as examples of a series of goods or services.

ASU 2014-09 BC115
[IFRS 15.BC115]

However, if the contract is modified then the entity considers the distinct goods or services rather than the performance obligation. This in turn simplifies the accounting for the contract modification (see Section 7).

Comparison with current U.S. GAAP

Separate performance obligations

605-25-25-5

The current U.S. GAAP separation model focuses on whether *delivered* goods or services are separable from other goods or services – i.e., *undelivered* goods or services do not need to meet explicit separability criteria. Under the new standard, entities consider at contract inception whether each good or service in the contract is a separate performance obligation or whether they have promised a series of distinct goods or services that is a single performance obligation.

5.3 Step 3: Determine the transaction price

Overview

606-10-32-2
[IFRS 15.47]

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g., some sales taxes. To determine this amount, an entity considers multiple factors.

606-10-32-4
[IFRS 15.49]

An entity estimates the transaction price at contract inception, including any variable consideration, and updates the estimate each reporting period for any changes in circumstances. When determining the transaction price, an entity assumes that the goods or services will be transferred to the customer based on the terms of the existing contract, and does not take into consideration the possibility of a contract being canceled, renewed, or modified.

In determining the transaction price, an entity considers the following components.

606-10-32-3
[IFRS 15.48]

Transaction price

Variable consideration (and the constraint) (see 5.3.1)

An entity estimates the amount of variable consideration to which it expects to be entitled, giving consideration to the risk of revenue reversal in making the estimate

Significant financing component (see 5.3.2)

For contracts with a significant financing component, an entity adjusts the promised amount of consideration to reflect the time value of money

Noncash consideration (see 5.3.3)

Noncash consideration is measured at fair value, if that can be reasonably estimated; if not, an entity uses the stand-alone selling price of the good or service that was promised in exchange for noncash consideration

Consideration payable to a customer (see 5.3.4)

An entity needs to determine whether consideration payable to a customer represents a reduction of the transaction price, a payment for a distinct good or service, or a combination of the two

Customer credit risk is not considered when determining the amount to which an entity expects to be entitled – instead, credit risk is considered when assessing the existence of a contract (see 5.1). However, if the contract includes a significant financing component provided to the customer, the entity considers credit risk in determining the appropriate discount rate to use (see 5.3.2).

606-10-32-13, 55-65
[IFRS 15.58, B63]

An exception exists for sales- or usage-based royalties arising from licenses of intellectual property (see 8.4).

5.3.1 Variable consideration (and the constraint)

Requirements of the new standard

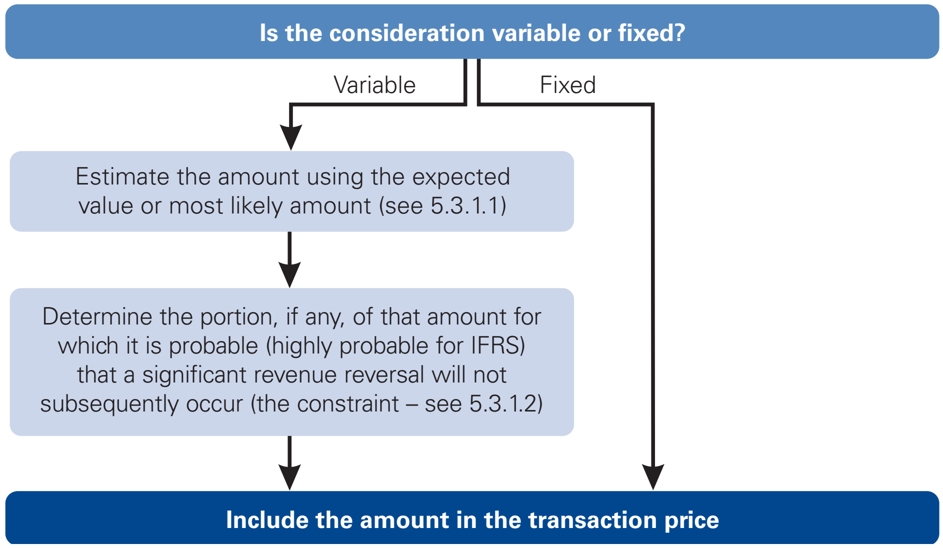
606-10-32-6 to 32-7
[IFRS 15.51 to 52]

Items such as discounts, rebates, refunds, rights of return, credits, price concessions, incentives, performance bonuses, penalties, or similar items may result in variable consideration. Promised consideration can also vary if it is contingent on the occurrence or non-occurrence of a future event. Variability may be explicit or implicit, arising from customary business practices, published policies or specific statements, or any other facts and circumstances that would create a valid expectation by the customer.

606-10-32-8, 32-11, 32-13
[IFRS 15.53, 56, 58]

An entity assesses whether, and to what extent, it can include an amount of variable consideration in the transaction price at contract inception. The following flow chart sets out how an entity determines the amount of variable consideration in the transaction price, except for sales- or usage-based royalties from licenses of intellectual property.

Home



606-10-32-10
[IFRS 15.55]

An entity recognizes a refund liability for consideration received or receivable if it expects to refund some or all of the consideration to the customer.

The new standard applies the mechanics of estimating variable consideration in a variety of scenarios, some of which include fixed consideration – e.g., sales with a right of return (see 10.1) and customers' unexercised rights (breakage) (see 10.5).

Observations

Consideration can be deemed to be variable even if the stated price in the contract is fixed

ASU 2014-09 BC190 to BC194
[IFRS 15.BC190 to BC194]

The guidance on variable consideration may apply to a wide variety of circumstances. The promised consideration may be variable if an entity's customary business practices and relevant facts and circumstances indicate that the entity may accept a price lower than stated in the contract – i.e., the contract contains an implicit price concession, or the entity has a history of providing price concessions or price support to its customers.

In such cases, it may be difficult to determine whether the entity has implicitly offered a price concession, or whether it has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (customer credit risk). Entities need to exercise judgment and consider all of the relevant facts and circumstances in making that determination.

5.3.1.1 Estimate the amount of variable consideration

Requirements of the new standard

606-10-32-8
[IFRS 15.53]

When estimating the transaction price for a contract with variable consideration, an entity's initial measurement objective is to determine the method that better predicts the consideration to which the entity will be entitled, using either of the following methods.

Expected value	The entity considers the sum of probability-weighted amounts for a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
Most likely amount	The entity considers the single most likely amount from a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if the contract has only two (or perhaps a few) possible outcomes.

606-10-32-9
[IFRS 15.54]

The method selected is applied consistently throughout the contract when estimating the effect of uncertainty on the amount of variable consideration to which the entity will be entitled.

Example 13

Estimate of variable consideration – Expected value

Electronics Manufacturer M sells 1,000 televisions to Retailer R for 500,000 (500 per television). Electronics Manufacturer M provides price protection to Retailer R by agreeing to reimburse Retailer R for the difference between this price and the lowest price that it offers for that television during the following six months. Based on Electronics Manufacturer M's extensive experience with similar arrangements, it estimates the following outcomes.

Price reduction in next six months	Probability
0	70%
50	20%
100	10%

Manufacturer M determines that the expected value method provides the better prediction of the amount of consideration to which it will be entitled. As a result, it estimates the transaction price to be 480 per television – i.e., (500 × 70%) + (450 × 20%) + (400 × 10%) – before considering the constraint (see 5.3.1.2).

Example 14

Estimate of variable consideration – Most likely amount

Building and Construction Company C enters into a contract with a customer to build an asset. Depending on when the asset is completed, Company C will receive either 110,000 or 130,000.

Outcome	Consideration	Probability
Project completes on time	130,000	90%
Project is delayed	110,000	10%

Because there are only two possible outcomes under the contract, Company C determines that using the most likely amount provides the better prediction of the amount of consideration to which it will be entitled. Company C estimates the transaction price – before it considers the constraint (see 5.3.1.2) – to be 130,000, which is the single most likely amount.

Observations

All facts and circumstances considered when selecting estimation method

ASU 2014-09 BC200
[IFRS 15.BC200]

The use of a probability-weighted estimate, especially when there are binary outcomes, could result in revenue being recognized at an amount that is not a possible outcome under the contract. In such situations, using the most likely amount may be more appropriate. However, all facts and circumstances should be considered when selecting the method that better predicts the amount of consideration to which an entity will be entitled.

Expected value method – No need to quantify less probable outcomes

ASU 2014-09 BC201
[IFRS 15.BC201]

The Boards believe that when using a probability-weighted method to estimate the transaction price, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes, and that it may not be necessary for an entity to quantify all possible outcomes using complex models and techniques.

A combination of methods may be appropriate

ASU 2014-09 BC202
[IFRS 15.BC202]

The new standard requires an entity to use the same method to measure a given uncertainty throughout the contract. However, if a contract is subject to more than one uncertainty, then an entity determines an appropriate method for each uncertainty. This may result in an entity using a combination of expected values and most likely amounts within the same contract.

For example, a construction contract may state that the contract price will depend on:

- the price of a key material, such as steel – this uncertainty will result in a range of possible consideration amounts, depending on the price of steel; and
- a performance bonus if the contract is finished by a specified date – this uncertainty will result in two possible outcomes, depending on whether the target completion date is achieved.

In this case, the entity may conclude that it is appropriate to use an expected value method for the first uncertainty, and a most likely amount method for the second uncertainty.

5.3.1.2 Determine the amount for which it is probable (highly probable for IFRS) that a significant reversal will not occur ('the constraint')

Requirements of the new standard

606-10-32-11
[IFRS 15.56]

After estimating the variable consideration, an entity may include some or all of it in the transaction price – but only to the extent that it is probable (highly probable for IFRS) that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

606-10-32-12
[IFRS 15.57]

To assess whether – and to what extent – it should apply this 'constraint', an entity considers both:

- the likelihood of a revenue reversal arising from an uncertain future event; and
- the potential magnitude of the revenue reversal when the uncertainty related to the variable consideration has been resolved.

In making this assessment, the entity will use judgment, giving consideration to all facts and circumstances – including the following factors, which could increase the likelihood or magnitude of a revenue reversal.

- The amount of consideration is highly susceptible to factors outside of the entity's influence – e.g., volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence.
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience with (or other evidence from) similar types of contracts is limited, or 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 a broad range of possible consideration amounts.

606-10-32-14
[IFRS 15.59]

This assessment needs to be updated at each reporting date.

606-10-32-13
[IFRS 15.58]

An exception exists for sales- or usage-based royalties arising from licenses of intellectual property (see 8.4).

Difference between IFRS and U.S. GAAP

Level of confidence – A difference in wording only

ASU 2014-09 BC208 to BC212
[IFRS 15.BC208 to BC212]

The term 'highly probable' in the IFRS version of the new standard has been used with the intention of converging with the term 'probable' as used in the U.S. GAAP version of the new standard. The IASB took a similar approach in IFRS 5.

Example 15

Applying the constraint to an investment management contract

606-10-55-221 to 55-225
[IFRS 15.IE129 to IE133]

Investment Manager M enters into a two-year contract to provide investment management services to its customer Fund N, a non-registered investment partnership. Fund N's investment objective is to invest in equity instruments issued by large listed companies. Investment Manager M receives the following fees for providing the investment management services.

Quarterly management fee	2% per quarter, calculated on the basis of the fair value of the net assets at the end of the most recent quarter
Performance-based incentive fee	20% of the fund's return in excess of an observable market index over the contract period

Investment Manager M determines that the contract includes a single performance obligation that is satisfied over time, and identifies that both the management fee and the performance fee are variable consideration. Before including the estimates of consideration in the transaction price, Investment Manager M considers whether the constraint should be applied to either the management fee or the performance fee.

At contract inception, Investment Manager M determines that the cumulative amount of consideration is constrained because the promised consideration for both the management fee and the performance fee is highly susceptible to factors outside of its own influence. At each subsequent reporting date, Investment Manager M will make the following assessment as to whether any portion of the consideration continues to be constrained.

Quarterly management fee	Investment Manager M determines that the cumulative amount of consideration from the management fee to which it is entitled is not constrained, because it is calculated based on asset values at the end of each quarter; therefore, once the quarter finishes the consideration for the quarter is known. Investment Manager M determines that it can allocate the entire amount of the fee to the completed quarters, because the fee relates specifically to the service provided for those quarters.
Performance-based incentive fee	Investment Manager M determines that the full amount of the performance fee is constrained, and therefore excluded from the transaction price. This is because: • the performance fee has a high variability of possible consideration amounts, and the magnitude of any downward adjustment could be significant; • although Investment Manager M has experience with similar contracts, that experience is not predictive of the outcome of the current contract because the amount of consideration is highly susceptible to volatility in the market based on the nature of the assets under management; and • there are a large number of possible outcomes.

As a result, Investment Manager M determines that before the end of the contract period, the revenue recognized during the reporting period is limited to the quarterly management fees.

Observations

Constraint assessment made against cumulative revenue

When constraining its estimate of variable consideration, an entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognized – i.e., for both variable and fixed consideration, rather than on a reversal of only the variable consideration. Although the constraint is included in Step 3 of the model, there are diverse views on whether the constraint applies at the contract level or at the individual performance obligation level.

Specified level of confidence included in constraint requirements

ASU 2014-09 BC209
[IFRS 15.BC209]

The inclusion of a specified level of confidence – 'probable' ('highly probable' under IFRS) – clarifies the notion of whether an entity *expects* a significant revenue reversal. The use of existing defined terms should improve consistency in application between preparers, and reduce concerns about how regulators and users will interpret the requirement. This is an area of significant judgment, and entities will need to align their judgmental thresholds, processes, and internal controls with these new requirements. Documentation of these judgments will also be critical.

ASU 2014-09 BC207
[IFRS 15.BC207]

Constraint introduces an element of prudence

The constraint introduces a downward bias into estimates, requiring entities to exercise prudence before they recognize revenue – i.e., they have to make a non-neutral estimate. This exception to the revenue recognition model, and to the Boards' respective conceptual frameworks' requirement to make neutral estimates, reflects the particular sensitivity with which revenue reversals are viewed by many users and regulators.

Comparison with current IFRS

Estimation uncertainty limits rather than precludes revenue recognition

[IAS 18.14(c)]

The constraint represents a significant change in accounting for revenue under IFRS. Under current IFRS, an entity recognizes revenue only if it can estimate the amount reliably – so uncertainty over the outcome may preclude revenue recognition. By contrast, the constraint sets a ceiling – it limits rather than precludes revenue recognition.

Comparison with current U.S. GAAP

Applying the constraint

SEC SAB Topic 13

Unlike current U.S. GAAP, the new standard requires an entity to estimate variable consideration and apply the constraint in determining the transaction price, rather than assessing whether the amount is fixed or determinable. This may result in earlier revenue recognition in a number of circumstances.

Sell-in versus sell-through

985-605-25-36

Many entities sell products through distributors or resellers. When a reseller is unable to sell the products, the entity is often compelled to grant a price concession through price protection, or accept product returns.

Under current U.S. GAAP, some entities conclude that fees are not fixed or determinable, or that the significant risks and rewards of ownership have not been transferred to the customer if the entity has a history of offering price concessions. These entities recognize revenue when they have evidence that the reseller has sold the product to an end customer (sell-through), rather than when they sell products to a distributor or reseller (sell-in). However, other entities conclude that the fees are fixed or determinable because they can reasonably predict the amount of price concessions or returns that will be given to customers based on the entity's historical experience. These entities recognize revenue on sell-in.

Under the new standard, the transfer of risks and rewards of ownership is only one of several indicators of control transfer. An entity also needs to:

- determine the total amount of consideration to which it expects to be entitled, and for which it is probable that a significant revenue reversal will not occur (the constraint); and
- recognize that amount at the time of the sale to the distributor or reseller. Its determination of the consideration will also need to be updated each reporting period until the uncertainty is resolved.

Sell-through may not be appropriate unless:

- control of the goods has not transferred – e.g., inventory is consigned (see 5.5.6); or
- by applying the constraint, the amount recognized on selling to the distributor or reseller will be zero (which will not usually be the case) – i.e., the entire amount of consideration is at risk of a significant revenue reversal. Even then, however, if the entity has transferred control of the products to the distributor or reseller, it will derecognize the inventory and recognize the cost of goods sold.

Extended payment terms

985-605-25-33 to 25-35

Under current U.S. GAAP on software revenue recognition, for transactions in which the risk of technological obsolescence is high, an arrangement fee is presumed not to be fixed or determinable if payment of a significant portion of the licensing fee is not due until after expiration of the license, or more than 12 months after delivery. Other entities with extended payment terms and technological obsolescence risk sometimes follow this guidance by analogy.

In these circumstances, revenue is currently not recognized (unless the presumption can be overcome) until the payments become due and payable, assuming that all other revenue recognition criteria are met.

Under the new standard, extended payment terms do not necessarily preclude revenue recognition; rather, an entity applies the constraint – i.e., the amount included in the transaction price is limited to amounts for which it is probable that a significant revenue reversal will not occur. When determining the transaction price, an entity also considers the existence of a significant financing component. Therefore, the new standard is likely to result in earlier revenue recognition for many software arrangements with extended payment terms.

Performance-based incentive fees

605-20-S99

An asset manager's performance-based incentive fees are subject to the revenue constraint. The inclusion of these fees in the transaction price is limited to amounts for which it is probable that a significant revenue reversal will not occur, considering that the consideration is highly susceptible to external factors – e.g., market volatility (see Example 15 in this publication).

Although Method 2 under current SEC guidance – i.e., to recognize revenue each period at the amount that the asset manager would earn if the reporting date were the end of the contract period – is seen by some as providing a good depiction of an asset manager's performance each period, it is not consistent with the constraint's objective, because a risk of significant revenue reversal due to market volatility is likely to exist.

The new standard's guidance on performance-based incentive fees is also different from Method 1 under current SEC guidance – i.e., to recognize revenue at the end of the contract period. This is because an asset manager is not precluded from recognizing a portion of the performance-based incentive fee before the contingency is resolved if it is probable that there will not be a significant revenue reversal when the uncertainty is resolved. For example, if the asset manager locks in the performance fee before the end of the contract period by investing the managed funds in money market investments, and intends to hold the managed funds in money market investments until the end of the contract period, then the asset manager may be able to recognize a portion of the performance fees before the end of the contract period.

5.3.2 Significant financing component

Requirements of the new standard

606-10-32-15
[IFRS 15.60]

To estimate the transaction price in a contract, an entity adjusts the promised amount of consideration for the time value of money if that contract contains a significant financing component.

606-10-32-16
[IFRS 15.61]

The objective when adjusting the promised amount of consideration for a significant financing component is to recognize revenue at an amount that reflects what the cash selling price of the promised good or service would have been if the customer had paid cash at the same time that control of that good or service transferred to the customer. The discount rate used is the rate that would be reflected in a separate financing transaction between the entity and the customer at contract inception.

To make this assessment, an entity considers all relevant factors – in particular:

- the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services;
- the combined effect of the expected length of time between:
  - the entity transferring the promised goods or services to the customer;
  - the customer paying for those goods or services; and
- the prevailing interest rates in the relevant market.

606-10-32-17
[IFRS 15.62]

A contract does not have a significant financing component if any of the following factors exists.

Factor	Example
An entity receives an advance payment where the timing of the transfer of goods or services to a customer is at the discretion of the customer	A prepaid phone card or customer loyalty points
A substantial portion of the consideration is variable, and the amount and/or timing of the consideration is outside of the customer's or entity's control	A transaction whose consideration is a sales-based royalty
The difference between the amount of promised consideration and the cash selling price of the promised goods or services arises for reasons other than the provision of finance	Protection from the counterparty not completing its obligations under the contract

606-10-32-19
[IFRS 15.64]

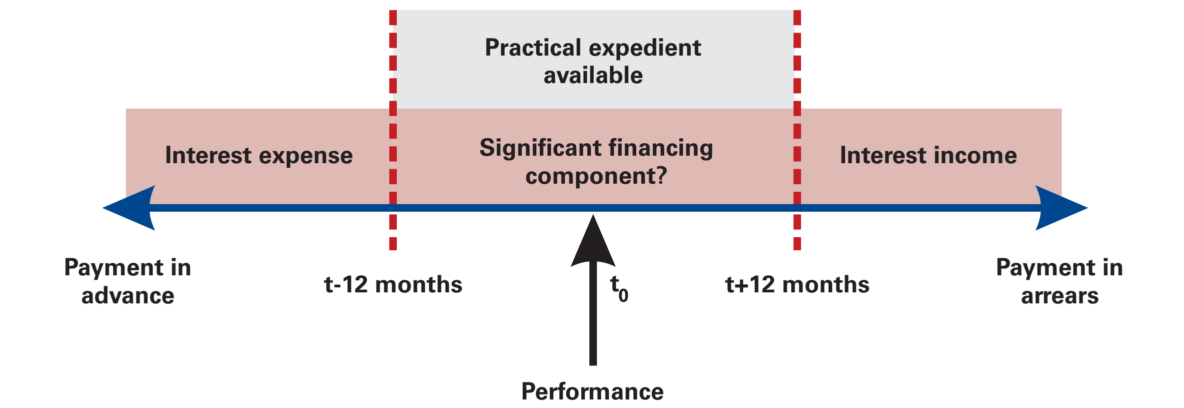
The new standard indicates that:

- an entity should determine the discount rate at contract inception, reflecting the credit characteristics of the party receiving credit; and
- that rate should not be updated for a change in circumstances.

606-10-32-18
[IFRS 15.63]

As a practical expedient, an entity is not required to adjust the transaction price for the effects of a significant financing component if the entity expects, at contract inception, that the period between customer payment and the transfer of goods or services will be one year or less.

For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for that performance is one year or less.



606-10-32-20
[IFRS 15.65]

The financing component is recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears), and is presented separately from revenue from customers.

Example 16

Time value of money in a multiple-element arrangement

Construction Company B enters into a contract with Customer C to construct and deliver Product X and Product Y for an up-front cash payment of 150,000. Product X will be delivered in two years and Product Y will be delivered in five years.

Construction Company B determines that the contract contains two performance obligations that are satisfied at the points in time at which the products are delivered to Customer C. Construction Company B allocates the 150,000 to Products X and Y at an amount of 37,500 and 112,500 respectively – i.e., based on their relative stand-alone selling prices. Construction Company B concludes that the contract contains a significant financing component and that a financing rate of 6% is appropriate based on Construction Company B's credit-standing at contract inception. Construction Company B accounts for the contract as follows.

Contract inception	Recognize a contract liability for the payment of 150,000
Years 1 and 2	During the 2 years from contract inception until the transfer of Product X, recognize interest expense of 18,540[a] on 150,000 at 6% for 2 years
	Recognize revenue of 42,135[b] for the transfer of Product X
Years 3, 4 and 5	Recognize interest expense of 24,145[c] for 3 years on the remaining contract liability of 126,405[d]
	Recognize revenue of 150,550[e] for the transfer of Product Y

Notes

(a) Calculated as 150,000 × (1.06^2 - 1).

(b) Calculated as 37,500 + 4,635, being the initial allocation to Product X plus Product X's portion of the interest for the first 2 years of the contract (25% x 18,540).

(c) Calculated as 126,405 × (1.06^3 - 1), being the contract liability balance after 2 years.

(d) Calculated as 150,000 + 18,540 - 42,135, being the initial contract liability plus interest for 2 years less the amount derecognized from the transfer of Product X.

(e) Calculated as 126,405 + 24,145, being the contract liability balance after 2 years plus interest for 3 years.

Observations

Assessment undertaken at the individual contract level

ASU 2014-09 BC234
[IFRS 15.BC234]

An entity determines the significance of the financing component at an individual contract level, rather than at a portfolio level. The Boards believe that it would be unduly burdensome to require an entity to account for a financing component if the effects of the financing component are not material to the individual contract, but the combined effects for a portfolio of similar contracts would be material to the entity as a whole. An entity should apply judgment in evaluating whether a financing component is significant to the contract.

No significant financing component if timing of transfer of goods or services is at customer's discretion

ASU 2014-09 BC233(a)
[IFRS 15.BC233(a)]

Customers pay for some types of goods or services in advance – e.g., prepaid phone cards, gift cards, and customer loyalty points – and the transfer of the related goods or services to the customer is at the customer's discretion. In these cases, the contracts do not include a significant financing component, because the payment term does not relate to a financing arrangement. Also, the Boards believe that the costs of requiring an entity to account for the financing component in these situations would outweigh any perceived benefits, because the entity would not know – and would therefore have to continually estimate – when the goods or services will transfer to the customer.

Limited examples provided of when payments have a primary purpose other than financing

ASU 2014-09 BC233(c)
[IFRS 15.BC233(c)]

In some circumstances, a payment in advance or arrears on terms that are typical for the industry and jurisdiction may have a primary purpose other than financing. For example, a customer may withhold an amount of consideration that is payable only on successful completion of the contract or the achievement of a specified milestone. The primary purpose of these payment terms, as illustrated in Example 27 of the new standard, may be to provide the customer with assurance that the entity will perform its obligations under the contract rather than provide financing to the customer.

While it seems that the Boards are attempting to address retention payments in the construction industry with these observations, it is unclear whether this concept might apply to other situations. The Boards explicitly considered advance payments received by an entity during their redeliberations – e.g., compensating the entity for incurring up-front costs – but decided not to exempt entities from accounting for the time value of money effect of advance payments.

Accounting for long-term and multiple-element arrangements with a significant financing component may be complex

Determining the effect of the time value of money for a contract with a significant financing component can be complex for long-term or multiple-element arrangements. In these contracts, goods or services are transferred at various points in time, cash payments are made throughout the contract, and there may be a change in the estimated timing of the transfer of goods or services to the customer. If additional variable elements are present in the contract – e.g., contingent consideration – then these calculations can be even more sophisticated, making the cost and complexity for preparers significant. In addition, an entity will need to have appropriate processes and internal controls in place to handle these potential complexities in assessing whether a significant financing component exists and, if so, developing the appropriate calculations and estimates.

Using an interest rate that is explicitly specified in the contract may not always be appropriate

ASU 2014-09 BC239 to BC241
[IFRS 15.BC239 to BC241]

It may not always be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer 'cheap' financing as a marketing incentive. Consequently, an entity applies the rate that would be used in a separate financing transaction between the entity and its customer that does not involve the provision of goods or services. This can lead to practical difficulties for entities with large volumes of customer contracts, as they will have to determine a specific discount rate for each customer or class of customer.

Presentation of interest income as revenue is not precluded

ASU 2014-09 BC247
[IFRS 15.BC247]

The new standard does not preclude an entity presenting interest income (when it has provided financing to the customer) as a type of revenue if the interest represents income arising from ordinary activities – e.g., for banks, and entities with similar operations.

Advance payments will affect EBITDA

When an entity receives an advance payment that represents a significant financing component, the entity increases the amount of revenue recognized, with a corresponding increase to interest expense. This change will result in an increase to EBITDA, which may affect compensation arrangements and debt covenant compliance.

Comparison with current IFRS

No specific guidance for advance payments

[IAS 18.11]

Under current IFRS, an entity discounts consideration to a present value if payment is deferred and the arrangement effectively constitutes a finance transaction. However, current IFRS is silent on whether an entity adjusts consideration if payment is received in advance.

Comparison with current U.S. GAAP

Advance payments

835-30-15-3(b); 932-835-25-2

Amounts that do not require repayment in the future, but that will instead be applied to the purchase price of the property, goods, or services involved, are currently excluded from the requirement to impute interest. This is because the liability – i.e., deferred revenue – is not a financial liability. Examples include deposits or progress payments on construction contracts, advance payments for the acquisition of resources and raw materials, and advances to encourage exploration in the extractive industries.

The requirements under the new standard represent a change from current practice, and may particularly impact contracts in which payment is received significantly earlier than the transfer of control of goods or services. For example, they may affect construction contractors with long-term contracts and software entities that bundle several years of PCS in arrangements with payments received at the outset or in the early stages of a contract.

When the financing component is significant to a contract, an entity increases the contract liability and recognizes a corresponding interest expense for customer payments received before the delivery of the good or service. When it satisfies its performance obligation, the entity recognizes more revenue than the cash received from the customer, because the contract liability has been increased by the interest expense that has accreted.

5.3.3 Noncash consideration

Requirements of the new standard

606-10-32-21 to 32-22
[IFRS 15.66 to 67]

Noncash consideration received from a customer is measured at fair value. If it cannot make a reasonable estimate of the fair value, an entity refers to the estimated selling price of the promised goods or services.

606-10-32-23
[IFRS 15.68]

Estimates of the fair value of noncash consideration may vary. Although this may be due to the occurrence or non-occurrence of a future event, it can also vary due to the form of the consideration – i.e., variations due to changes in the price per share where the noncash consideration is an equity instrument.

606-10-32-24
[IFRS 15.69]

Noncash consideration received from the customer to facilitate an entity's fulfillment of the contract – e.g., materials or equipment – is accounted for when the entity obtains control of those contributed goods or services.

Observations

Constraint does not apply when variation is due to the form of noncash consideration

ASU 2014-09 BC251 to BC252
[IFRS 15.BC251 to BC252]

The Boards believe that the requirement for constraining estimates of variable consideration apply regardless of whether the amount received will be in the form of cash or noncash consideration. They therefore decided to constrain variability in the estimate of the fair value of noncash consideration if that variability relates to changes in the fair value for reasons other than the form of the consideration – i.e., changes other than the price of the noncash consideration. If the variability is because of the entity's performance – e.g., a noncash performance bonus – then the constraint applies. If the variability is because of the form of the noncash consideration – e.g., changes in the stock price – then the constraint does not apply.

Measurement date of share-based payments received by an entity is not specified

ASU 2014-09 BC254
[IFRS 15.BC254]

The general principles covering noncash consideration include accounting for share-based payments received by an entity in exchange for goods or services. However, the new standard does not specify when to measure noncash consideration. Therefore, there may be diversity in views about whether to measure the consideration:

- when the contract is entered into; or
- when or as the performance obligation is satisfied.

It is also unclear how to account for equity-based consideration when the terms change after the measurement date – i.e., whether revenue could increase or decrease by the entire change in fair value, by some incremental portion of the change in fair value, or not at all.

No measurement date for noncash consideration specified

606-10-55-248 to 55-250
[IFRS 15.IE156 to IE158]

The new standard does not provide explicit guidance on the measurement date for noncash consideration. Example 31 in the new standard illustrates how an entity measures equity instruments for a single performance obligation that is satisfied over time. On completion of each weekly service, the entity measures the fair value of the shares received as consideration for that week. Subsequent changes in the fair value of the shares received are not presented as revenue.

Entities will need to apply judgment to determine the measurement date for:

- performance obligations that are satisfied over time;
- multiple performance obligations that are satisfied at different points in time in one contract; and
- performance obligations that are satisfied at a point in time but for which the terms of the noncash consideration – e.g., equity instruments – change after that point in time.

Comparison with current IFRS

Changes in the measurement threshold

[IAS 18.12; IFRS 2]

The requirement to measure noncash consideration at fair value is broadly similar to the current IFRS requirements. However, under current IFRS, when the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by any cash transferred. By contrast, under the new standard, in these circumstances the entity measures the transaction price at the stand-alone selling price of the goods or services transferred.

Furthermore, the threshold for using the fair value of the noncash consideration as the measurement basis is that the entity can 'reliably measure' the fair value, not 'reasonably estimate' it.

Barter transactions involving advertising services

[SIC-31]

Currently, revenue from advertising barter transactions is measured at the fair value of the advertisement services given, provided that the fair value of these services can be measured reliably. Furthermore, an exchange of similar advertisement services is not a transaction that generates revenue under IAS 18.

The new standard does not contain any specific guidance on the accounting for barter transactions involving advertising services; therefore, the general principles for measuring noncash consideration apply.

Transfer of assets from customers

[IFRIC 18]

Unlike current IFRS, the new standard does not contain any specific guidance on transfers of items of property, plant, and equipment that entities receive from their customers. However, if an entity recognizes revenue on the transfer, there is no change in the measurement attribute, and the entity continues to measure revenue at the fair value of the item transferred.

Comparison with current U.S. GAAP

Exchanges of non-monetary assets

845-10-30-3 to 30-4

The accounting for non-monetary transactions based on fair value under the new standard is broadly consistent with the current U.S. GAAP on non-monetary transactions, except for those in which the consideration received from the customer is a share-based payment.

One of the requirements for a contract to exist under the new standard is that it has commercial substance, which would result in non-monetary exchanges being accounted for at fair value. Under the new standard, if an entity cannot reasonably estimate the fair value of the noncash consideration received, then it looks to the estimated selling price of the promised goods or services.

However, under current U.S. GAAP, rather than looking to the estimated selling price of the promised goods or services, the entity uses the fair value of either the assets received or the assets relinquished in the exchange – unless the fair value of the assets cannot be determined within reasonable limits, or the transaction lacks commercial substance.

Goods or services in exchange for share-based payments

505-50

Current U.S. GAAP provides guidance on the measurement date for equity-based consideration received by an entity in exchange for goods or services transferred to a customer. In addition, it provides guidance on recognition and measurement when the equity-based consideration includes terms that change after the measurement date as a result of achieving a performance or market condition – e.g., a change in the exercise price or term of a stock option.

The new standard eliminates current U.S. GAAP on the accounting for share-based payments received by an entity in exchange for goods or services; therefore, equity instruments received in a contract with a customer are accounted for consistently with other noncash consideration.

Use of the estimated selling price

Topic 845; 605-20-25-14 to 25-18

The alternative of using the estimated selling price of the promised goods or services if the fair value of the noncash consideration cannot be reasonably estimated may result in differences from current practice if an entity uses the stand-alone selling price rather than following the guidance for other fair value measurements.

In addition, the new standard eliminates the specific requirements on determining whether sufficient evidence exists – including prescriptive guidance requiring sufficient recent cash transactions to support the selling price – when recognizing revenue on exchanges of advertising space and exchanges involving barter credit transactions. Rather, under the new standard an entity recognizes revenue based on the fair value of the services received if that fair value can be reasonably estimated in a barter transaction involving advertising services. If not, the entity recognizes revenue based on the estimated stand-alone selling price of the services provided. However, an entity will need to conclude that the contract has commercial substance – i.e., it will change the amount, timing, or uncertainty of the contract's future cash flows – in order to conclude that a contract exists; otherwise, no revenue is recognized because the requirements for a contract under the new standard are not met.

5.3.4 Consideration payable to a customer

Requirements of the new standard

606-10-32-25
[IFRS 15.70]

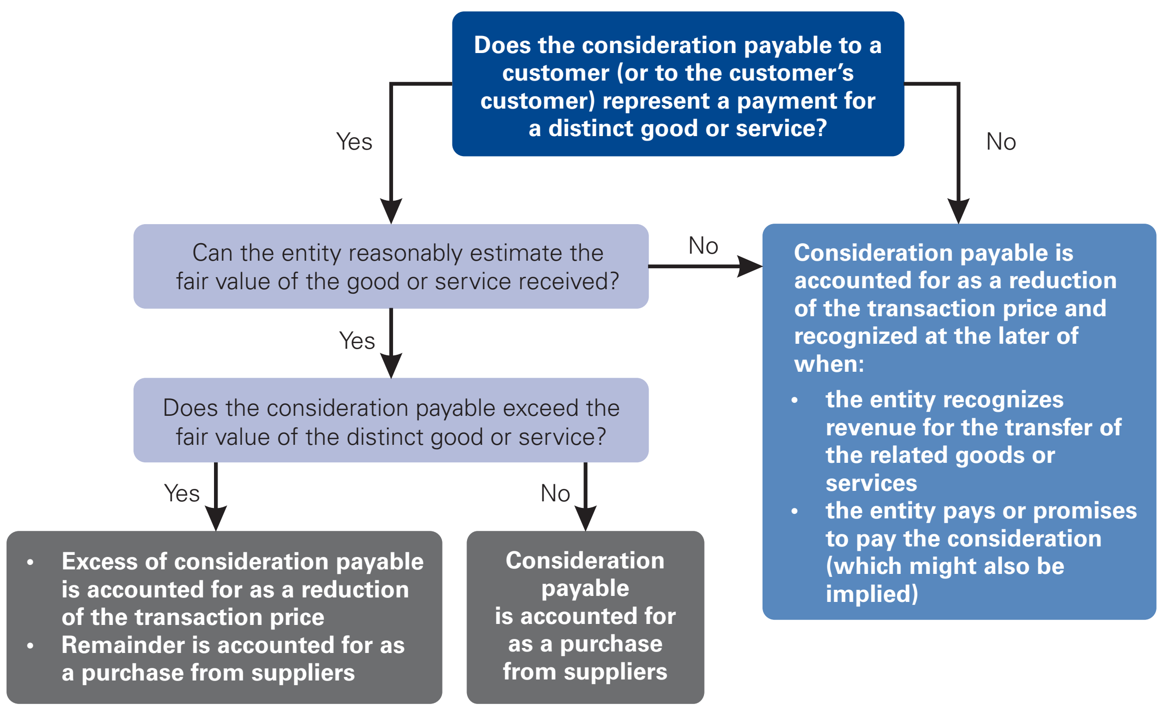
Consideration payable to a customer includes cash amounts that an entity pays or expects to pay to the customer, or to other parties that purchase the entity's goods or services from the customer. Consideration payable to a customer also includes credits or other items – e.g., a coupon or voucher – that can be applied by the customer against the amount owed to the entity or to other parties that purchase the entity's goods or services from the customer.

An entity evaluates the consideration payable to a customer to determine whether the amount represents a reduction of the transaction price, a payment for distinct goods or services, or a combination of the two.

606-10-32-26
[IFRS 15.71]

If the entity cannot reasonably estimate the fair value of the good or service received from the customer, then it accounts for all of the consideration payable to the customer as a reduction of the transaction price.

606-10-32-25 to 32-27
[IFRS 15.70 to 72]



Example 17

Payments to customers

606-10-55-252 to 55-254
[IFRS 15.IE160 to IE162]

Consumer Goods Manufacturer M enters into a one-year contract with Retailer R to sell goods. Retailer R commits to buy at least 1,500 worth of the products during the year. Manufacturer M also makes a non-refundable payment of 15 to Retailer R at contract inception to compensate Retailer R for the changes it needs to make to its shelving to accommodate Manufacturer M's products.

Manufacturer M concludes that the payment to Retailer R is not in exchange for a distinct good or service because Manufacturer M does not obtain control of the rights to the shelves. Consequently, Manufacturer M determines that the payment of 15 is a reduction of the transaction price. Manufacturer M accounts for the consideration paid as a reduction of the transaction price when it recognizes revenue for the transfer of the goods.

Observations

Payments to distributors and retailers may be for distinct goods or services

Consumer goods companies often make payments to their distributors and retailers. In some cases, the payments are for identifiable goods or services – e.g., display cases for their products or co-branded advertising. In these cases, the goods or services provided by the customer may be distinct from the customer's purchase of the seller's products. If the entity cannot estimate the fair value of the good or service received from the customer, it recognizes the payments as a reduction of the transaction price. If the payments to customers exceed the fair value of the good or service provided, any excess is a reduction in the transaction price.

No specific guidance on slotting fees

605-50-45-4

Slotting fees are payments made to a retailer in exchange for product placement in the retailer's store. IFRS is silent on how to account for slotting fees. Under U.S. GAAP, these payments are presumed to be a reduction in revenue.

Under the new standard, an entity determines whether slotting fees are:

- paid in exchange for a distinct good or service that the customer transfers to the entity, and therefore recognized as an expense by the entity; or
- sales incentives granted by the entity, and therefore recognized as a reduction from the transaction price by the entity.

The new standard does not contain an example, and is silent on its application specifically to slotting fees. As a consequence, an entity will need to carefully consider the guidance above in respect of its particular circumstances to conclude whether such payments are for a distinct good or service or should be treated as a reduction of the transaction price. For many of these arrangements, this will require significant judgment and an entity will need appropriate internal controls and documentation to support that judgment.

Comparison with current IFRS

Customer incentives

[IFRIC 13]

Accounting for customer incentives and similar items is a complex area for which there is limited guidance under current IFRS, other than specific guidance on customer loyalty programs (see 10.4). Customer incentives take many forms, including cash incentives, discounts and volume rebates, free or discounted goods or services, customer loyalty programs, loyalty cards, and vouchers. Currently, there is some diversity in practice as to whether incentives are accounted for as a reduction in revenue, as an expense, or as a separate deliverable (as in the case of customer loyalty programs) depending on the type of incentive. The requirements of the new standard may change the accounting for some entities.

Comparison with current U.S. GAAP

No rebuttable presumption

605-50-45-2 Under current U.S. GAAP, cash payments made from an entity to a customer are presumed to be a reduction of revenue. This presumption can be overcome if the entity receives an identifiable benefit in exchange for the cash payment and the fair value of the benefit can be reasonably estimated.

Unlike current U.S. GAAP, the new standard requires an entity to evaluate whether it receives distinct goods or services in exchange for its payment to a customer, instead of whether the entity has received an identifiable benefit. Although these concepts appear to be similar, the new standard does not contain the rebuttable presumption that the payment is a reduction of revenue, which exists under current U.S. GAAP.

Other parties in the distribution chain

605-50-15-2 Similar to current U.S. GAAP, the new standard requires an entity to consider other parties in the distribution chain that purchase the entity's goods or services from the entity's customer when applying the guidance on consideration payable to the customer.

Reduction of revenue may be recognized earlier in some cases

605-50-25-3 The new standard indicates that consideration payable to a customer might be implied by the entity's customary business practices. Under current U.S. GAAP, consideration payable to a customer is recognized at the later of when revenue is recognized and when an offer is made to a customer – which some have interpreted to be when an explicit offer is made to the customer. When an entity's promise to pay the consideration is implied by its customary business practices, the consideration payable to a customer that is accounted for as a reduction of revenue could be recognized earlier under the new standard than under current U.S. GAAP.

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

Overview

606-10-32-28, 32-30
[IFRS 15.73, 75] The transaction price is allocated to each performance obligation – or distinct good or service – to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

606-10-32-29
[IFRS 15.74] An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

606-10-32-31
[IFRS 15.76] This step of the revenue model comprises two sub-steps that an entity performs at contract inception.

Determine stand-alone selling prices (see 5.4.1) → **Allocate the transaction price (see 5.4.2)**

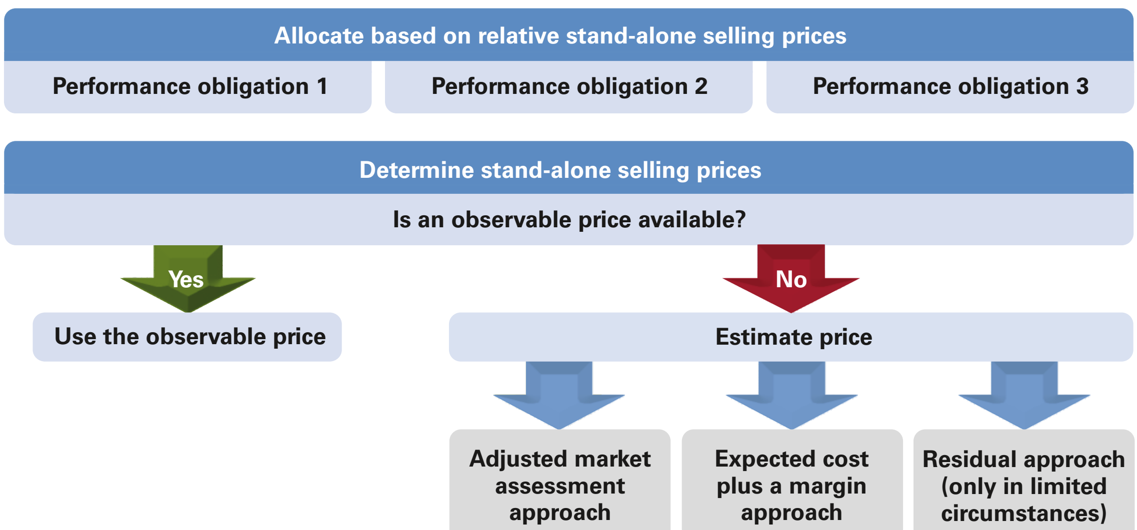
5.4.1 Determine stand-alone selling prices

Requirements of the new standard

606-10-32-32 [IFRS 15.77] The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of this is an observable price from stand-alone sales of that good or service to similarly situated customers. A contractually stated price or list price may be the stand-alone selling price of that good or service, although this is not presumed to be the case.

606-10-32-33 [IFRS 15.78] If the stand-alone selling price is not directly observable, then the entity estimates the amount using a suitable method (see 5.4.1.1), as illustrated below. In limited circumstances, an entity may estimate the amount using the residual approach (see 5.4.1.2).

606-10-32-34 [IFRS 15.79]



Observations

New standard does not contain a reliability threshold

Under the new standard, the stand-alone selling price is determined at contract inception for each performance obligation in a contract. There are no circumstances in which revenue recognition is postponed for lack of a stand-alone selling price. If an observable price is available, it is used to determine the stand-alone selling price, and if not, the entity is required to estimate the amount. The new standard does not require that the amount can be 'reliably' estimated, nor does it prescribe another threshold. An entity is required to maximize the use of observable inputs, but in all circumstances will need to arrive at a stand-alone selling price and allocate the transaction price to each performance obligation in the contract. An entity will need to apply judgment when there are observable prices but those prices are highly variable.

Comparison with current IFRS

Introduction of specific guidance

[IFRIC 12.13; IFRIC 13.5 to 7; IFRIC 15.8]

Current IFRS is largely silent on the allocation of consideration to components of a transaction. However, recent interpretations include guidance on allocation for service concession arrangements, customer loyalty programs, and agreements for the sale of real estate, under which consideration can be allocated:

- to components with reference to the relative fair values of the different components; or
- to the undelivered components measured at their fair value, with the remainder of the balance allocated to components that were delivered up-front (residual method).

The new standard introduces guidance applicable to all in-scope contracts with customers. It therefore enhances comparability and brings more rigor and discipline to the process of allocating the transaction price.

Comparison with current U.S. GAAP

More flexibility in establishing stand-alone selling prices

605-25

Currently, arrangement consideration is allocated to all deliverables meeting the separation criteria on the basis of their relative selling price, unless some other specific guidance is applicable – e.g., software arrangements and separately priced warranty contracts. Multiple-element arrangement guidance requires an entity to determine the selling price for each deliverable by using:

- VSOE of the selling price, if it exists;
- third-party evidence of the selling price, if VSOE does not exist; or
- the best estimate of the selling price for that deliverable, if neither VSOE nor third-party evidence exists.

The effect of allocating the transaction price to performance obligations based on stand-alone selling prices will vary among contracts and industries. However, the approach and methods available for establishing stand-alone selling prices provide more flexibility than is currently available – e.g., using 'observable selling prices' under the new standard versus the current practice of establishing VSOE (for example, 80 percent of sales within +/- 15 percent of the median selling price for the good or service).

5.4.1.1 Estimating stand-alone selling prices

Requirements of the new standard

606-10-32-33
[IFRS 15.78]

An entity considers all information that is reasonably available when estimating a stand-alone selling price – e.g., market conditions, entity-specific factors, and information about the customer or class of customer. It also maximizes the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of other goods or services with similar characteristics.

606-10-32-34
[IFRS 15.79]

The new standard does not preclude or prescribe any particular method for estimating the stand-alone selling price for a good or service when observable prices are not available, but describes the following estimation methods as possible approaches.

Adjusted market assessment approach	Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service
Residual approach (limited circumstances)	Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price

606-10-32-43
[IFRS 15.88]

After contract inception, an entity does not reallocate the transaction price to reflect subsequent changes in stand-alone selling prices.

Observations

Judgment will often be required

ASU 2014-09 BC269
[IFRS 15.BC269]

Observable selling prices will often not exist for all of the goods or services in a contract with a customer. As a result, significant judgment will often be involved in estimating the stand-alone selling price of a good or service. Whereas some entities may already have robust processes in place, others will need to develop new processes with appropriate internal controls over those processes for estimating stand-alone selling prices of goods or services that are not typically sold separately.

Reasonably available information that may be considered in developing these processes might include:

- reasonably available data points – e.g., costs incurred to manufacture or provide the good or service, profit margins, supporting documentation to establish price lists, third party or industry pricing, and contractually stated prices;
- market conditions – e.g., market demand, competition, market constraints, awareness of the product, and market trends;
- entity-specific factors – e.g., pricing strategies and objectives, market share, and pricing practices for bundled arrangements; and
- information about the customer or class of customer – e.g., type of customer, geography, or distribution channels.

The following framework may be a useful tool for estimating and documenting the stand-alone selling price and for establishing internal controls over the estimation process.

Gather all reasonably available data points

Consider adjustments based on market conditions and entity-specific factors

Consider the need to stratify selling prices into meaningful groups

Weigh available information and make the best estimate

Establish processes for ongoing monitoring and evaluation

Estimated stand-alone selling prices for a particular good or service may change over time due to changes in market conditions and entity-specific factors. Although the estimated stand-alone selling prices for previously allocated arrangements are not revised, new arrangements should reflect current reasonably available information, including shifts in pricing, customer base, or product offerings. The extent of the monitoring process and the frequency of necessary changes to estimated stand-alone selling prices will vary based on the nature of the performance obligations, the markets in which they are being sold, and various entity-specific factors. For example, a new product offering or sales in a new geographical market may require more frequent updates to the estimated stand-alone selling price as market awareness and demand change.

Comparison with current IFRS

Similar emphasis on use of observable inputs

[IAS 18.IE11; IFRIC 13.AG3]

Under current IFRS, our view is that a cost plus a margin approach should generally be applied only when it is difficult to measure the fair value of a component based on market inputs because of a lack of such inputs (see 4.2.60.110 of *Insights into IFRS*, 11th Edition). This emphasis on the use of available market inputs – e.g., sales prices for homogeneous or similar products – is consistent with the new standard's requirement to maximize the use of observable inputs.

Comparison with current U.S. GAAP

No specified hierarchy for non-observable inputs

605-25; ASU 2014-09 BC274 to BC276

Multiple-element arrangement guidance currently contains a specified hierarchy for determining the selling price. Similar to the requirement to use VSOE first, the new standard requires an entity to use 'observable prices' (which is a lower threshold than VSOE) when it sells a good or service separately. However, the new standard does not prescribe a hierarchical order or a particular method for estimating the stand-alone selling price when observable prices are not available. Additionally, even when observable prices are not consistent enough to constitute VSOE, an entity will still consider those observable transactions in estimating the stand-alone selling price of the good or service. Furthermore, an entity may be able to use an alternative estimation method, even if third party evidence of the selling price is available, as long as the approach taken maximizes the use of observable inputs.

985-605-25-10; 605-20-25-2

The new standard applies the same approach regardless of the type of transaction or industry, and therefore differs from certain transaction- and industry-specific guidance in U.S. GAAP – e.g., the use of the residual method if VSOE exists for undelivered items in a software arrangement or the requirement to assign the stated price in an extended-price warranty arrangement to the warranty component of the arrangement.

5.4.1.2 Using the residual approach

Requirements of the new standard

606-10-32-34(c) [IFRS 15.79(c)]

The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices can be established for the other goods or services promised in the contract.

Selling price is …	… if …
Highly variable	The entity sells the same good or service to different customers at or near the same time for a broad range of prices
Uncertain	The entity has not yet established the price for a good or service and the good or service has not previously been sold on a stand-alone basis

Under the residual approach, an entity estimates the stand-alone selling price of a good or service on the basis of the difference between the total transaction price and the observable stand-alone selling prices of other goods or services in the contract.

606-10-32-35 [IFRS 15.80]

If two or more goods or services in a contract have highly variable or uncertain stand-alone selling prices, then an entity may need to use a combination of methods to estimate the stand-alone selling prices of the performance obligations in the contract. For example, an entity may:

- use the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then
- use another technique to estimate the stand-alone selling prices of the individual goods or services relative to the estimated aggregate stand-alone selling price that was determined by the residual approach.

Example 18

Residual approach

Software Vendor M enters into a contract to provide rights to use Licenses S and T for three years, as well as PCS services for both licenses, for a contract price of 100,000.

The PCS services comprise telephone technical support for each license. Vendor M has identified four performance obligations in the contract: License S; technical support for License S; License T; and technical support for License T. The stand-alone observable price of 12,500 is available for the technical support for each of the licenses based on renewals that are sold separately. However, the prices at which Vendor M has sold licenses similar to Licenses S and T are not directly observable and the level of discounting in bundled arrangements varies based on negotiations with individual customers.

Vendor M estimates the stand-alone selling prices of the performance obligations in the contract as follows.

Product	Stand-alone selling price	Approach
Licenses S and T	75,000	Residual approach (100,000 - 12,500 - 12,500)
Technical support for License S	12,500	Directly observable price
Technical support for License T	12,500	Directly observable price
Total	**100,000**	

The residual approach is used to estimate the stand-alone selling price for the bundle of products (Licenses S and T) with highly variable selling prices. Because the licenses will transfer to the customer at different points in time, Vendor M then estimates the stand-alone selling price of each license. Vendor M estimates the stand-alone selling price by allocating the 75,000 to Licenses S and T based on its average residual selling price over the past year, as follows.

Product	Average residual selling price	Ratio	Allocation	
License S	40,000	40%	30,000	(75,000 x 40%)
License T	60,000	60%	45,000	(75,000 x 60%)
Total	**100,000**		**75,000**	

Observations

In contracts for intellectual property or other intangible products, a residual approach may be the appropriate technique

ASU 2014-09 BC271
[IFRS 15.BC271]

Determining stand-alone selling prices may be particularly challenging for contracts for intellectual property or intangible assets as they are infrequently sold separately but are often sold in a wide range of differently priced bundles. They often have little or no incremental cost to the entity providing those goods or services to a customer (resulting in a cost plus a margin approach being inappropriate) and may not have substantially similar market equivalents from which to derive a market assessment. In such circumstances, the residual approach may be the most appropriate approach for estimating the stand-alone selling price of these types of performance obligations in a contract.

Consideration allocated is unlikely to be zero or close to zero

ASU 2014-09 BC273
[IFRS 15.BC273]

If applying the residual approach results in no or very little consideration being allocated to a good or service, or to a bundle of goods or services, then this outcome may not be reasonable unless other GAAP applies (see 4.3). In applying Step 2 of the model, if an entity has determined that a good or service is distinct, then by definition it has value to the customer on a stand-alone basis. In this case, an entity considers all reasonably available data and whether the stand-alone selling price of that good or service should be estimated using another method.

Comparison with current IFRS

Conditions need to be met to use the residual approach, but its application is not restricted to delivered items

Unlike current guidance, the new standard requires specific conditions to be met for an entity to use the residual approach. Entities in certain industries that use the residual method may conclude that these conditions are not met, and therefore that the transaction price will be allocated based on stand-alone selling prices – generally resulting in accelerated revenue recognition for the delivered good or service (e.g., the handset).

However, when it is appropriate to apply the residual approach, the new standard permits its application to any promised goods or services in the contract, including undelivered items. This is a change from our current view that the reverse residual method is not an appropriate basis for allocating revenue (see 4.2.60.50 of *Insights into IFRS*, 11th Edition).

Comparison with current U.S. GAAP

Broader application of the residual method and potential acceleration of software license revenue recognition

605-25

Using the residual approach to estimate stand-alone selling prices under the new standard may yield similar results to current guidance on multiple-element arrangements in some circumstances. Although under current guidance it is not an allowed method for estimating the selling price, the amount that would be allocated under the residual approach may be one of several data points identified when developing an estimated selling price for the delivered element. In addition, the use of the residual method is currently permitted for:

- software arrangements in which the entire discount is allocated to the delivered item(s) in the contract and for which there is VSOE for all of the remaining undelivered elements in the contract; and
- deliverables bundled together with a separately priced extended warranty or maintenance obligation, in which the stated price is allocated to that obligation and the residual is allocated to the remaining deliverables in the contract.

The residual approach under the new standard differs from the residual method under current software guidance, in that:

- it can be used to develop an estimate of the selling price of a good or service, rather than to determine the allocation of consideration to a specific performance obligation – although in some circumstances it will result in the same outcome;

- its application is not limited to delivered items – i.e., a reverse residual approach is allowed; and
- it requires only observable stand-alone selling prices of other goods or services that are promised in the contract, which allows greater application of the residual method than the requirement to establish VSOE.

Given that an entity is no longer required to have VSOE for the undelivered items in a software arrangement, and the entity is required to estimate the stand-alone selling price for each distinct good or service, the new standard may accelerate revenue recognition for many multiple-element software arrangements.

5.4.2 Allocate the transaction price

Requirements of the new standard

606-10-32-31
[IFRS 15.76]

At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stand-alone selling prices. However, when specified criteria are met, a discount (see 5.4.2.1) or variable consideration (see 5.4.2.2) is allocated to one or more, but not all, of the performance obligations in the contract.

606-10-32-43 to 32-44
[IFRS 15.88 to 89]

After initial allocation, changes in the transaction price are allocated to satisfied and unsatisfied performance obligations on the same basis as at contract inception, subject to certain limited exceptions (see 5.4.3).

Example 19

Allocation of the transaction price

Telco T enters into a 12-month phone contract in which a customer is provided with a handset and a data/calls/texts plan (the wireless plan) for a price of 35 per month. Telco T has identified the handset and the wireless plan as separate performance obligations.

Telco T sells the handset separately for a price of 200, which provides observable evidence of a stand-alone selling price. Telco T also offers a 12-month plan without a phone that includes the same level of data/calls/texts for a price of 25 per month. This pricing is used to determine the stand-alone selling price of the wireless plan as 300 (25 x 12 months).

The transaction price of 420 (35 x 12 months)[a] is allocated to the performance obligations based on their relative stand-alone selling prices as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	
Handset	200	40%	168	(420 x 40%)
Wireless plan	300	60%	252	(420 x 60%)
Total	**500**	**100%**	**420**	

Note

(a) In this example, the entity does not adjust the consideration to reflect the time value of money. This could happen if the entity concludes that the transaction price does not include a significant financing component, or if the entity elects to use the practical expedient (see 5.3.2).

5.4.2.1 Allocating a discount

Requirements of the new standard

606-10-32-36
[IFRS 15.81]

If the sum of the stand-alone selling prices of a bundle of goods or services exceeds the promised consideration in a contract, then the discount is allocated proportionately to all of the performance obligations in the contract unless there is observable evidence that the entire discount relates to only one or more of the performance obligations.

606-10-32-37
[IFRS 15.82]

Such evidence exists, and a discount is allocated entirely to one or more, but not all, of the performance obligations, if the following criteria are met:

- the entity regularly sells each distinct good or service, or each bundle of distinct goods or services, in the contract on a stand-alone basis;
- the entity also regularly sells, on a stand-alone basis, a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and
- the discount attributable to each bundle of goods or services is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation(s) to which the entire discount in the contract belongs.

606-10-32-38
[IFRS 15.83]

Before using the residual approach, an entity applies the guidance on allocating a discount.

Example 20

Discount allocated entirely to one or more, but not all, performance obligations in a contract

606-10-55-259 to 55-264
[IFRS 15.IE167 to IE172]

Company B enters into a contract to sell Products X, Y, and Z for a total amount of 100. Company B regularly sells the products individually for the following prices.

Product	Price
X	40
Y	55
Z	45
Total	**140**

Company B also regularly sells Products Y and Z together for 60.

The contract includes a discount of 40 on the overall transaction (140 - 100), which would be allocated proportionately to all three products in the contract when applying the relative stand-alone selling price method. However, because Company B regularly sells Products Y and Z as a bundle for 60 and Product X for 40, it has evidence that the entire discount should be allocated to the promises to transfer Products Y and Z.

Control of Products Y and Z is transferred at different points in time, and therefore the allocated amount of 60 is individually allocated to the promises to transfer Products Y and Z by reference to their relative stand-alone selling prices as follows.

Product	Stand-alone selling price	Selling price ratio	Allocation	
X	55	55%	33	(60 x 55%)
Y	45	45%	27	(60 x 45%)
Total	**100**	**100%**	**60**	

Observations

Analysis required when a large number of goods or services are bundled in various ways

In an arrangement involving several different goods or services, an entity may need to consider numerous possible combinations of products that are sold separately in various bundles, to determine whether the entire discount in the contract can be allocated to a particular bundle. This raises the question of how much analysis needs to be performed by an entity that sells a large number of goods or services that are bundled in various ways and for which the discount varies based on the particular bundle.

However, this analysis is required only if the entity regularly sells each good or service – or bundle of goods or services – on a stand-alone basis. Therefore, if the entity regularly sells only some of the goods or services in the contract on a stand-alone basis, then the criteria for allocating the discount entirely to one or more, but not all, of the performance obligations would not be met and a more detailed analysis would not be required.

Determination of 'regularly sells' will be a key judgment

The guidance on allocating a discount entirely to one or more performance obligations requires that a bundle of goods or services is regularly sold on a stand-alone basis. An entity may need to establish a policy to define 'regularly sells' for implementing this aspect of the new standard. The entity will need to have processes and related controls to monitor sales transactions and determine which bundles are regularly sold.

Guidance on allocating a discount will typically apply to contracts with at least three performance obligations

ASU 2014-09 BC283
[IFRS 15.BC283]

The guidance on allocating a discount entirely to one or more performance obligations also requires that the discount in the contract is substantially the same as the discount attributable to the bundle of goods or services. As a result, an entity will typically be able to demonstrate that the discount relates to two or more performance obligations but it will be difficult for the entity to have sufficient evidence to allocate the discount entirely to a single performance obligation. Therefore, this provision is not likely to apply to most arrangements with fewer than three performance obligations.

Comparison with current IFRS

New prescriptive guidance

There is no specific guidance on allocating a discount in current IFRS. If an entity allocates consideration according to the relative fair value of components, then it effectively allocates a discount to all components in the arrangement. If an entity uses the residual method to allocate consideration, then it effectively allocates the discount to the delivered component. The new standard introduces specific guidance on allocating discounts.

Comparison with current U.S. GAAP

Discount may be allocated to undelivered items

Generally, an entity cannot attribute a discount in a contract to one or more separate deliverables, other than when the residual method is used – e.g., in software arrangements – and the entire discount is attributed to the delivered items. However, the allocation of a discount under the new standard is not restricted to particular industries or circumstances – so if the criteria are met, a discount is allocated entirely to one or more performance obligations in a contract, regardless of whether they are delivered or undelivered items.

5.4.2.2 Allocating variable consideration

Requirements of the new standard

606-10-32-39
[IFRS 15.84]

Variable consideration (see 5.3.1) may be attributable to:

- all of the performance obligations in a contract;
- one or more, but not all, of the performance obligations in a contract – e.g., a bonus that is contingent on transferring a promised good or service within a specified time period; or
- one or more, but not all, distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation – e.g., an annual increase in the price of cleaning services linked to an inflation index within a facilities management contract.

606-10-32-40
[IFRS 15.85]

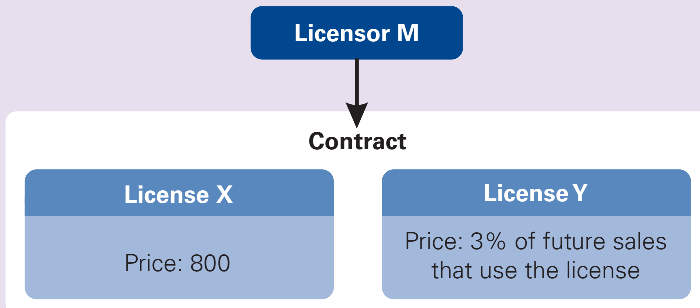
An entity allocates a variable amount – and subsequent changes to that amount – entirely to a performance obligation, or to a distinct good or service that forms part of a single performance obligation, only if both of the following criteria are met:

- the variable payment terms relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome of satisfying the performance obligation or transferring the distinct good or service); and
- allocating the variable amount of consideration entirely to the performance obligation or distinct good or service is consistent with the new standard's overall allocation principle when considering all of the performance obligations and payment terms in the contract.

Example 21

Variable consideration allocated entirely to one performance obligation in the contract

606-10-55-271 to 55-274
[IFRS 15.IE179 to IE182]



Licensor M enters into a contract with Customer N for two intellectual property licenses (Licenses X and Y), which Licensor M determines to represent two performance obligations, each satisfied at a point in time. The stand-alone selling prices of Licenses X and Y are 800 and 1,000 respectively.

The price stated in the contract for License X is a fixed amount of 800 and for License Y is 3% of the customer's future sales that use License Y. Licensor M estimates that it will be entitled to variable consideration of 1,000.

Licensor M allocates the estimated 1,000 in sales-based royalties entirely to License Y because:

- the variable payment relates specifically to sales resulting from the transfer of License Y; and
- the estimated amount of variable consideration and the fixed amount for License X approximate the stand-alone selling prices of each product.

Licensor M transfers License Y at contract inception and License X one month later. Based on the new standard's guidance on sales- or usage-based royalties for licenses of intellectual property (see Section 8), Licensor M does not recognize revenue on the transfer of License Y because the subsequent sales have not yet occurred. When License X is transferred, Licensor M recognizes revenue of 800.

Comparison with current IFRS

A new area of practice

[IAS 18.9]

There is no specific guidance in current IFRS on allocating variable consideration. Arguably, the general requirement in current IFRS to measure revenue at the fair value of the consideration received or receivable means that such guidance is less relevant than it is under the new standard. However, the new standard's guidance on variable consideration and the constraint, including the exception for some sales- or usage-based royalties (see 8.4), could produce counter-intuitive results if variable consideration were always allocated to all performance obligations in a contract. The new standard therefore requires alternative approaches in specific circumstances.

Comparison with current U.S. GAAP

Similarities to the milestone method

605-28

The notion of allocating variable consideration to distinct goods or services within a single performance obligation when the consideration relates specifically to transferring a distinct good or service is similar to the milestone method. Although under current U.S. GAAP, the milestone method is a recognition method – not an allocation method – the outcomes may be similar in many circumstances.

Provided that a milestone is substantive, an entity currently recognizes a milestone payment as revenue when that milestone is achieved – effectively allocating the payment entirely to the efforts to satisfy that milestone. A milestone is 'substantive' only if:

- the payment is commensurate with either:
  - the entity's performance to achieve the milestone; or
  - the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the entity's performance to achieve the milestone;
- the payment relates solely to past performance by the entity; and
- the payment is reasonable relative to all of the deliverables and payment terms – including other potential milestone considerations – in the arrangement.

Under the new standard, similar results are likely when variable consideration in the contract remains constrained until an entity achieves a milestone. However, revenue may be recognized:

- before a milestone is achieved if it is probable that a subsequent change in the estimate of the amount of variable consideration will not result in a significant revenue reversal; or
- if the variable consideration is a sales- or usage-based royalty for a license of intellectual property, then at the later of when the customer's sales or usage occur and when the performance obligation is satisfied or partially satisfied.

5.4.3 Changes in the transaction price

Requirements of the new standard

606-10-32-42 to 32-45
[IFRS 15.87 to 90]

After contract inception, the transaction price may change for various reasons – including the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which an entity expects to be entitled. In most cases, such changes are allocated to performance obligations on the same basis as at contract inception; however, changes in the transaction price resulting from a contract modification are accounted for under the new standard's contract modifications guidance (see Section 7). If a change in the transaction price occurs after a contract modification, then it is allocated to the performance obligations in the modified contract – i.e., those that were unsatisfied or partially unsatisfied immediately after the modification – unless:

- the change is attributable to an amount of variable consideration that was promised before the modification; and
- the modification was accounted for as a termination of the existing contract and creation of a new contract.

606-10-32-44
[IFRS 15.89]

A change in the transaction price is allocated to one or more distinct goods or services only if specified criteria are met (see 5.4.2.2).

606-10-32-43
[IFRS 15.88]

Any portion of a change in transaction price that is allocated to a satisfied performance obligation is recognized as revenue – or as a reduction in revenue – in the period of the transaction price change.

Comparison with current IFRS

Introduction of guidance on reallocation

Current IFRS is largely silent on the allocation of revenue to components, and is therefore silent on the reallocation of revenue. Under the new standard, if some of the performance obligations to which the transaction price was initially allocated have already been satisfied when the change in transaction price takes place, then this results in an adjustment to the amount of revenue recognized to date – including revenue on completed performance obligations.

Comparison with current U.S. GAAP

Removal of the contingent cap

ASU 2014-09 BC287 to BC293; 605-25-30

The allocation of arrangement consideration to delivered items is currently limited to amounts of revenue that are not contingent on an entity's future performance. The new standard does not have such a limitation: the full estimated transaction price – which includes all amounts, including contingent amounts, to which the entity expects to be entitled – is allocated on a relative stand-alone selling price basis to each separate performance obligation. However, the recognition of variable consideration may be constrained (see 5.3.1.2). Nevertheless, the new standard's removal of the contingent cap may accelerate the recognition of contingent or variable consideration.

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

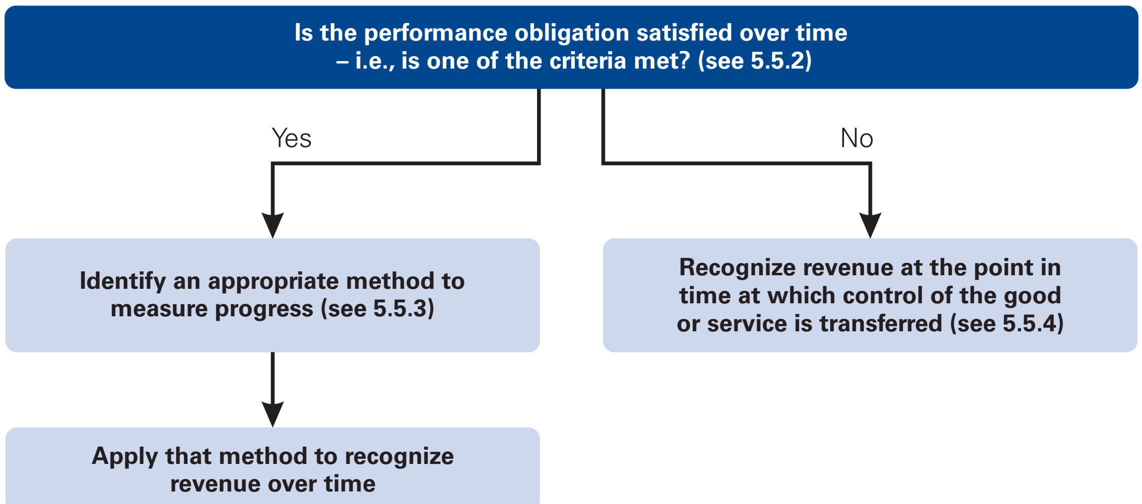
Overview

An entity recognizes revenue when or as it satisfies a performance obligation by transferring a good or service to a customer, either at a point in time (when) or over time (as). A good or service is transferred when or as the customer obtains control of it.

Requirements of the new standard

606-10-25-24
[IFRS 15.32]

At contract inception, an entity first evaluates whether it transfers control of the good or service over time – if not, then it transfers control at a point in time.



606-10-55-54 to 55-64
[IFRS 15.B52 to B62]

For a distinct license of intellectual property, the new standard provides specific application guidance on assessing whether revenue is recognized at a point in time or over time (see Section 8).

Comparison with current IFRS

Over-time recognition retained, but with new criteria

[IAS 11; IAS 18.21]

Construction contracts, and contracts for the rendering of services, are currently accounted for under the stage-of-completion method. The new standard is consistent with stage-of-completion accounting, but introduces new criteria to determine when revenue should be recognized over time. Accordingly, some contracts that are currently accounted for under the stage-of-completion method may now require revenue to be recognized on contract completion; however, for other contracts, over-time recognition may be required for the first time under the new model.

Comparison with current U.S. GAAP

Over-time recognition retained, but with criteria rather than guidance based on type of activity

605-35-25-57

Currently, construction- and production-type contracts in the scope of ASC Subtopic 605-35 are generally accounted for under the percentage-of-completion method, and although service contracts do not fall in the scope of ASC Subtopic 605-35, revenue from services is generally recognized under the proportional performance or straight-line method.

Under the new standard, an entity currently applying these methods can continue to recognize revenue over time only if one or more of three criteria are met (see 5.5.2). Unlike current industry- and transaction-specific guidance, the requirements in Step 5 of the model are not a matter of scope, but rather are applied consistently to each performance obligation in a contract. Accordingly, on applying the new criteria some entities may determine that revenue that is currently recognized at a point in time should be recognized over time, or vice versa.

5.5.1 Transfer of control

Requirements of the new standard

606-10-25-23 to 25-24
[IFRS 15.31 to 32]

A good or service is transferred to a customer when the customer obtains control of it. 'Control' refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Potential cash flows that are obtained either directly or indirectly – e.g., from the use, consumption, sale, or exchange of an asset – represent benefits of an asset.

Control is …	
the ability	– i.e., the customer has a present right
to direct the use of	– i.e., the right enables it: • to deploy the asset in its activities • to allow another entity to deploy the asset in its activities • to restrict another entity from deploying the asset
and obtain the remaining benefits from	– i.e., the right also enables it to obtain potential cash flows directly or indirectly, for example through: • use of the asset • consumption of the asset • sale or exchange of the asset • pledging the asset • holding the asset
… an asset.	

606-10-55-84
[IFRS 15.B82]

If an entity concludes that it is appropriate to recognize revenue for a bill-and-hold arrangement, then it is also providing a custodial service to the customer. The entity will need to determine whether the custodial service constitutes a separate performance obligation to which a portion of the transaction price is allocated.

Observations

Use of control concept to recognize revenue aligns with the accounting for assets

ASU 2014-09 BC118
[IFRS 15.BC118]

The new standard is a control-based model. First, an entity determines whether control of the good or service transfers to the customer over time based on the criteria in the new standard and, if so, the pattern of that transfer. If not, control of the good or service transfers to the customer at a point in time, with the notion of risks and rewards being retained only as an indicator of the transfer of control (see 5.5.4). Assessing the transfer of goods or services by considering when the customer obtains control may result in different outcomes – and therefore significant differences in the timing of revenue recognition. The Boards believe that it can be difficult to judge whether the risks and rewards of ownership have been transferred to a customer, such that applying a control-based model may result in more consistent decisions about the timing of revenue recognition.

The new standard extends a control-based approach to all arrangements, including service contracts. The Boards believe that goods and services are assets – even if only momentarily – when they are received and used by the customer. The new standard's use of control to determine when a good or service is transferred to a customer is consistent with the current definitions of an asset under both U.S. GAAP and IFRS, which principally use control to determine when an asset is recognized or derecognized.

New conceptual basis for revenue recognition

The new standard takes a conceptually different approach to revenue recognition than current U.S. GAAP and IFRS. Although the basic accounting outcomes – recognition of revenue at a point in time or over time – are similar, they may apply in different circumstances for many entities.

Comparison with current IFRS

Move away from a risk-and-reward approach

[IAS 11.23; IAS 18.14, 20; IFRS 15.BC118]

Currently, revenue from the sale of goods that are in the scope of IAS 18 is recognized based on when, among other criteria, the entity has transferred to the buyer the significant risks and rewards of ownership. Under this approach, which is unlike the new standard, revenue is typically recognized at the point in time at which risks and rewards pass.

However, IFRIC 15 introduced the notion that the criteria for recognizing a sale of goods could also be met progressively over time, resulting in the recognition of revenue over time. However, this approach is not generally applied, except in the specific circumstances envisaged in IFRIC 15.

For construction contracts that are in the scope of IAS 11, and for contracts for the rendering of services, revenue is recognized by reference to the stage of completion of the transaction at the reporting date. This is essentially an activity-based model, rather than a transfer of control model. The new standard applies a control-based approach (whereby control can be transferred either over time or at a point in time) to all arrangements, regardless of transaction or industry type.

Comparison with current U.S. GAAP

Move away from a risk-and-reward approach

SEC SAB Topic 13; ASU 2014-09 BC118; 605-35-25

Unlike the new standard, revenue from the sale of goods is currently recognized when the entity has transferred the significant risks and rewards of ownership to the buyer. This is evidenced by:

- persuasive evidence of an arrangement;
- delivery or performance having occurred;
- the sales price being fixed or determinable; and
- collectibility being reasonably assured.

Revenue from contracts in the scope of current guidance on construction- or production-type contracts is generally accounted for under the percentage-of-completion method and revenue from service contracts is generally recognized under the proportional performance or straight-line method. Additionally, there are other revenue recognition models and requirements in the industry- and transaction-specific guidance in current U.S. GAAP that can result in other patterns of revenue recognition. The new standard applies a control-based approach to all arrangements, regardless of transaction or industry type.

5.5.2 Performance obligations satisfied over time

Requirements of the new standard

606-10-25-24, 25-27 [IFRS 15.32, 35]

For each performance obligation in a contract, an entity first determines whether the performance obligation is satisfied over time – i.e., control of the good or service transfers to the customer over time – using the following criteria.

	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs	Routine or recurring services – e.g., cleaning services
2	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Building an asset on a customer's site
3	The entity's performance does not create an asset with an alternative use to the entity (see 5.5.2.1) and the entity has an enforceable right to payment for performance completed to date (see 5.5.2.2)	Building a specialized asset that only the customer can use, or building an asset to a customer order

606-10-25-27, 25-30 to 25-31 [IFRS 15.35, 38 to 39]

If one or more of these criteria are met, then the entity recognizes revenue over time, using a method that depicts its performance – i.e., the pattern of transfer of control of the good or service to the customer. If none of the criteria is met, control transfers to the customer at a point in time and the entity recognizes revenue at that point in time (see 5.5.4).

Criterion 1

606-10-55-5 to 55-6
[IFRS 15.B3 to B4]

A customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs if another entity would not need to substantially reperform the work that the entity has completed to date.

When determining whether another party would not need to substantially reperform, an entity also presumes that another party would not have the benefit of any asset that the entity presently controls and would continue to control – e.g., work in progress – if the performance obligation were to transfer.

Criterion 2

606-10-55-7
[IFRS 15.B5]

In evaluating whether a customer controls an asset as it is created or enhanced, an entity considers the guidance on control in the new standard, including the indicators of the transfer of control (see 5.5.4).

Criterion 3

606-10-25-28
[IFRS 15.36]

In assessing whether an asset has an alternative use, at contract inception an entity considers its ability to readily direct that asset in its completed state for another use, such as selling it to a different customer.

606-10-55-6, 55-8 to 55-10; ASU 2014-09 BC127
[IFRS 15.B4, B6 to B8, BC127]

The new standard provides the following guidance on the assumptions that an entity should make when applying Criteria 1 and 3.

Determining whether …	Consider contractual restrictions?	Consider practical limitations?	Consider possible termination?
… another entity would not need to substantially re-perform (Criterion 1)	No	No	Yes
… the entity's performance does not create an asset with an alternative use (Criterion 3)	Yes	Yes	No

Example 22

Assessing whether another entity would need to substantially reperform the work completed by the entity to date

ASU 2014-09 BC126
[IFRS 15.BC126]

Company M enters into a contract to transport equipment from Los Angeles to New York City. If Company M delivers the equipment to Denver – i.e., only part of the way – then another entity could transport the equipment the remainder of the way to New York City without re-performing Company M's performance to date. In other words, the other entity would not need to take the goods back to Los Angeles in order to deliver them to New York City. Accordingly, Criterion 1 is met and transportation of the equipment is a performance obligation that is satisfied over time.

Observations

Differences in assumptions used when applying Criteria 1 and 3

ASU 2014-09 BC139 [IFRS 15.BC139]

The consideration of contractual restrictions and practical limitations differs for the assessment of Criteria 1 and 3, because they are designed to apply to different scenarios.

Criterion 1 involves a hypothetical assessment of what another entity would need to do if it took over the remaining performance obligation. Accordingly, contractual restrictions or practical limitations are not relevant when assessing whether the entity has transferred control of the goods or services provided to date.

By contrast, Criterion 3 focuses on the entity's ability to direct the completed asset for an alternative use. That ability is directly affected by the existence of contractual restrictions and practical limitations.

Comparison with current IFRS

Applying the new criteria may alter the timing of revenue recognition

[IAS 11; IAS 18; IFRIC 15]

Under current IFRS, there are three circumstances in which revenue is recognized over time:

- the contract is a construction contract in the scope of IAS 11 – this is the case when, and only when, the contract has been specifically negotiated for the construction of an asset or assets;
- the contract is for the sale of goods under IAS 18 and the conditions for the recognition of a sale of goods are met progressively over time; and
- the contract is for the rendering of services.

By contrast, the new standard introduces new concepts and uses new wording that entities need to apply to the specific facts and circumstances of individual performance obligations. Subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition compared with current practice.

In practice, many contracts for the rendering of services will meet Criterion 1, and many construction contracts will meet Criterion 2 and/or Criterion 3. However, detailed analysis may be required to assess these and other arrangements, notably pre-sale contracts for real estate, which are the main focus of IFRIC 15.

Comparison with current U.S. GAAP

Some similarities but new concepts to be applied

605-35-05-8; ASU 2014-09 BC130

The basis for using the percentage-of-completion method for construction- and production-type contracts in the scope of ASC Subtopic 605-35 is that in many cases the contractor has, in effect, agreed to sell its rights to work in progress as the work progresses. Accordingly, the parties have agreed, in effect, to a continuous sale that occurs as the contractor performs. This rationale is similar to Criterion 2 under the new standard – that control of a good or service is transferred over time if the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

However, Criteria 1 and 3 under the new standard will require entities to think differently about the satisfaction of performance obligations. In general, the impact of applying the new criteria will vary depending on relevant facts and circumstances, but subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition.

For example, manufacturing arrangements to produce goods to a customer's specifications are currently generally treated as product sales, and revenue is recognized at the point in time at which the manufactured goods are shipped or delivered to the customer. Under the new standard, these types of performance obligations may meet Criterion 3 and, if so, revenue will be recognized over time.

5.5.2.1 Performance does not create an asset with an alternative use

Requirements of the new standard

606-10-55-9 [IFRS 15.B7]

For an asset to have no alternative use to an entity, a contractual restriction on the ability to direct its use has to be substantive – i.e., an enforceable right. If an asset is largely interchangeable with other assets and could be transferred to another customer without breaching the contract or incurring significant incremental costs, then the restriction is not substantive.

606-10-55-10 [IFRS 15.B8]

A practical limitation on an entity's ability to direct an asset for another use – e.g., design specifications that are unique to a customer – exists if the entity would:

- incur significant costs to rework the asset; or
- be able to sell the asset only at a significant loss.

606-10-25-28 [IFRS 15.36]

The assessment of whether an asset has an alternative use is made at contract inception and is not subsequently updated, unless a contract modification substantially changes the performance obligation (see Section 7).

Example 23

Applying the guidance on alternative use

606-10-55-165 to 55-168 [IFRS 15.IE73 to IE76]

Manufacturer Y enters into a contract with a customer to build a specialized satellite. Manufacturer Y builds satellites for various customers; however, the design and construction of each satellite differs substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, Manufacturer Y assesses whether the satellite, in its completed state, will have an alternative use. Although the contract does not preclude Manufacturer Y from directing the completed satellite to another customer, Manufacturer Y would incur significant costs to rework the design and function of the satellite to do so. The customer-specific design of the satellite therefore restricts Manufacturer Y's practical ability to readily direct the satellite to another customer, and the satellite does not have an alternative use to Manufacturer Y.

Observations

Many factors to consider when evaluating alternative use

ASU 2014-09 BC136 to BC139
[IFRS 15.BC136 to BC139]

Under the new standard, an asset may not have an alternative use due to contractual restrictions. For example, units constructed for a multi-unit residential complex may be standardized; however, an entity's contract with a customer may preclude it from transferring a specific unit to another customer.

Protective rights – e.g., a customer having legal title to the goods in a contract – may not limit the entity's practical ability to physically substitute or redirect an asset, and therefore on their own are not sufficient to establish that an asset has no alternative use to the entity.

In the absence of a contractual restriction, an entity considers:

- the characteristics of the asset that will ultimately be transferred to the customer; and
- whether that asset, in its completed form, could be redirected without a significant cost of rework.

The focus is not on whether the asset can be redirected to another customer or for another purpose during a portion of the production process – e.g., up until the point where significant customization begins to occur. For example, in some manufacturing contracts the basic design of an asset may be the same across many contracts, but the customization of the finished good is substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework.

5.5.2.2 The entity has an enforceable right to payment for performance completed to date

Requirements of the new standard

606-10-25-29
[IFRS 15.37]

An entity that is constructing an asset with no alternative use is effectively constructing the asset at the direction of the customer, and the contract will often contain provisions providing some economic protection from the risk of the customer terminating the contract and leaving the entity with an asset with little or no value. Therefore, to demonstrate that a customer controls an asset that has no alternative use as it is being created, an entity evaluates whether it has an enforceable right to payment for the performance completed to date. In performing this evaluation, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

606-10-55-11 to 55-15
[IFRS 15.B9 to B13]

In assessing whether this part of Criterion 3 is met, the entity's right to payment should be for an amount that approximates the selling price of the goods or services transferred – e.g., a right to recover costs incurred plus a reasonable profit margin. The amount to which it is entitled does not need to equal the contract margin, but should be based on either a reasonable proportion of the entity's expected profit margin or a reasonable return on the entity's cost of capital.

Other factors to consider include the following.

Payment terms	• An unconditional right to payment is not required, but rather an enforceable right to demand or retain payment if the contract is terminated
Payment schedule	• A payment schedule does not necessarily indicate whether an entity has an enforceable right to payment for performance to date
Contractual terms	• If a customer acts to terminate a contract without having a contractual right at that time, then the contract terms may entitle the entity to continue to transfer the promised goods or services and require the customer to pay the corresponding consideration promised
Legislation or legal precedent	• Even if a right is not specified in the contract, jurisdictional matters such as legislation, administrative practice, or legal precedent may confer a right to payment on the entity • By contrast, legal precedent may indicate that rights to payment in similar contracts have no binding legal effect, or an entity's customary business practice not to enforce a right to payment may result in that right being unenforceable in that jurisdiction

Example 24

Applying the over-time criteria to a consulting contract

606-10-55-161 to 55-164
[IFRS 15.IE69 to IE72]

Consulting Firm B enters into a contract to provide a professional opinion to Customer C based on Customer C's specific facts and circumstances. If Customer C terminates the consulting contract for reasons other than Consulting Firm B's failure to perform as promised, then the contract requires Customer C to compensate Consulting Firm B for its costs incurred plus a 15% margin. The 15% margin approximates to the profit margin that Consulting Firm B earns from similar contracts.

Consulting Firm B assesses the contract against the over-time criteria, and reaches the following conclusions.

Criterion	Conclusion	Rationale
1	**Not met**	If Consulting Firm B did not issue the professional opinion and Customer C hired another consulting firm, then the other firm would need to substantially re-perform the work completed to date, because it would not have the benefit of any work in progress performed by Consulting Firm B. Accordingly, Customer C does not simultaneously receive and consume the benefits of its performance.
2	**Not met**	Consulting Firm B is not creating or enhancing an asset of which Customer C obtains control as it performs because the professional opinion is delivered to Customer C only on completion.
3	**Met**	The development of the professional opinion does not create an asset with an alternative use to Consulting Firm B, because it relates to facts and circumstances that are specific to Customer C. Therefore, there is a practical limitation on Consulting Firm B's ability to readily direct the asset to another customer. The contract's terms provide Consulting Firm B with an enforceable right to payment, for its performance completed to date, of its costs incurred plus a reasonable margin.

Because one of the three criteria is met, Consulting Firm B recognizes revenue relating to the consulting services over time.

Conversely, if Consulting Firm B determined that it did not have a legally enforceable right to payment if Customer C terminated the consulting contract for reasons other than Consulting Firm B's failure to perform as promised, then none of the three criteria would be met and the revenue from the consulting service would be recognized at a point in time – probably on completion of the engagement and delivery of the professional opinion.

Example 25

Applying the over-time criteria to sales of real estate

606-10-55-173 to 55-182
[IFRS 15.IE81 to IE90]

Developer D is developing a multi-unit residential complex. Customer Y enters into a binding sales contract with Developer D for Unit X, which is under construction. Each unit has a similar floor plan and is of a similar size. The following facts are relevant.

- Customer Y pays a nonrefundable deposit on entering into the contract and will make progress payments intended to cover costs to date plus the margin percentage in the contract during construction of Unit X.
- The contract has substantive terms that preclude Developer D from being able to direct Unit X to another customer.
- If Customer Y defaults on its obligations by failing to make the promised progress payments as and when they are due, then Developer D has a right to all of the consideration promised in the contract if it completes the construction of the unit.

- The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

At contract inception, Developer D determines that because it is contractually restricted from transferring Unit X to another customer, Unit X does not have an alternative use. In addition, if Customer Y were to default on its obligations, then Developer D would have an enforceable right to all of the consideration promised under the contract. Consequently, Criterion 3 is met and Developer D recognizes revenue from the construction of Unit X over time.

Observations

Agreements for the construction of real estate may have different patterns of transfer of control

ASU 2014-09 BC150
[IFRS 15.BC150]

Applying the criteria to real estate contracts may result in different conclusions on the pattern of transfer of control, depending on the relevant facts and circumstances of each contract. For example, the terms of some real estate contracts may prohibit an entity from transferring an asset to another customer and require the customer to pay for performance completed to date (therefore meeting Criterion 3). However, other real estate contracts that create an asset with no alternative use may only require a customer to make an up-front deposit, and therefore would not provide the entity with an enforceable right to payment for its performance completed to date (therefore failing to meet Criterion 3).

In practice, a detailed understanding of the terms of the contract and local laws may be required to assess whether an entity has a right to payment for performance to date. For example, in some jurisdictions customer default may be infrequent and contracts may not include extensive detail on the rights and obligations that arise in the event of termination. In such cases, expert opinion may be required to establish the legal position.

In other jurisdictions, real estate developers may have a practice of not enforcing their contractual rights if a customer defaults, preferring instead to take possession of the property with a view to selling it to a new customer. Again, evaluation of the specific facts and circumstances, including appropriate legal consultation, may be required to establish whether the contractual rights remain enforceable given an established pattern of non-enforcement in practice.

Comparison with current IFRS

Analysis of specific facts and circumstances is still a key consideration for real estate arrangements

[IFRS 15.BC149 to BC150; IFRIC 15]

Difficulty in determining when control of real estate transfers to the customer has resulted in diversity in current practice, particularly for certain multi-unit residential developments. The new standard replaces IFRIC 15 with specific requirements for determining when goods or services transfer over time. Applying this guidance – especially when assessing whether Criterion 3 is met – will require consideration of the specific facts and circumstances of each case. Given the judgment that may be required in this assessment, the recognition of revenue for real estate arrangements may continue to be a challenging area in practice.

Comparison with current U.S. GAAP

Revenue from real estate sales may be recognized earlier or later

360-20-40

Current U.S. GAAP includes transaction-specific guidance on profit recognition for sales of real estate. For real estate sales that transfer at a point in time, the new standard may result in earlier recognition of profit because, for example, the guidance on the amount of downpayment and the seller's continuing involvement is less prescriptive. Conversely, for other transactions – e.g., certain condominium developments – profit is recognized using the percentage-of-completion method when certain criteria are met; in many of these arrangements, none of the three criteria for recognition of revenue over time will be met, which will delay profit recognition for some entities.

5.5.3 Measuring progress toward complete satisfaction of a performance obligation

5.5.3.1 Selecting a method to measure progress

Requirements of the new standard

606-10-25-31 to 25-35, 55-17 to 55-21 [IFRS 15.39 to 43, B15 to B19]

For each performance obligation that is satisfied over time, an entity applies a single method of measuring progress toward the complete satisfaction of that performance obligation. The objective is to depict the transfer of control of the goods or services to the customer. To meet this objective, an entity selects an appropriate output or input method. It then applies that method consistently to similar performance obligations and in similar circumstances.

Method	Description	Examples
Output	Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under the contract	• Surveys of performance to date • Appraisals of results achieved • Milestones reached • Time elapsed
Input	Based on an entity's efforts or inputs toward satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation	• Resources consumed • Costs incurred • Time elapsed • Labor hours expended • Machine hours used

606-10-55-18 [IFRS 15.B16]

As a practical expedient, if an entity has a right to invoice a customer at an amount that corresponds directly with its performance to date, then it can recognize revenue at that amount. For example, in a services contract an entity may have the right to bill a fixed amount for each unit of service provided.

606-10-55-17 [IFRS 15.B15]

If an entity's performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units-of-delivery or units-of-production as they have been historically applied may not faithfully depict progress. This is because not all of the work performed is included in measuring the output.

606-10-55-20
[IFRS 15.B18]

If an input method provides an appropriate basis to measure progress and an entity's inputs are incurred evenly over time, then it may be appropriate to recognize revenue on a straight-line basis.

606-10-55-21
[IFRS 15.B19]

However, there may not be a direct relationship between an entity's inputs and the transfer of control. As such, an entity that uses an input method considers the need to adjust the measure of progress for uninstalled goods and significant inefficiencies in the entity's performance that were not reflected in the price of the contract – e.g., wasted materials, labor, or other resources (see 5.5.3.3). For example, if the entity transfers to the customer control of a good that is significant to the contract but will be installed later, and if certain criteria are met, then the entity recognizes the revenue on that good at zero margin.

606-10-25-36 to 25-37
[IFRS 15.44 to 45]

An entity recognizes revenue over time only if it can reasonably measure its progress toward complete satisfaction of the performance obligation. However, if the entity cannot reasonably measure the outcome but expects to recover the costs incurred in satisfying the performance obligation, then it recognizes revenue to the extent of the costs incurred.

Observations

Determining which measure of progress to apply is not a free choice

ASU 2014-09 BC159
[IFRS 15.BC159]

The new standard requires an entity to select a method that is consistent with the objective of depicting its performance. An entity therefore does not have a free choice of which method to apply to a given performance obligation – it needs to consider the nature of the good or service that it promised to transfer to the customer.

The new standard also provides examples of circumstances in which a particular method does not faithfully depict performance – e.g., it states that units-of-production may not be an appropriate method when there is a material amount of work in progress. Accordingly, judgment is required when identifying an appropriate method of measuring progress.

When evaluating which method depicts the transfer of control of a good or service, the entity's ability to apply that method reliably may also be relevant. For example, the information required to use an output method may not be directly observable or may require undue cost to obtain – in such circumstances, an input method may be appropriate.

Comparison with current IFRS

Similar measures of progress

[IAS 11.30;
IFRS 15.BC164]

Under IAS 11, no specific method is mandated for assessing the stage of completion, but an entity is required to use a method that reliably measures the work performed. The methods described as being appropriate under IAS 11 are consistent with the more detailed descriptions and examples provided in the new standard.

The new standard does not prescribe when certain methods should be used, but the Boards believe that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer. The Boards also believe that an input method would be appropriate if it would be less costly and would provide a reasonable basis for measuring progress. Our view under current IFRS is that output measures are the more appropriate measure of the stage of completion as long as they can be established reliably (see 4.2.290.30 of *Insights into IFRS*, 11th Edition).

Comparison with current U.S. GAAP

Similar measures of progress

605-35-25-70 to 25-81, 25-83 to 25-84; ASU 2014-09 BC164

When applying the percentage-of-completion method under current construction- and production-type-specific guidance, either input or output methods of measuring progress toward completion may be appropriate. The new standard provides descriptions and examples of methods that may be applied.

Current guidance indicates that if a reliable measure of output can be established, it is generally the best measure of progress toward completion; however, it acknowledges that output measures often cannot be established, in which case input measures are used. Similarly, the Boards believe that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer. The Boards also believe that an input method would be appropriate if it would be less costly and would provide a reasonable basis for measuring progress.

Currently, the percentage-of-completion method is used to determine the amount of income to recognize – i.e., revenue and costs – but there are two methods for this determination. Alternative A provides a basis for recognizing costs in the financial statements earlier or later than when they are incurred. Alternative B allows an entity to apply a margin to the costs incurred. The new standard supersedes both of these methods. However, if an entity uses cost-to-cost as its measure of progress, the amount of revenue and costs recognized will be similar to the amounts under Alternative B in current construction- and production-type-specific guidance.

5.5.3.2 Limitations on applying the units-of-delivery or units-of-production methods

Requirements of the new standard

606-10-55-17 [IFRS 15.B15]

An output method may not provide a faithful depiction of performance if the output selected fails to measure some of the goods or services for which control has transferred to the customer. For example, if at the reporting date an entity's performance has produced work in progress or finished goods that are controlled by the customer, then using an output method based on units produced or units delivered as it has been historically applied would distort the entity's performance. This is because it would not recognize revenue for the assets that are created before delivery or before production is complete but that are controlled by the customer.

Observations

A units-of-delivery method or a units-of-production method may not be appropriate if both design and production services are provided under the contract

ASU 2014-09 BC165 to BC166 [IFRS 15.BC165 to BC166]

A units-of-delivery method or a units-of-production method may not be appropriate if the contract provides both design and production services, because in this case each item produced or delivered may not transfer an equal amount of value to the customer. These contracts are common, for example, in the aerospace and defense, contract manufacturing, engineering, and construction industries.

The clarifications provided in the new standard as to when certain methods for measuring progress may not be appropriate emphasize the need for an entity to consider its facts and circumstances and select the method that depicts its performance and the transfer of control of the goods or services to the customer.

605-35-25-55
[IAS 11.30]

Current IFRS and U.S. GAAP do not restrict the use of a measure of progress based on units of delivery or units of production. Therefore, for some entities that currently use these methods to measure progress, the guidance in the new standard may result in a change in practice.

5.5.3.3 Adjusting the measure of progress

Requirements of the new standard

606-10-55-21
[IFRS 15.B19]

An entity applying an input method excludes the effects of any inputs that do not depict its performance in transferring control of goods or services to the customer. In particular, when using a cost-based input method – i.e., cost-to-cost – an adjustment to the measure of progress may be required when an incurred cost:

- does not contribute to an entity's progress in satisfying the performance obligation – e.g., unexpected amounts of wasted materials, labor, or other resources (such costs are expensed as incurred); or
- is not proportionate to the entity's progress in satisfying the performance obligation – e.g., uninstalled materials.

For uninstalled materials, a faithful depiction of performance may be for the entity to recognize revenue only to the extent of the cost incurred – i.e., at a zero percent profit margin – if, at contract inception, the entity expects that all of the following conditions will be met:

- the good is not distinct;
- the customer is expected to obtain control of the good significantly earlier than it receives services related to the good;
- the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
- the entity is acting as principal, but procures the good from a third party and is not significantly involved in designing and manufacturing the good.

Example 26

Treatment of uninstalled materials

606-10-55-187 to 55-192
[IFRS 15.IE95 to IE100]

In November 2015, Contractor P enters into a lump-sum contract with Customer Q to refurbish a three-story building and install new elevators for total consideration of 5,000. The following facts are relevant.

- The refurbishment service, including the installation of elevators, is a single performance obligation that is satisfied over time.
- Contractor P is not involved in designing or manufacturing the elevators, but is acting as principal and obtains control of the elevators when they are delivered to the site in December 2015.
- The elevators are not expected to be installed until June 2016.
- Contractor P uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation.

The transaction price and expected costs are as follows.

Transaction price	**5,000**
Costs	
Elevators	1,500
Other costs	2,500
Total expected costs	**4,000**

Contractor P concludes that including the costs of procuring the elevators in the measure of progress would overstate the extent of its performance. Consequently, it adjusts its measure of progress to exclude these costs from the costs incurred and from the transaction price, and recognizes revenue for the transfer of the elevators at a zero margin.

As at December 31, 2015, other costs of 500 have been incurred (excluding the elevators) and Contractor P therefore determines that its performance is 20% complete (500 / 2,500). Consequently, it recognizes revenue of 2,200 (20% x 3,500[a] + 1,500) and costs of goods sold of 2,000 (500 + 1,500).

Note

(a) Calculated as the transaction price of 5,000 less the cost of the elevators of 1,500.

Observations

No guidance on the timing and pattern of the recognition of margin on uninstalled materials

An entity may be entitled to a margin on the uninstalled goods that is clearly identified in the contract terms or forms part of the overall transaction price. The new standard does not provide guidance on the timing of recognition for this margin – i.e., whether it is recognized when the materials are installed, or incorporated into the revenue recognition calculation for the remainder of the contract.

ASU 2014-09 BC171
[IFRS 15.BC171]

The Boards believe that recognizing a contract-wide profit margin before the goods are installed could overstate the measure of the entity's performance and, therefore, revenue. However, requiring an entity to estimate a profit margin that is different from the contract-wide profit margin could be complex and could effectively create a performance obligation for goods that are not distinct (therefore bypassing the requirements for identifying performance obligations). The adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of goods in a construction-type contract – i.e., only to those goods that have a significant cost relative to the contract and only if the entity is essentially providing a simple procurement service to the customer.

Judgment will be required in determining whether a customer is obtaining control of a good 'significantly' before receiving services related to the good. In Example 26 in this publication, it is unclear whether the same guidance would apply if the elevators were expected to be installed in January 2016 instead of June 2016.

No detailed guidance on identification of inefficiencies and wasted materials

ASU 2014-09 BC176 to BC178
[IFRS 15.BC176 to BC178]

Generally, some level of inefficiency, reworks or overruns is assumed in a service or construction contract and an entity contemplates these in the arrangement fee. Although the new standard specifies that unexpected amounts of wasted materials, labor, or other resources should be excluded from a cost-to-cost measure of progress, it does not provide additional guidance on how to identify unexpected costs. Judgment is therefore required to distinguish normal wasted materials or inefficiencies from those that do not depict progress toward completion.

Comparison with current IFRS

Revenue recognized to the extent of costs

[IAS 11.31(a)]

Under IAS 11, materials that have not yet been installed are excluded from contract costs when determining the stage of completion of a contract. Therefore, recognizing revenue on uninstalled materials at a zero percent profit margin under the new standard may result in changes to an entity's profit recognition profile.

Comparison with current U.S. GAAP

Revenue recognized to the extent of costs

605-35-25-75

Current guidance indicates that some costs incurred – particularly in the early stages of a contract – are disregarded in applying the percentage-of-completion method because they do not relate to contract performance. These include the costs of items such as uninstalled materials that are not specifically produced or fabricated for the project or subcontracts that have not been performed. This guidance is largely consistent with the new standard, except that the costs of these items are currently excluded from costs incurred for the purpose of measuring progress toward completion, whereas under the new standard they are measured at a zero percent profit margin.

5.5.3.4 Reasonable measures of progress

Requirements of the new standard

606-10-25-36
[IFRS 15.44]

In order to recognize revenue, an entity needs to have a reasonable basis to measure its progress. An entity may not be able to measure its progress if reliable information required to apply an appropriate method is not available.

606-10-25-37
[IFRS 15.45]

If an entity cannot reasonably measure its progress, but nevertheless expects to recover the costs incurred in satisfying the performance obligation, then it recognizes revenue only to the extent of the costs incurred until it can reasonably measure the outcome.

Comparison with current IFRS

Similar to current practice

[IAS 11.33]

IAS 11 indicates that, during its early stages, the outcome of a contract often cannot be estimated reliably, but it may be probable that the entity will recover the contract costs incurred. The recognition of revenue is restricted to those costs incurred that are expected to be recoverable, and no profit is recognized. However, if it is probable that the total contract costs will exceed the total contract revenue, then any expected excess is recognized as an expense immediately.

This requirement is consistent with the new standard's guidance that revenue is recognized only to the extent of the costs incurred – i.e., at a zero percent profit margin – until the entity can reasonably measure its progress.

[IAS 37]

However, the new standard does not include guidance on the accounting for losses. Instead, an entity applies IAS 37 to assess whether the contract is onerous and, if it is onerous, to measure the provision (see 10.7).

Comparison with current U.S. GAAP

Similar to current practice

605-35-25-60, 25-66 to 25-67

If estimating the final outcome is impracticable, except to assure that no loss will be incurred, then current U.S. GAAP recommends the percentage-of-completion method based on a zero percent profit margin (rather than the completed-contract method) until more precise estimates can be made. Such a scenario may arise if the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms.

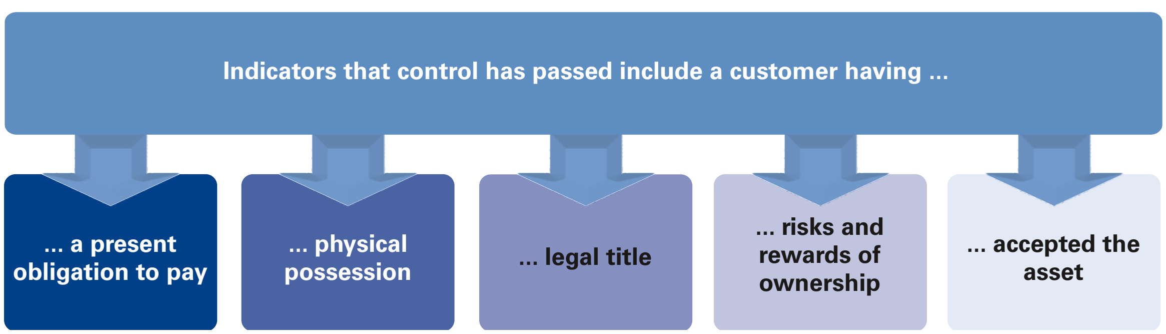
This requirement is consistent with the new standard's guidance that revenue is recognized only to the extent of costs incurred – i.e., at a zero percent profit margin – until the entity can reasonably measure its progress, although this situation does not arise frequently in our experience. However, the new standard does not include guidance on the accounting for losses, and therefore this method is not directly linked to loss considerations (see 10.7).

5.5.4 Performance obligations satisfied at a point in time

Requirements of the new standard

606-10-25-30
[IFRS 15.38]

If a performance obligation is not satisfied over time, then an entity recognizes revenue at the point in time at which it transfers control of the good or service to the customer. The new standard includes indicators as to when transfer of control occurs.



Relevant considerations for some of these indicators include the following.

- In some cases, possession of legal title is a protective right and may not coincide with the transfer of control of the goods or services to a customer – e.g., when a seller retains title solely as protection against the customer's failure to pay.
- In consignment arrangements (see 5.5.6) and some repurchase arrangements (see 5.5.5), an entity may have transferred physical possession but still retain control. Conversely, in bill-and-hold arrangements (see 5.5.7) an entity may have physical possession of an asset that the customer controls.
- When evaluating the risks and rewards of ownership, an entity excludes any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset.
- An entity needs to assess whether it can objectively determine that a good or service provided to a customer is in accordance with the specifications agreed in a contract (see 5.5.8).

Observations

Judgment may be required to determine the point in time at which control transfers

ASU 2014-09 BC155
[IFRS 15.BC155]

The indicators of transfer of control represent a list of factors that are often present if a customer has control of an asset; however, they are not individually determinative, nor do they represent a list of conditions that have to be met. The new standard does not suggest that certain indicators should be weighted more heavily than others, nor does it establish a hierarchy that applies if only some of the indicators are present.

Accordingly, judgment may be required to determine the point in time at which control transfers. This determination may be particularly challenging when there are indicators that control has transferred alongside 'negative' indicators suggesting that the entity has not satisfied its performance obligation.

Potential challenges may exist in determining the accounting for some delivery arrangements

SEC SAB Topic 13
[IAS 18.14]

Revenue is not currently recognized if an entity has not transferred to the buyer the significant risks and rewards of ownership. For product sales, the risks and rewards are generally considered to be transferred when a product is delivered to the customer's site – i.e., if the terms of the sale are 'free on board' (FOB) destination, then legal title to the product passes to the customer when the product is handed over to the customer. When a product is shipped to the customer FOB shipping point, legal title passes and the risks and rewards are generally considered to have transferred to the customer when the product is handed over to the carrier.

Under the new standard, an entity considers whether any risks may give rise to a separate performance obligation in addition to the performance obligation to transfer the asset itself. A common example is when an entity ships a product FOB shipping point, but the seller has a historical business practice of providing free replacements of that product to the customer or waiving its invoice amount if the products are damaged in transit (commonly referred to as a 'synthetic FOB destination arrangement'). It is unclear whether this will result in a separate performance obligation – i.e., a stand-ready obligation to cover the risk of loss if goods are damaged in transit – or whether control of the product has not transferred. Under current guidance, depending on the relevant facts and circumstances, revenue recognition is generally precluded until the product is delivered to the customer's destination, because the risks and rewards of ownership have not transferred to the customer, despite having satisfied the FOB shipping point delivery terms.

It may be difficult in practice to distinguish between situations in which the lack of transfer of the significant risks and rewards of ownership of an asset:

- leads to a conclusion that control of the asset has not transferred to a customer; or
- creates a separate performance obligation.

5.5.5 Repurchase agreements

Overview

An entity has executed a repurchase agreement if it sells an asset to a customer and promises, or has the option, to repurchase it. If the repurchase agreement meets the definition of a financial instrument, it is outside the scope of the new standard. If not, the repurchase agreement is in the scope of the new standard and the accounting for it depends on its type – e.g., a forward, call option, or put option – and on the repurchase price.

Requirements of the new standard

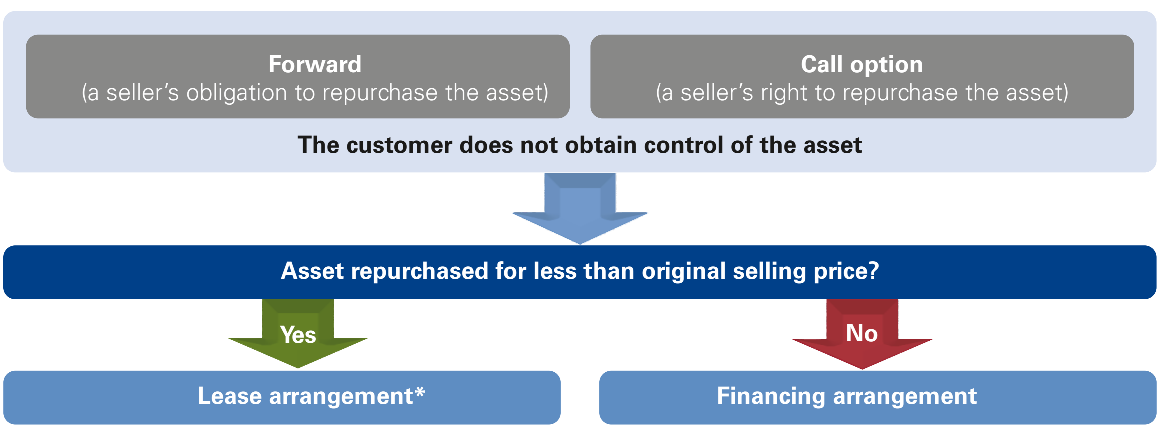
A forward or a call option

606-10-55-68 to 55-69 *[IFRS 15.B66 to B67]*

If an entity has an obligation (a forward) or a right (a call option) to repurchase an asset, then a customer does not have control of the asset. This is because the customer is limited in its ability to direct the use of and obtain the benefits from the asset, despite its physical possession. If the entity expects to repurchase the asset for less than its original sales price, the entity accounts for the entire agreement as a lease. Conversely, if the entity expects to repurchase the asset for an amount that is greater than or equal to the original sales price, it accounts for the transaction as a financing arrangement. When comparing the repurchase price with the selling price, the entity considers the time value of money.

606-10-55-70 to 55-71 *[IFRS 15.B68 to B69]*

In a financing arrangement, the entity continues to recognize the asset and recognizes a financial liability for any consideration received. The difference between the consideration received from the customer and the amount of consideration to be paid to the customer is recognized as interest, and processing or holding costs if applicable. If the option expires unexercised, the entity derecognizes the liability and the related asset, and recognizes revenue.



* Under U.S. GAAP, if the contract is part of a sale-leaseback transaction it is accounted for as a financing arrangement.

A put option

606-10-55-72 to 55-73
[IFRS 15.B70 to B71]

If a customer has a right to require the entity to repurchase the asset (a put option) at a price that is lower than the original selling price, then at contract inception the entity assesses whether the customer has a significant economic incentive to exercise that right. To make this assessment, an entity considers factors including:

- the relationship of the repurchase price to the expected market value of the asset at the date of repurchase; and
- the amount of time until the right expires.

606-10-55-72, 55-74
[IFRS 15.B70, B72]

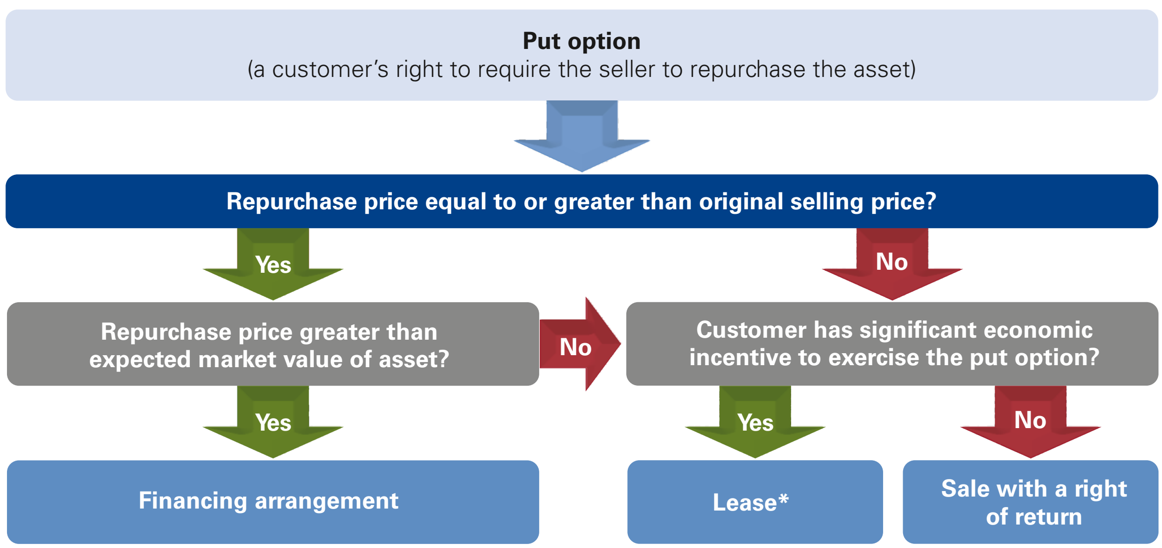
If the customer has a significant economic incentive to exercise the put option, the entity accounts for the agreement as a lease. Conversely, if the customer does not have a significant economic incentive, the entity accounts for the agreement as the sale of a product with a right of return (see 10.1).

606-10-55-75, 55-78
[IFRS 15.B73, B76]

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is accounted for as a financing arrangement. In this case, if the option expires unexercised, the entity derecognizes the liability and the related asset and recognizes revenue at the date on which the option expires.

606-10-55-77
[IFRS 15.B75]

When comparing the repurchase price with the selling price, the entity considers the time value of money.



* Under U.S. GAAP, if the contract is part of a sale-leaseback transaction it is accounted for as a financing arrangement.

Observations

A revised approach that focuses on the repurchase price

The new standard includes guidance on the nature of the repurchase right or obligation and the repurchase price relative to the original selling price, whereas the current accounting focuses on whether the risks and rewards of ownership have been transferred. As a result, determining the accounting treatment for repurchase agreements may, in some cases, be more straight forward under the new standard, but different from current practice. However, judgment will be required to determine whether a customer with a put option has a significant economic incentive to exercise its right.

Requirements for repurchase agreements not applicable to arrangements with a guaranteed resale amount

ASU 2014-09 BC431; 460-10
[IFRS 15.BC431]

The Boards observed that although the cash flows of an agreement with a guaranteed minimum resale value may be similar to those of an agreement with a put option, the customer's ability to control the asset is different, and therefore the recognition of revenue may differ. This is because if a customer has a significant economic incentive to exercise a put option, it is restricted in its ability to consume, modify, or sell the asset – which would not be the case if instead the entity had guaranteed a minimum amount of resale proceeds. This could result in different accounting for arrangements with similar expected cash flows.

Accounting for vehicles sold and subsequently repurchased subject to a lease depends on facts and circumstances

840-10-55-10 to 55-25

A car manufacturer's customer is typically a dealer; however, in some cases, the car manufacturer agrees to subsequently repurchase the vehicle if the dealer's customer chooses to lease it through the car manufacturer's finance affiliate. The dealer and the end customer are not related parties, and therefore under the new standard the contracts – i.e., the initial sale of the vehicle to the dealer, and the lease contract with the end customer – are not evaluated for combination purposes and are treated as separate contracts.

Generally, when a car manufacturer sells a vehicle to a dealership, it recognizes revenue on the sale using the point-in-time transfer of control indicators in the new standard. On repurchase of the vehicle from the dealer, the car manufacturer typically records the vehicle at an amount in excess of the price the dealer initially paid, and then applies leases guidance to classify the lease. In our experience, the lease is usually an operating lease and is accounted for independently of the original transaction between the car manufacturer and the dealer.

840-10-25-1, 25-40 to 25-43

In a transaction where the end customer orders a customized vehicle from the car manufacturer and concurrently enters into a finance agreement with the car manufacturer's finance affiliate, the car manufacturer considers the principal versus agent guidance in the new standard to evaluate whether the dealer is acting as an agent for the car manufacturer (see 10.3). If the dealer is deemed to be an agent, the car manufacturer's revenue considers the sales price of the vehicle to the end customer and the amount due to the dealer. However, if the dealer is deemed to be a principal, the car manufacturer's revenue is based on the selling price to the dealer and not the price to the ultimate customer.

Differences between IFRS and U.S. GAAP

Sale-leaseback transactions

840-40
[IAS 17]

The accounting for sale-leaseback transactions currently differs between U.S. GAAP and IFRS. As a result, the specific guidance on the accounting for repurchase agreements that are part of sale-leaseback transactions included in the U.S. GAAP version of the new standard is not included in the IFRS version. Under IFRS, the existing authoritative guidance on sale-leaseback transactions continues to apply.

Comparison with current IFRS

Introduction of more prescriptive guidance

[IAS 18.IE5]

The limited guidance on repurchase agreements in current IFRS focuses on whether the seller has transferred the risks and rewards of ownership to the buyer. The new standard introduces explicit guidance that requires entities to apply a conceptually different approach when accounting for repurchase arrangements, and may therefore result in differences from current practice.

[IAS 17; IAS 18]

In addition, under current IFRS guaranteed residual amounts offered by an entity to the customer may preclude revenue recognition if significant risks are retained. By contrast, the specific guidance in the new standard on repurchase arrangements focuses on whether the entity retains control of the asset.

Comparison with current U.S. GAAP

New guidance for certain sale-leaseback transactions

840-40

Except in cases when the seller-lessee holds a forward or call option to repurchase an asset for an amount that is less than its original selling price, or the buyer-lessor has a significant economic incentive to exercise a put option, the guidance on the accounting for sale-leaseback transactions has not changed. However, if the seller-lessee holds a forward or call option to repurchase an asset for an amount that is less than its original selling price, or if the buyer-lessor has a significant economic incentive to exercise a put option, then the contract is accounted for as a financing arrangement under the new standard.

Consistent treatment of processing costs for product financing arrangements

470-40

A product financing arrangement may include processing performed by the buyer. For example, a car manufacturer may sell aluminum to a parts supplier, and in a related transaction agree to purchase component parts from the supplier containing a similar amount of aluminum. The price of the component parts includes processing, holding, and financing costs. The new standard is consistent with current guidance on the accounting for these types of arrangements. The entity will identify the processing costs from the financing and holding costs separately, and recognize the processing costs as part of the cost of the product.

Change in practice for guarantees of resale value

840-10-55-10 to 55-25;
460-10

Under current U.S. GAAP, if an entity guarantees the resale value of an asset, the arrangement is accounted for as a lease. Under the new standard, revenue is recognized at the point in time at which the customer obtains control of the asset, which may result in a significant change in practice for some entities.

5.5.6 Consignment arrangements

Requirements of the new standard

606-10-55-79
[IFRS 15.B77]

An entity may deliver goods to another party but retain control of those goods – e.g., it may deliver a product to a dealer or distributor for sale to an end customer. These types of arrangements are called consignment arrangements, which do not allow the entity to recognize revenue on delivery of the products to the intermediary.

606-10-55-80
[IFRS 15.B78]

The new standard provides indicators that an arrangement is a consignment arrangement, as follows.

Indicators of a consignment arrangement

The entity controls the product until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires	The entity is able to require the return of the product or transfer the product to a third party, such as another dealer	The dealer does not have an unconditional obligation to pay for the products, although it might be required to pay a deposit

When is revenue recognized?

While the entity retains control of the product ...	Performance obligation is not met and revenue is not recognized ✗
When control transfers to the intermediary or end customer ...	Performance obligation is met and revenue is recognized ✓

Example 27

Consignment arrangement

Manufacturer M enters into a 60-day consignment contract to ship 1,000 dresses to Retailer A's stores. Retailer A is obligated to pay Manufacturer M 20 per dress when the dress is sold to an end customer. During the consignment period, Manufacturer M has the contractual right to require Retailer A to either return the dresses or transfer them to another retailer. Manufacturer M is also required to accept the return of the inventory.

Manufacturer M determines that control has not transferred to Retailer A on delivery, for the following reasons:

- Retailer A does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;
- Manufacturer M is able to require that the dresses be transferred to another retailer at any time before Retailer A sells them to an end customer; and
- Manufacturer M is able to require the return of the dresses or transfer them to another retailer.

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer – i.e., when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses – and therefore recognizes revenue as the dresses are sold to the end customer.

Observations

Move away from a risk-and-reward approach

Under the new standard, an entity typically considers contract-specific factors to determine whether revenue should be recognized on sale into the distribution channel or whether the entity should wait until the product is sold by the intermediary to its customer.

SEC SAB Topic 13
[IAS 18.16, IE2(c), IE6]

This assessment may differ from current IFRS and U.S. GAAP as a result of the shift from a risk-and-reward approach to a transfer of control approach. However, consideration of whether the significant risks and rewards of ownership have been transferred is an indicator of the transfer of control under the new standard (see 5.5.4) and conclusions about when control has passed to the intermediate party or the end customer are generally expected to stay the same.

5.5.7 Bill-and-hold arrangements

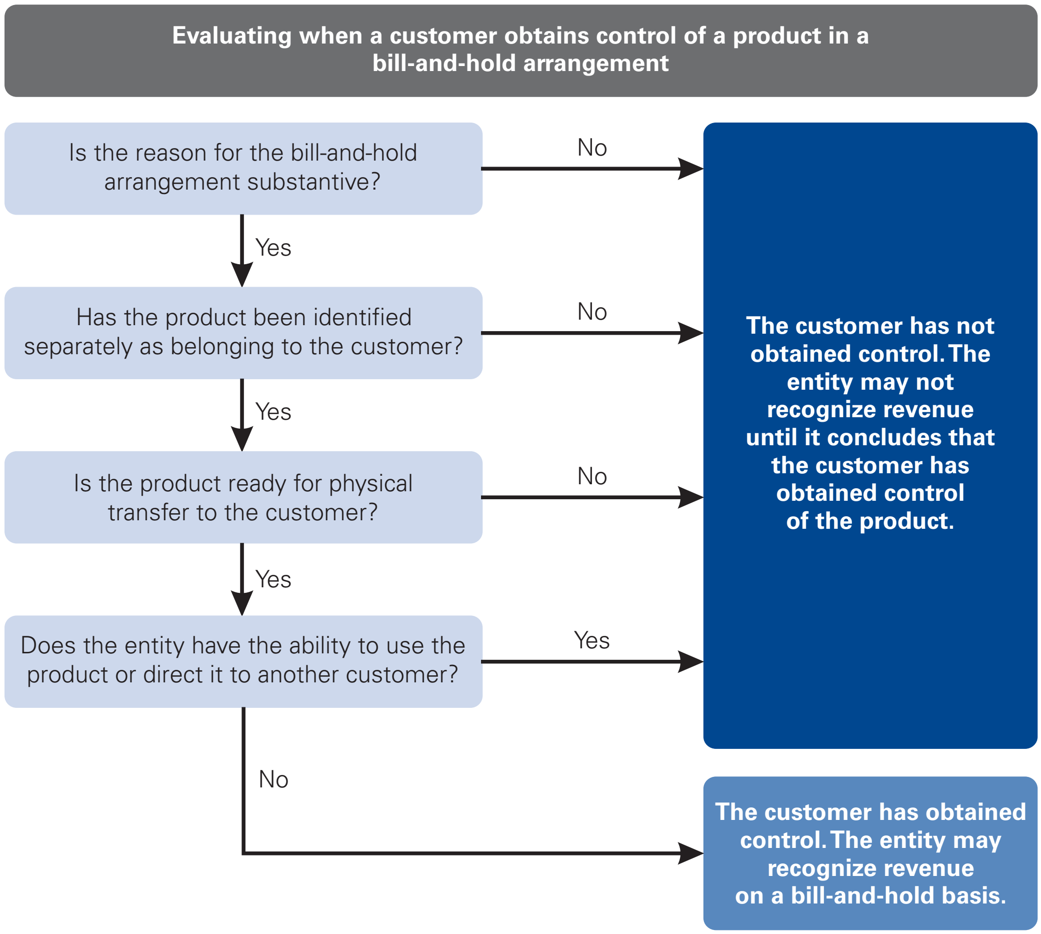
Requirements of the new standard

606-10-55-81
[IFRS 15.B79]

Bill-and-hold arrangements occur when an entity bills a customer for a product that it transfers at a point in time, but retains physical possession of the product until it is transferred to the customer at a future point in time – e.g., due to a customer's lack of available space for the product or delays in production schedules.

606-10-55-82 to 55-83
[IFRS 15.B80 to B81]

To determine when to recognize revenue, an entity needs to determine when the customer obtains control of the product. Generally, this occurs at shipment or delivery to the customer, depending on the contract terms (for discussion of the indicators for transfer of control at a point in time, see 5.5.4). The new standard provides criteria that have to be met for a customer to obtain control of a product in a bill-and-hold arrangement. These are illustrated below.



606-10-55-84
[IFRS 15.B82]

If an entity concludes that it is appropriate to recognize revenue for a bill-and-hold arrangement, then it is also providing a custodial service to the customer. The entity will need to determine whether the custodial service constitutes a separate performance obligation to which a portion of the transaction price is allocated.

Example 28

Bill-and-hold arrangement

Company C enters into a contract to sell equipment to Customer A, who is awaiting completion of a manufacturing facility and requests that Company C holds the equipment until the manufacturing facility is completed.

Company C bills and collects the nonrefundable transaction price from Customer A and agrees to hold the equipment until Customer A requests delivery. The equipment is complete and segregated from Company C's inventory and is ready for shipment. Company C cannot use the equipment or sell it to another customer. Customer A has requested that the delivery be delayed, with no specified delivery date.

Company C concludes that Customer A's request for the bill-and-hold basis is substantive. Company C concludes that control of the equipment has transferred to Customer A and that it will recognize revenue on a bill-and-hold basis even though Customer A has not specified a delivery date. The obligation to warehouse the goods on behalf of Customer A represents a separate performance obligation. Company C needs to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. The amount of the transaction price allocated to the warehousing obligation is deferred and then recognized over time as the warehousing services are provided.

Comparison with current IFRS

Broadly similar requirements, but with some differences

[IAS 18.IE1]

Although the criteria to recognize revenue on a bill-and-hold basis are broadly similar under current IFRS and under the new standard, there are some differences. For example, current IFRS requires that an entity's usual payment terms apply if it recognizes revenue on a bill-and-hold basis.

Another condition under current IFRS to recognize revenue on a bill-and-hold basis is that it is probable that delivery will be made. Under the new standard, this is not stated explicitly; however, if it is not probable that delivery will be made, then it is possible that the contract will not exist for the purpose of applying the requirements of the new standard or that the reason for the bill-and-hold arrangement will be deemed not to be substantive.

The fact that the entity pays for the cost of storage, shipment, and insurance on the goods is also taken into account under current requirements to assess whether the significant risks and rewards of ownership of the products have passed to the customer. This analysis is no longer directly relevant under the new requirements. However, it may be part of the assessment of whether the bill-and-hold terms are substantive.

Comparison with current U.S. GAAP

An explicit customer request and a specified delivery schedule are no longer required

SEC SAB Topic 13

The criteria for bill-and-hold arrangements under the new standard differ in two key respects from current SEC guidance.

First, the bill-and-hold arrangement is not required to be at the customer's explicit request. The new standard requires that the reason for the bill-and-hold arrangement has to be substantive. In some cases, this may require an explicit request from the customer as evidence to support a conclusion that it is substantive.

Second, the entity does not need a specified delivery schedule to meet the bill-and-hold criteria. However, an obligation to warehouse the goods is a separate performance obligation, and the entity will need a process and relevant controls to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided.

5.5.8 Customer acceptance

Requirements of the new standard

606-10-25-30(e)
[IFRS 15.38(e)]

To determine the point in time at which a customer obtains control for point-in-time performance obligations (and therefore satisfies the performance obligation), an entity considers several indicators of the transfer of control, including whether the customer has accepted the goods or services.

606-10-55-85
[IFRS 15.B83]

Customer acceptance clauses included in some contracts are intended to ensure the customer's satisfaction with the goods or services promised in the contract. The table below illustrates examples of customer acceptance clauses.

	If the entity:	Then:	For example:
606-10-55-86 *[IFRS 15.B84]*	**Can objectively verify that the goods or services comply with the specifications underlying acceptance**	Customer acceptance would be a formality, and revenue could be recognized before explicit acceptance	The customer acceptance clause is based on meeting objective size and weight specifications
606-10-55-87 *[IFRS 15.B85]*	**Cannot objectively determine whether the specifications have been met**	It is unlikely that the entity would be able to conclude that the customer has obtained control before formal customer acceptance	The customer acceptance clause is based on a modified product functioning in the customer's new production line
606-10-55-88 *[IFRS 15.B86]*	**Delivers products for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses**	Control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses	The customer acceptance clause specifies that the customer may use prototype equipment for a specified period of time

606-10-55-86
[IFRS 15.B84]

An entity's experience with similar contracts may provide evidence that goods or services transferred to the customer are based on the agreed specifications.

For further discussion on the accounting for consignment arrangements that may have attributes similar to customer acceptance clauses, see 5.5.6.

Comparison with current IFRS

Revenue may be recognized if certain formalities remain outstanding

[IAS 18.IE2(a)]

Under current IFRS, revenue from goods that are shipped subject to customer acceptance is normally recognized when the customer accepts delivery. Current IFRS does not explicitly permit recognition of revenue before customer acceptance. However, if a transaction meets the general criteria for recognition of revenue, then revenue may be recognized under the new standard even if certain formalities remain outstanding.

Comparison with current U.S. GAAP

Unlikely to significantly change current practice

SEC SAB Topic 13

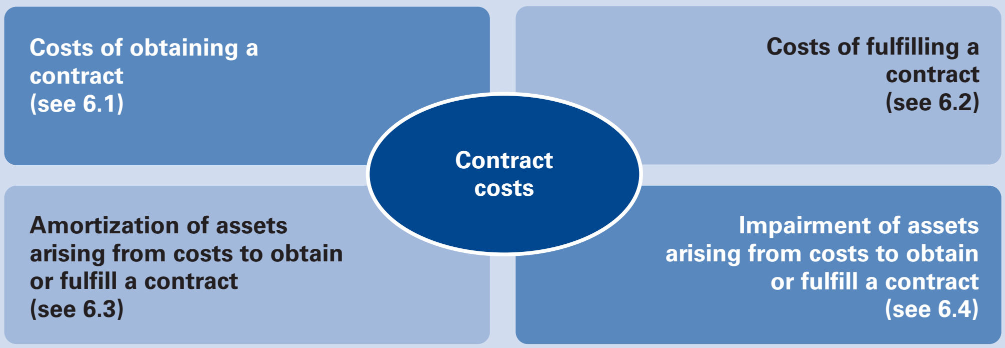
The SEC has provided guidance for specific types of acceptance clauses – e.g., vendor-specified objective criteria, customer-specified objective criteria, products shipped for trial or evaluation purposes, and subjective right of return or exchange.

While the new standard is unlikely to significantly change the current accounting for contracts that contain customer acceptance clauses, entities should consider whether certain customer-specified objective criteria give rise to a separate performance obligation. For further discussion on warranties, see 10.2.

6 Contract costs

Overview

The new standard does not seek to provide comprehensive guidance on the accounting for contract costs. In many cases, entities continue to apply existing cost guidance under U.S. GAAP and IFRS. However, the new standard does include specific guidance in the following areas.



6.1 Costs of obtaining a contract

Requirements of the new standard

340-40-25-1 to 25-2
[IFRS 15.91 to 92]

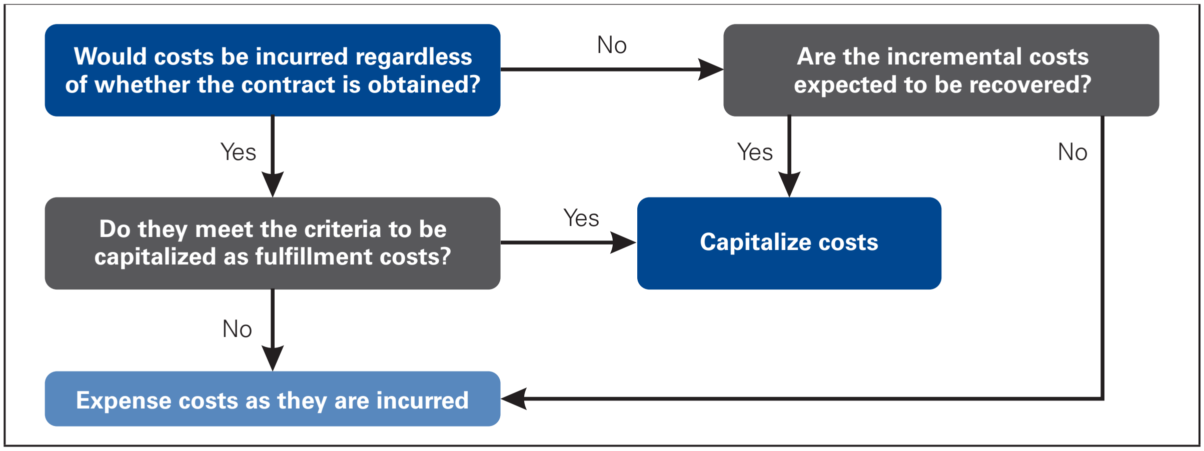
An entity capitalizes incremental costs to obtain a contract with a customer – e.g., sales commissions – if the entity expects to recover those costs.

340-40-25-4
[IFRS 15.94]

However, as a practical expedient, an entity is not required to capitalize the incremental costs to obtain a contract if the amortization period for the asset would be one year or less.

340-40-25-3
[IFRS 15.93]

Costs that will be incurred regardless of whether the contract is obtained – including costs that are incremental to *trying* to obtain a contract, such as bid costs that are incurred even if the entity does not obtain the contract – are expensed as they are incurred, unless they meet the criteria to be capitalized as fulfillment costs (see 6.2).



Example 29

Costs incurred to obtain a contract

340-40-55-2 to 55-4
[IFRS 15.IE189 to IE191]

Consulting Company E provides consulting services to customers. Following a competitive tender process, Consulting Company E wins a contract to provide consulting services to a new customer. Consulting Company E incurs the following costs to obtain the contract.

External legal fees for due diligence	15
Travel costs to deliver proposal	25
Commissions to sales employees	10
Total costs incurred	**50**

The commissions payable to sales employees are an incremental cost to obtain the contract, since they are payable only upon successfully obtaining the contract. Consulting Company E therefore recognizes an asset for the sales commissions of 10, subject to recoverability.

By contrast, although the external legal fees and travel costs are incremental costs, they are costs associated with *trying* to obtain the contract. Therefore, they were incurred even if the contract is not obtained. Consequently, Consulting Company E expenses the legal fees and travel costs as they are incurred, unless they are in the scope of other applicable guidance.

Observations

Amount of costs capitalized by an entity may change under the new standard

The requirement to capitalize the costs of obtaining a contract will be a change for entities that currently expense those costs. It may also be complex to apply, especially for entities with many contracts and a variety of contract terms and commission structures. Also, those entities that have not previously tracked the costs of acquiring a contract, and have expensed them as they were incurred, may find it difficult to determine which costs to capitalize, both for the transition amounts on adoption and in the ongoing application of the new standard.

An entity that currently capitalizes the costs to obtain a contract will need to assess whether its current capitalization policy is consistent with the new requirements. For example, an entity that currently capitalizes incremental bid costs will need to identify those costs that are incremental to obtaining the contract and exclude bid costs that are incurred irrespective of whether the contract is obtained. Likewise, an entity that capitalizes both incremental and allocable costs of obtaining a contract will need to revise its policy to only capitalize the incremental costs of obtaining a contract.

The practical expedient not to capitalize the incremental costs to obtain a contract offers potential relief for entities that enter into contracts of relatively short duration without a significant expectation of renewals. However, it will reduce comparability between entities that do and do not elect to use the practical expedient. The question over whether to use the practical expedient will be a key implementation decision for some entities.

Judgment required for multiple-tier commissions

Some entities pay sales commissions on a multiple-tier system, whereby the salesperson receives a commission on all contracts executed with customers, and their direct supervisor receives a commission based on the sales of the employees that report to them. Entities should use judgment when determining whether the supervisor's commission is incremental to obtaining a specific contract. The incremental cost should be the amount of acquisition cost that can be directly attributable to an identified contract.

Many sales commission models are based on multiple criteria, not just the acquisition of an individual contract – e.g., overall contract performance or the achievement of quotas for a period of time. It will require judgment to determine what portion of the supervisor's commission or quota 'kickers' are an acquisition cost that is directly related to a specific contract.

Comparison with current IFRS

Capitalizing costs to obtain a contract

[IAS 38] There is no specific guidance on the accounting for the costs to obtain a contract with a customer in current IFRS. The IFRS Interpretations Committee discussed the treatment of selling costs and noted that only in limited circumstance will direct and incremental recoverable costs to obtain a specifically identifiable contract with a customer qualify for recognition as an intangible asset in the scope of IAS 38.

[IAS 11.21] In addition, when a contract is in the scope of IAS 11, costs that relate directly to the contract and are incurred in securing it are included as part of the contract costs if they can be separately identified and reliably measured, and it is probable that the contract will be obtained.

[IAS 38] The new standard therefore brings clarity to this topic. It also introduces a new cost category – an asset arising from the capitalization of the incremental costs to obtain a contract will be in the scope of the new standard, and not in the scope of IAS 38.

Comparison with current U.S. GAAP

Policy election

SEC SAB Topic 13

Under current SEC guidance, an entity can elect to capitalize direct and incremental contract acquisition costs – e.g., sales commissions – in certain circumstances. Under the new standard, an entity capitalizes costs that are incremental to obtaining a contract if it expects to recover them – unless it elects the practical expedient for costs with amortization periods of one year or less. This may affect those entities that currently elect to expense contract acquisition costs, because they will now be required to capitalize them if the anticipated amortization period for such costs is greater than one year.

310-20-25-6 to 25-7

Currently, some entities capitalize a portion of an employee's compensation relating to origination activities by analogy to current U.S. GAAP on loan origination fees. This is not permitted under the new standard, because these costs are not incremental to a specific contract – i.e., an employee's salary and benefits are paid whether or not they successfully solicit a sale.

Direct-response advertising costs

340-20-25-4; 720-35-25-5

The new standard amends existing cost-capitalization guidance to require the costs of direct-response advertising to be expensed as they are incurred, because they are not incremental costs to obtain a specific contract.

Costs for investment companies

946-605-25-8

The new standard will not affect current U.S. GAAP cost guidance for mutual fund distribution fees associated with contingent deferred sales charges.

6.2 Costs of fulfilling a contract

Requirements of the new standard

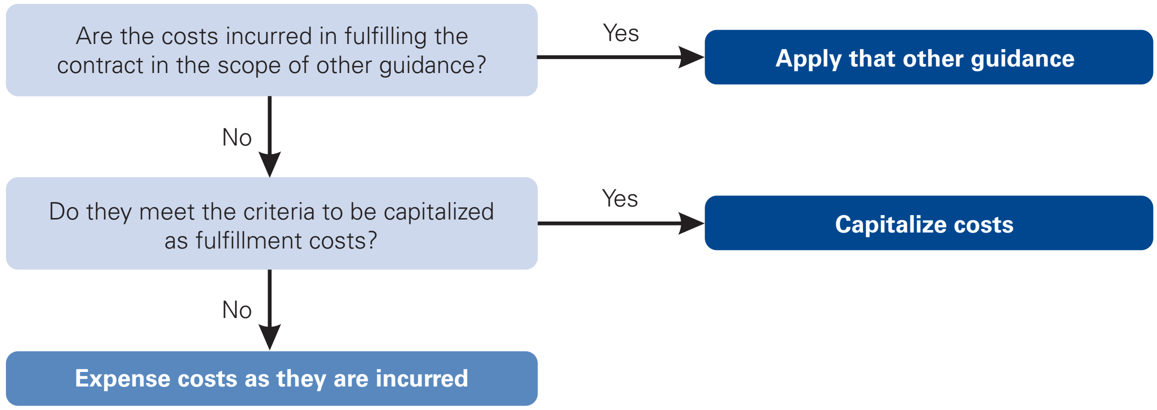
340-40-25-5 [IFRS 15.95]

If the costs incurred in fulfilling a contract with a customer are not in the scope of other guidance – e.g., inventory, intangibles, or property, plant, and equipment – then an entity recognizes an asset only if the fulfillment costs meet the following criteria:

- they relate directly to an existing contract or specific anticipated contract;
- they generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and
- they are expected to be recovered.

340-40-25-6 [IFRS 15.96]

If the costs incurred to fulfill a contract are in the scope of other guidance, then the entity accounts for them in accordance with that other guidance.



340-40-25-7 to 25-8
[IFRS 15.97 to 98]

The following are examples of costs that may or may not be capitalized when the specified criteria are met.

✓ Direct costs that are eligible for capitalization if other criteria are met	✗ Costs required to be expensed when incurred
Direct labor – e.g., employee wages	**General and administrative costs** – unless explicitly chargeable under the contract
Direct materials – e.g., supplies	**Costs that relate to satisfied performance obligations**
Allocation of costs that relate directly to the contract – e.g., depreciation and amortization	**Costs of wasted materials, labor or other contract costs**
Costs that are explicitly chargeable to the customer under the contract	**Costs that do not clearly relate to unsatisfied performance obligations**
Other costs that were incurred only because the entity entered into the contract – e.g., subcontractor costs	

Example 30

Set-up costs incurred to fulfill a contract

340-40-55-5 to 55-9
[IFRS 15.IE192 to IE196]

Managed Services Company M enters into a contract to manage Customer Y's IT data center for five years, for a monthly fixed fee. Before providing the services, Company M designs and builds a technology platform to migrate and test Customer Y's data. This platform is not transferred to Customer Y and is not considered a separate performance obligation. The initial costs incurred to set up the platform are as follows.

Design services	40
Hardware and software	210
Migration and testing	100
Total	**350**

These set-up costs relate primarily to activities to fulfill the contract, but do not transfer goods or services to the customer. M accounts for them as follows.

Type of cost	Accounting treatment
Hardware	Accounted for under guidance for property, plant, and equipment
Software	Accounted for under guidance for internal-use software development/ intangible assets
Design, migration, and testing of the data center	Capitalized under the new standard because they: • relate directly to the contract • generate or enhance resources of the entity that will be used to satisfy performance obligations in the future • are expected to be recovered over the five-year contract period

The capitalized hardware and software costs are subsequently measured in accordance with other applicable guidance, including the potential capitalization of depreciation if certain criteria are met. The costs capitalized under the new standard are subject to its amortization and impairment requirements (see 6.3 and 6.4).

Observations

Judgment needed in determining whether to capitalize learning curve costs

ASU 2014-09 BC312 to BC316
[IFRS 15.BC312 to BC316]

The new standard may affect the accounting for contracts that have significant learning curve costs that decrease over time as process and knowledge efficiencies are gained. The Boards believe that if an entity has a single performance obligation that is satisfied over time, and also has significant learning curve costs, then the entity may recognize revenue over time (e.g., using a cost-to-cost method). This will result in the entity recognizing more revenue and expense in the earlier phases of the contract.

330-10
[IAS 2]

If a contract is for multiple performance obligations (e.g., selling multiple goods or products, such as multiple pieces of equipment or machinery) that are each satisfied at a point in time (e.g., on transfer of control of the good) then an entity will principally account for the costs of those performance obligations under existing inventory guidance.

Comparison with current IFRS

Capitalizing costs to fulfill a contract

[IAS 11.21]

The new guidance on the accounting for the costs to fulfill a contract is likely to be particularly relevant for contracts that are currently accounted for using the stage-of-completion method under IAS 11. The new standard withdraws IAS 11, including the cost guidance contained therein.

[IAS 11]

Notably, the new standard requires an entity to capitalize the costs of fulfilling an *anticipated* contract, if the other conditions are met. This is similar to the notion in IAS 11 that costs incurred before a contract is obtained are recognized as contract costs if it is 'probable' that the contract will be obtained. It is not clear whether the Boards intend 'anticipated' to imply the same degree of confidence that a contract will be obtained as 'probable'.

[IAS 2; IAS 18]

IAS 2 will remain relevant for many contracts for the sale of goods that are currently accounted for under IAS 18.

Comparison with current U.S. GAAP

Policy election

SEC SAB Topic 13

Although there is no specific authoritative guidance under current U.S. GAAP, fulfillment costs are generally expensed as they are incurred. For certain set-up costs, however, entities may make an accounting policy election under current SEC guidance to either expense or capitalize these costs. Entities that currently expense those costs may be required to capitalize them under the new standard.

Costs in excess of constrained transaction price

In limited circumstances under current U.S. GAAP, the SEC concluded that an entity should not necessarily recognize a loss on a delivered item in a multiple-element revenue arrangement – i.e., not recognize the full costs of a delivered good or service – where the loss that would result:

- is solely a result of applying the contingent revenue cap under current U.S. GAAP, which limits the allocation of revenue to a delivered item to only those amounts that are not contingent on the entity's future performance; and
- is expected to be recovered by the revenue under the contract – i.e., it is essentially an investment in the remainder of the contract.[6]

Under the new standard, an entity may similarly deliver a good or provide a service, and all or a portion of the transaction price relating to that good or service may be constrained from revenue recognition. There is no provision in the new standard that is similar to the current SEC guidance when the new standard's constraint on variable consideration applies and applying it results in an up-front loss on the delivered good or service. As a result, in certain circumstances an entity may be required to recognize expenses before recognizing expected revenue on satisfied performance obligations.

Pre-production costs relating to long-term arrangements

340-10-25

The new standard does not amend the current U.S. GAAP guidance for pre-production costs related to long-term supply arrangements. Design and development costs for products to be sold under these arrangements continue to be expensed as they are incurred. However, the costs are recognized as an asset if there is a contractual guarantee for reimbursement. Design and development costs for molds, dies, and other tools that an entity owns and that are used in producing the products under a long-term supply arrangement continue to be capitalized as part of the molds, dies, and other tools – unless the design and development involves new technology, in which case they are expensed as they are incurred under the accounting for R&D costs.

926-20; 928-340; 350-40

In addition, the new standard does not amend the current guidance for accounting for film costs, advance royalties paid to a music artist, or internal-use software costs.

6 SEC Speech, *"Remarks Before the 2003 AICPA National Conference on Current SEC Developments,"* by Russell P. Hodge, Professional Accounting Fellow at the SEC, available at www.sec.gov.

6.3 Amortization

Requirements of the new standard

340-40-35-1
[IFRS 15.99]

An entity amortizes the asset recognized for the costs to obtain and/or fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates. This can include the goods or services in an existing contract, and also those to be transferred under a specific anticipated contract – e.g., goods or services to be provided following the renewal of an existing contract.

Example 31

Amortization of costs over specifically anticipated contracts

Company X enters into a contract with Customer Z to install a proprietary home security system and provide two years of monitoring services for an amount of 30 per month. Company X determines that the equipment is not distinct, because Company X does not sell the equipment on a stand-alone basis and Customer Z cannot benefit from the equipment without the monitoring service. Therefore, there is only one performance obligation. Company X incurs installation costs of 500. Based on historical experience and customer analysis, Company X expects Customer Z to renew the contract for an additional three years – i.e., it expects to provide five years of monitoring services in total.

Company X recognizes an asset of 500 for the set-up costs associated with installing the system and amortizes that asset over the five-year period – i.e., on a systematic basis consistent with the pattern of satisfaction of the performance obligation, and including specifically anticipated renewal period performance obligations.

Observations

Amortization period may need to include anticipated contracts

Under the new standard, a capitalized contract cost asset is amortized based on the transfer of goods or services to which the asset relates. In making this determination, the new standard notes that those goods or services could be provided under an anticipated contract that the entity can specifically identify.

The new standard does not prescribe how an entity should determine whether one or more anticipated contracts are specifically identifiable, such that practice is likely to develop over time. Relevant factors to consider may include the entity's history with that customer class, and predictive evidence derived from substantially similar contracts. In addition, an entity may consider the available information about the market for its goods or services beyond the initial contract term – e.g., whether it expects the service still to be in demand when renewal would otherwise be anticipated. Judgment will be involved in determining the amortization period of contract cost assets, but entities should apply consistent estimates and judgments across similar contracts, based on relevant experience and other objective evidence.

Anticipated contracts included when determining whether practical expedient applies

Under the new standard, an entity assesses the amortization period to determine whether it is eligible to apply the practical expedient not to recognize an asset for the incremental costs to obtain a contract. For example, a cable television company incurs incremental costs to obtain contracts with customers that have an initial term of one year. However, a significant proportion of customers renew the contracts at the end of the initial term. In this case, the company cannot assume that it is eligible for the practical expedient, but instead has to determine the amortization period.

Judgment required when contracts include recurring commissions

Some entities pay sales commissions on all contracts executed with customers, including new contracts – i.e., new services and/or new customers – and renewal or extension contracts. If the commission paid by an entity on a new contract will be followed by corresponding commissions for each renewal period – i.e., the salesperson will receive an incremental commission each time the customer renews, or does not cancel, the contract – then the entity applies judgment to determine whether the original commission on the new contract should be amortized only over the initial contract term, or over a longer period. The entity should consider the period for which it expects to benefit from the commissions.

No correlation with accounting for nonrefundable up-front fees

The amortization pattern for capitalized contract costs (i.e., including the term of specific anticipated contracts) and the revenue recognition pattern for nonrefundable up-front fees (see 10.6) (i.e., the existing contract plus any renewals for which the initial payment of the up-front fee provides a material right to the customer) are not symmetrical under the new standard. Therefore, there is no requirement under the new standard for the recognition pattern of these two periods to align, even where contract costs and nonrefundable up-front fees are both deferred on the same contract.

Comparison with current U.S. GAAP

No correlation with accounting for nonrefundable up-front fees

SEC SAB Topic 13

Current SEC guidance on revenue recognition indicates that registrants are required to defer nonrefundable up-front fees if they are not in exchange for goods delivered or services performed that represent the culmination of a separate earnings process. These fees are deferred and recognized as revenue over the expected period of performance, which may include expected renewal periods if the expected life of the contract extends beyond the initial period. Similarly, that guidance states that an entity may elect an accounting policy of deferring certain set-up costs or customer acquisition costs.

If the amount of deferred up-front fees exceeds the deferred costs, these two amounts are recognized over the same period and in the same manner. However, if the amount of deferred costs exceeds the deferred revenue from any up-front fees, the net deferred costs are amortized over the shorter of the estimated customer life and the stated contract period.

The new standard effectively decouples the amortization of contract fulfillment costs from that for any nonrefundable up-front fees in the contract (see 10.6). The capitalization of qualifying fulfillment costs is not a policy election (see 6.2). The amortization period for contract cost assets is determined in a manner substantially similar to that under current guidance when up-front fees result in an equal or greater amount of deferred revenue – i.e., the existing contract plus any anticipated renewals that the entity can specifically identify. However, contract costs that were previously deferred without any corresponding deferred revenue may be amortized over a longer period under the new standard than under current U.S. GAAP.

6.4 Impairment

Requirements of the new standard

340-40-35-3
[IFRS 15.101]

An entity recognizes an impairment loss to the extent that the carrying amount of the asset exceeds the recoverable amount. The recoverable amount is defined as:

- the remaining expected amount of consideration to be received in exchange for the goods or services to which the asset relates; *less*
- the costs that relate directly to providing those goods or services and that have not been recognized as expenses.

340-40-35-4
[IFRS 15.102]

When assessing an asset for impairment, the amount of consideration included in the impairment test is based on an estimate of the amounts that the entity expects to receive. To estimate this amount, the entity uses the principles for determining the transaction price, with two key differences:

- it does not constrain its estimate of variable consideration – i.e., it includes its estimate of variable consideration, regardless of whether the inclusion of this amount could result in a significant revenue reversal if adjusted; and
- it adjusts the amount to reflect the effects of the customer's credit risk.

Observations

New impairment model for capitalized contract costs

Topic 330; Topic 360; 985-20
[IAS 2; IAS 36]

The new standard introduces a new impairment model that applies specifically to assets that are recognized for the costs to obtain and/or fulfill a contract. The Boards chose not to apply the existing impairment models in U.S. GAAP or IFRS, in order to have an impairment model that focuses on contracts with customers. An entity applies this model in addition to the existing impairment models.

350-20-35-31 to 35-32; Topic 350; Topic 360
[IAS 36.22]

The entity applies, in order:

- any existing asset-specific impairment guidance – e.g., for inventory;
- the impairment guidance on contract costs under the new standard; and
- the impairment model for cash-generating units (IFRS), or for asset groups or reporting units (U.S. GAAP).

For example, if an entity recognizes an impairment loss under the new standard, it is still required to include the impaired amount of the asset in the carrying amount of the relevant cash-generating unit or asset group/reporting unit if it also performs an impairment test under IAS 36, or in applying current property, plant, and equipment, intangibles, or impairment guidance under U.S. GAAP.

Consideration that an entity expects to receive is calculated based on the goods or services to which the capitalized costs relate

The new standard specifies that an asset is impaired if the carrying amount exceeds the remaining amount of consideration that an entity expects to receive, less the costs that relate directly to providing those goods or services that have not been recognized as expenses. The TRG discussed impairment at its first meeting in July 2014, and most of its members expressed a view that cash flows from specific anticipated contracts should be included when determining the consideration expected to be received in the contract costs impairment analysis. They believed that an entity should exclude from the amount of consideration the portion that it does not expect to collect, based on an assessment of the customer's credit risk.

For certain long-term contracts that have a significant financing component, the estimated transaction price may be discounted. In these cases, it is unclear whether the estimated remaining costs to fulfill the contract and the contract cost asset should also be discounted for the purpose of performing the contract cost asset impairment analysis, even though the contract cost asset is not presented on a discounted basis in the entity's statement of financial position.

Difference between IFRS and U.S. GAAP

Reversal of an impairment loss

340-40-35-6
[IFRS 15.104]

The requirements on a reversal of an impairment loss are different under the U.S. GAAP and IFRS versions of the new standard, to maintain consistency with the existing respective U.S. GAAP and IFRS impairment models. Under U.S. GAAP, an entity does not recognize a reversal of an impairment loss that has previously been recognized. By contrast, under IFRS an entity recognizes a reversal of an impairment loss that has previously been recognized when the impairment conditions cease to exist. Any reversal of the impairment loss is limited to the carrying amount, net of amortization, that would have been determined if no impairment loss had been recognized.

7 Contract modifications

Overview

A contract modification occurs when the parties to a contract approve a change in its scope, price, or both. The accounting for a contract modification depends on whether distinct goods or services are added to the arrangement, and on the related pricing in the modified arrangement. This section discusses both identifying and accounting for a contract modification.

7.1 Identifying a contract modification

Requirements of the new standard

606-10-25-10
[IFRS 15.18]

A contract modification is a change in the scope or price of a contract, or both. This may in practice be described as a change order, a variation, or an amendment. When a contract modification is approved, it creates or changes the enforceable rights and obligations of the parties to the contract. Consistent with the determination of whether a contract exists in Step 1 of the model, this approval may be written, oral, or implied by customary business practices, and should be enforceable under law.

If the parties have not approved a contract modification, an entity continues to apply the requirements of the new standard to the existing contract until approval is obtained.

606-10-25-11
[IFRS 15.19]

If the parties have approved a change in scope, but have not yet determined the corresponding change in price – i.e., an unpriced change order – then the entity estimates the change to the transaction price by applying the guidance on estimating variable consideration and constraining the transaction price (see 5.3.1).

Observations

Applicable to all revenue contracts with customers

605-35-25-25 to 25-31
[IAS 11.13 to 14]

There is currently guidance on contract modifications for industries that have construction and production-type contracts in both IFRS and U.S. GAAP; however, neither revenue recognition framework includes a general framework for accounting for contract modifications.

Under the new standard, the guidance on contract modifications applies to all contracts with customers, and may therefore result in a change in practice for entities in industries without construction- and production-type contracts – and even for industries *with* such contracts, depending on the type of modification.

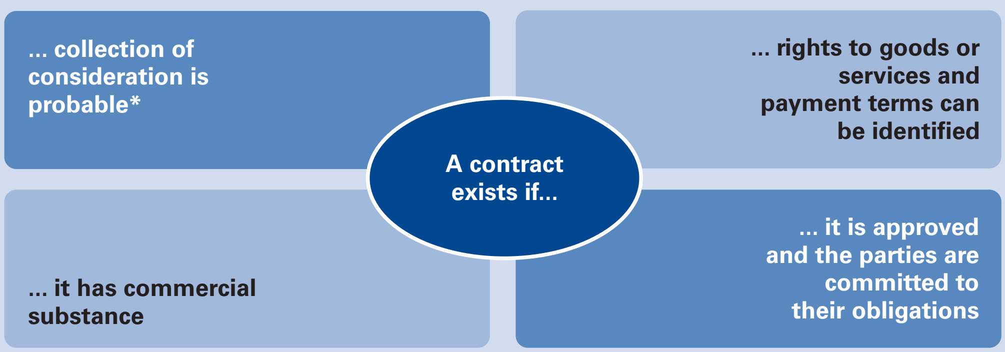
Some entities will need to develop new processes – with appropriate internal controls over those processes – to identify and account for contract modifications on an ongoing basis under the new guidance.

Assessment focuses on enforceability

The assessment of whether a contract modification exists focuses on whether the new or amended rights and obligations that arise under the modification are enforceable. This determination requires an entity to consider all related facts and circumstances, including the terms of the contract and relevant laws and regulations. This may require significant judgment in some jurisdictions or for some modifications – particularly if the parties to the contract have a dispute about the scope or the price. In cases of significant uncertainty about enforceability, written approval and legal representation may be required to support a conclusion that the parties to the contract have approved the modification.

Additional criteria to evaluate, including probability of collection

The new standard's guidance on contract modifications does not explicitly address whether the entity should assess the collectibility of consideration when determining that a modification has been approved. However, the objective of the guidance and its focus on whether the modification creates enforceable rights and obligations is consistent with the guidance on identifying a contract in Step 1 of the model (see 5.1). Under that guidance, the following criteria are used to determine whether a contract exists and therefore to help assess whether a modification exists.



* The threshold differs under IFRS and U.S. GAAP due to different meanings of the term 'probable'.

Relevant considerations when assessing whether the parties are committed to perform their respective obligations, and whether they intend to enforce their respective contract rights, may include:

- whether the contractual terms and conditions are commensurate with the uncertainty, if any, about the customer performing in accordance with the modification;
- whether there is experience about the customer (or class of customer) not fulfilling its obligations in similar modifications under similar circumstances; and
- whether the entity has previously chosen not to enforce its rights in similar modifications with the customer (or class of customer) under similar circumstances.

No specific guidance on accounting for contract claims

Currently, both U.S. GAAP and IFRS contain guidance on recognizing revenue related to construction contract claims, which are described as amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or other parties. Claims may arise from customer-caused delays, errors in specifications or design, contract terminations, change orders that are in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs.

ASU 2014-09 BC39, BC81
[IFRS 15.BC39, BC81]

The new standard does not retain specific guidance; rather, contract claims are evaluated using the guidance on contract modifications. Assessing whether a contract modification related to a claim exists may require a detailed understanding of the legal position, including third-party legal advice, even when a master services agreement or other governing document prescribes the claim resolution process under the contract. The assessment may be more straight forward if an objective framework for resolution exists – e.g., if the contract includes a defined list of cost overruns that will be eligible for reimbursement and a price list or rate schedule. Conversely, the mere presence of a resolution framework – e.g., a requirement to enter into binding arbitration rather than to enter into litigation – will generally not negate an entity's need to obtain legal advice to determine whether its claim is legally enforceable. If enforceable rights do not exist for a contract claim, a contract modification has not occurred and no additional contract revenue is recognized until there has been approval or until legal enforceability is established.

An entity's accounting for any costs incurred before approval of a contract modification will depend on the nature of the costs. In some circumstances, those costs will be expensed as incurred, while in others an entity will need to consider whether the expectation of costs without a corresponding increase in the transaction price requires the recognition of an onerous contract provision (see 10.7). In yet other cases, a contract modification may be considered a specifically anticipated contract such that the costs incurred before approval of the contract modification – i.e., pre-contract costs – may be considered for capitalization based on the new standard's fulfillment cost guidance (see 6.2).

Comparison with current IFRS

A new framework

IAS 11 includes specific guidance on the accounting for claims and variations in a construction contract, as follows.

[IAS 11.14]
[IAS 11.13]

Claims	A claim is an amount that the entity seeks to collect from the customer (or another party) as reimbursement for costs not included in the contract price. A claim is included in contract revenue only when: • negotiations have reached an advanced stage; • it is probable that the customer will accept the claim; and • the amount can be measured reliably.
Variations	A variation is an instruction from a customer to change the scope of work to be performed. A variation is included in contract revenue when: • it is probable that the customer will approve the variation; and • the amount of revenue can be measured reliably.

This specific guidance is not carried forward into the new standard. Instead, claims and variations in construction contracts are accounted for under the new standard's general guidance on contract modifications.

The criteria in the new standard for recognizing a contract modification, and for applying the general requirements about variable consideration to some contract modifications, may change the timing of recognition of revenue from claims and variations. Whether the new guidance will accelerate or defer revenue recognition will depend on the specific facts and circumstances of the contract.

Comparison with current U.S. GAAP

New general framework replaces specific guidance

605-35-15

Current U.S. GAAP on long-term construction- and production-type contracts includes guidance for unpriced change orders, contract options and additions, and claims. The new standard replaces this guidance with general guidance on contract modifications that applies to all entities, including those whose contracts were previously outside the scope of the guidance on construction- and production-type contracts. The new guidance also applies to contracts where performance obligations are satisfied at a point in time, over time, or a combination of both.

605-35-25-25, 25-28, 25-87

Unpriced change orders arise when the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. Under current U.S. GAAP, unpriced change orders are reflected in the accounting for a contract if recovery is probable. Some of the factors to consider in evaluating whether recovery is probable include:

- the customer's written approval of the scope of the change order;
- separate documentation for change order costs that are identifiable and reasonable; and
- the entity's experience in negotiating change orders, especially as they relate to the specific type of contract and change orders being evaluated.

605-35-25-30 to 25-31

Currently, a claim is included in contract revenue if it is probable that the claim will result in additional contract revenue that can be reliably estimated. This requirement is satisfied if all of the following conditions exist:

- the contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained;
- additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance;
- costs associated with the claim are identifiable or otherwise determinable; and
- the evidence supporting the claim is objective and verifiable.

The contract modification guidance in the new standard requires an entity to assess whether the modification creates new, or changes, enforceable rights and obligations. Similar to current U.S. GAAP, this assessment includes an evaluation of the collectibility of the consideration for an unpriced change order or claim; however, a number of additional criteria included in the new standard also need to be considered when evaluating whether a contract modification exists. These criteria may or may not have been incorporated into an entity's evaluation of the probability of recovery under current U.S. GAAP, and may therefore change the timing of revenue associated with contract modifications. For example, when determining whether and when to recognize revenue from contract claims, an entity should consider whether there are differences between there being a legal basis for a claim and the modification being legally enforceable.

7.2 Accounting for a contract modification

Requirements of the new standard

To faithfully depict the rights and obligations arising from a modified contract, the new standard requires that an entity accounts for modifications either on a prospective basis (when the additional goods or services are distinct) or on a cumulative catch-up basis (when the additional goods or services are not distinct).

606-10-25-12 [IFRS 15.20]

A contract modification is treated as a separate contract (prospective treatment) if the modification results in:

- a promise to deliver additional goods or services that are distinct (see 5.2.1); and
- an increase to the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price of those goods or services adjusted to reflect the circumstances of the contract.

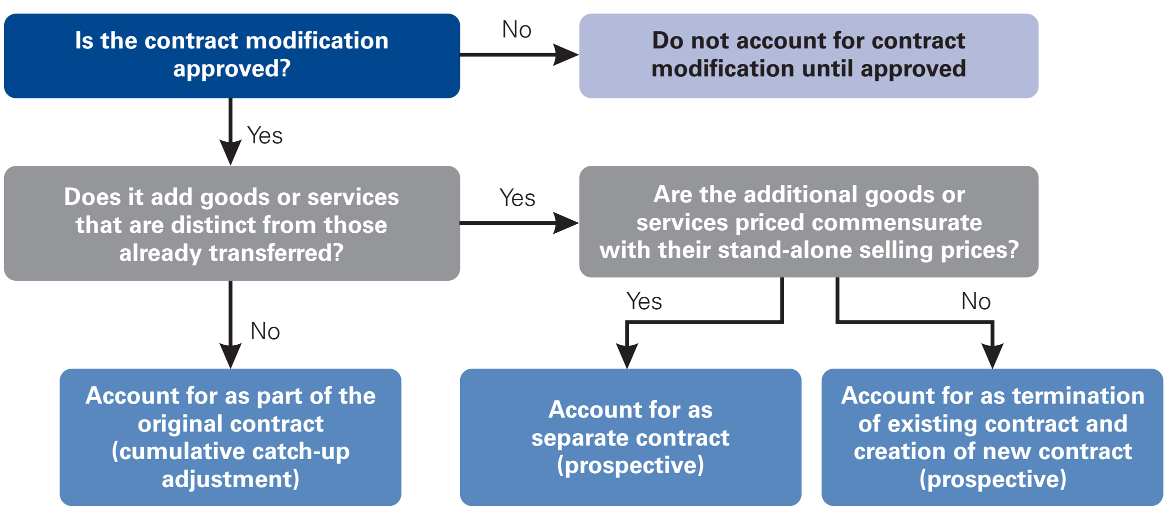
606-10-25-13 [IFRS 15.21]

If these criteria are not met, the entity's accounting for the modification is based on whether the remaining goods or services under the modified contract are distinct from those goods or services transferred to the customer before the modification. If they are distinct, the entity accounts for the modification as if it were a termination of the existing contract and the creation of a new contract. In this case, the entity does not reallocate the change in the transaction price to performance obligations that are completely or partially satisfied on or before the date of the contract modification. Instead, the modification is accounted for prospectively and the amount of consideration allocated to the remaining performance obligations is equal to:

- the consideration included in the estimate of the transaction price of the original contract that has not been recognized as revenue; plus or minus
- the increase or decrease in the consideration promised by the contract modification.

If the modification to the contract does not add distinct goods or services, the entity accounts for the modification on a combined basis with the original contract, as if the additional goods or services were part of the initial contract – i.e., a cumulative catch-up adjustment. The modification is recognized as either an increase in or reduction to revenue at the date of modification.

The key decision points to consider when determining whether a contract modification should be accounted for prospectively or through a cumulative catch-up adjustment are illustrated in the flow chart below.



606-10-32-45
[IFRS 15.90]

If the transaction price changes after a contract modification, an entity applies the guidance on changes in the transaction price (see 5.4.3).

Example 32

Contract modified to include additional goods or services

Construction Company G enters into a contract with Customer M to build a road for a contract price of 1,000. During the construction of the road, Customer M requests that a section of the road be widened to include two additional lanes. Construction Company G and Customer M agree that the contract price will be increased by 200.

In evaluating how to account for the contract modification, Construction Company G first needs to determine whether the modification adds distinct goods or services.

- If the road widening is not distinct from the construction of the road, then it becomes part of a single performance obligation that is partially satisfied at the date of the contract modification, and the measure of progress is updated using a cumulative catch-up method.
- If the road widening is distinct, then Construction Company G needs to determine whether the additional 200 is commensurate with the stand-alone selling price of the distinct good.
  - If the 200 reflects its stand-alone selling price, then construction of the additional two lanes is accounted for separately from the original contract for construction of the road. This will result in prospective accounting for the modification as if it were a separate contract for the additional two lanes.
  - If the 200 does not reflect its stand-alone selling price, then the agreement to construct the additional two lanes is combined with the original agreement to build the road and the unrecognized consideration is allocated to the remaining performance obligations. Revenue is recognized when or as the remaining performance obligations are satisfied – i.e., prospectively.

Observations

Different approaches for common types of contract modifications

To determine the appropriate accounting under the new standard, an entity will need to evaluate whether the modification adds distinct goods or services, and, if so, whether the prices of those distinct goods or services are commensurate with their stand-alone selling prices. This determination will depend on the specific facts and circumstances of the contract and the modification, and may require significant judgment.

Companies entering into construction-type contracts or project-based service contracts (e.g., a service contract with a defined deliverable such as a valuation report) may often account for contract modifications on a combined basis with the original contract; however, modifications to other types of contracts for goods (e.g., a sale of a number of distinct products) or services (e.g., residential television or internet services, or hardware/software maintenance services) may often result in prospective accounting.

Distinct goods or services in a series that are treated as a single performance obligation are considered separately

ASU 2014-09 BC115
[IFRS 15.BC115]

When applying the contract modifications guidance in the new standard to a series of distinct goods or services that is accounted for as a single performance obligation, an entity considers the distinct goods or services in the contract, rather than the single performance obligation.

Interaction of new contracts with pre-existing contracts needs to be considered

Any agreement with a customer where there is a pre-existing contract with an unfulfilled performance obligation may need to be evaluated to determine whether it is a modification of the pre-existing contract.

Comparison with current IFRS

Similarities to current practice

[IAS 11.13 to 14]

Although current IFRS does not include general guidance on the accounting for contract modifications, IAS 11 includes specific guidance on the accounting for contract claims and variations. When a claim or variation is recognized, the entity revises its measure of contract progress or contract price. Because the basic approach in IAS 11 is that the entity reassesses the cumulative contract position at each reporting date, this effectively results in a cumulative catch-up adjustment, although IAS 11 does not use this term.

[IAS 11.9]

Conversely, if an entity enters into a new construction contract with a customer that does not meet the contract combination criteria in IAS 11, then the entity accounts for the new construction contract as a separate contract. This outcome arises under the new standard when a contract modification adds a distinct good or service at its stand-alone selling price.

Comparison with current U.S. GAAP

Potential changes in practice for some entities

605-35-25-27

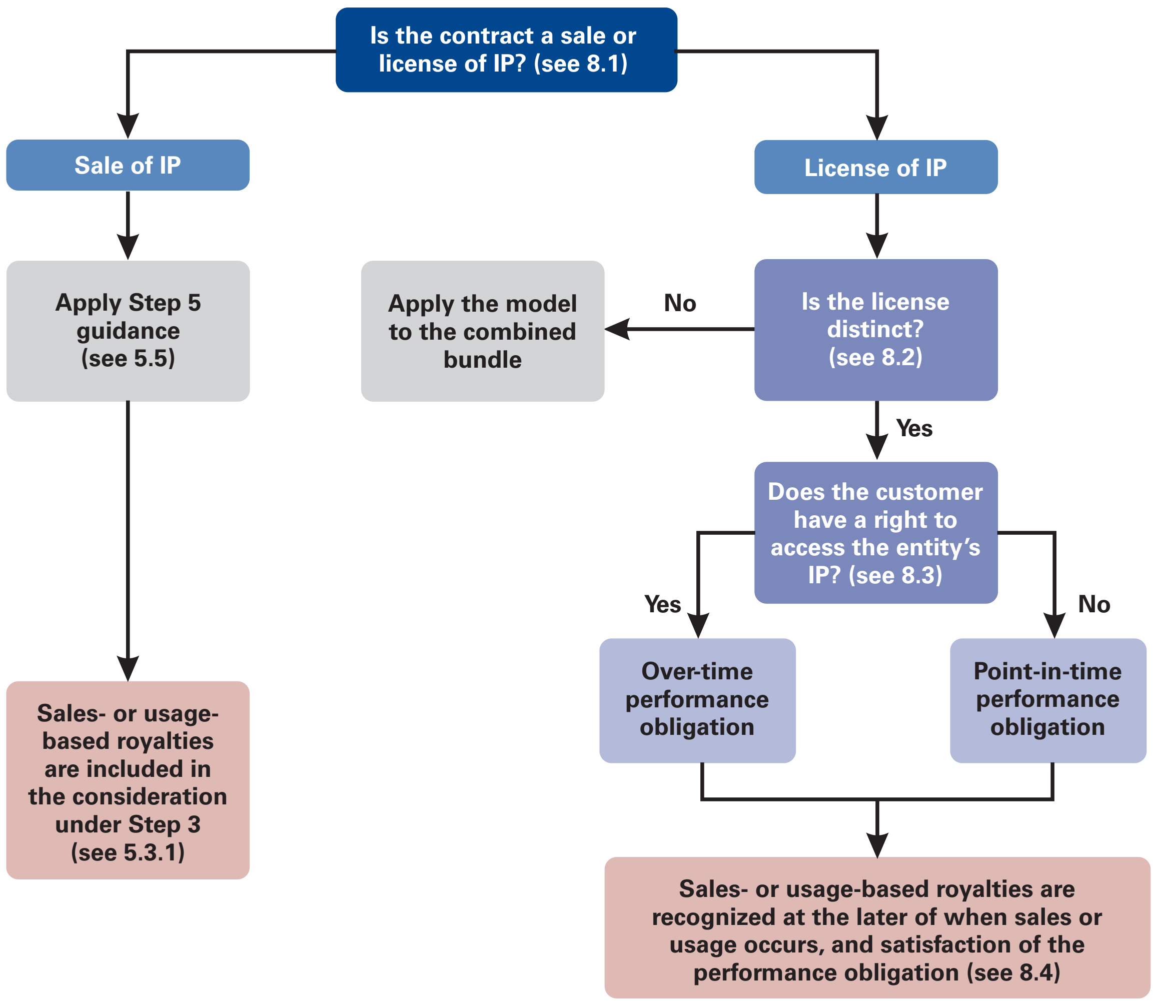
Current U.S. GAAP contains very limited guidance on the accounting for contract modifications other than for contracts that are in the scope of the guidance for construction- and production-type contracts. Entities with long-term construction- and production-type contracts generally account for contract modifications on a cumulative catch-up basis – i.e., updating their measure of progress under the contract for the effects of the modification. For contracts that are in the scope of other ASC Subtopics, practice may be mixed. Because the new standard provides guidance that applies to all contracts with customers, practice under U.S. GAAP is likely to change for some entities.

8 Licensing

Overview

The new standard provides specific application guidance on when to recognize revenue for distinct licenses of intellectual property (IP). If the license is not distinct from other promised goods or services in the contract, then the general model is applied. Otherwise, an entity assesses the nature of the license to determine whether to recognize revenue at a point in time or over time. However, an exception exists for sales- or usage-based royalties on licenses of IP.

The following decision tree summarizes the application of Step 5 of the model to licenses of IP under the new standard.



8.1 Licenses of intellectual property

Requirements of the new standard

606-10-55-54
[IFRS 15.B52]

A license establishes a customer's rights to the IP of another entity. Examples of IP licenses include:

- software and technology;
- franchises;
- patents and trademarks;
- movies, music, and video games; and
- scientific compounds.

Observations

Different accounting for a license and sale of IP

A license establishes a customer's rights to a licensor's IP and its obligations to provide those rights. In general, the transfer of control to all of the worldwide rights on an exclusive basis in perpetuity for all possible IP applications may be considered to be a sale. If the transferor limits the use of the IP – e.g., by geographic area, length of use, or type of application – or if substantial rights to the IP have not been transferred, then the transfer is generally a licensing arrangement.

If a transaction represents a sale of IP, then it is subject to the applicable steps of the new revenue recognition model. This includes applying the guidance on variable consideration and the constraint to any sales- or usage-based royalties. Conversely, specific application guidance is available for recognizing revenue from licensing transactions, including sales- or usage-based royalties (see 8.4).

No definition of intellectual property

The term 'intellectual property' is not defined in the new standard. In some cases, it will be clear that an arrangement includes IP – e.g., a trademark. In other cases, it may be less clear and the accounting may be different depending on that determination. Therefore, an entity may need to apply judgment to determine whether the guidance on licenses applies to an arrangement.

8.2 Determining whether a license is distinct

Requirements of the new standard

606-10-55-55
[IFRS 15.B53]

A contract to transfer a license to a customer may include promises to deliver other goods or services in addition to the promised license. These promises may be specified in the contract or implied by an entity's customary business practices.

Consistent with other types of contracts, an entity applies Step 2 of the model (see 5.2) to identify each of the performance obligations in a contract that includes a promise to grant a license in addition to other promised goods or services. This includes an assessment of:

- whether the customer can benefit from the license on its own or together with other resources that are readily available; and
- whether the license is separately identifiable from other goods or services in the contract.

606-10-55-56 to 55-57
[IFRS 15.B54 to B55]

If a license is not distinct, an entity recognizes revenue for the single performance obligation when or as the combined goods or services are transferred to the customer. An entity applies Step 5 of the model (see 5.5) to determine whether the performance obligation containing the license is satisfied over time or at a point in time.

ASU 2014-09 BC406
[IFRS 15.BC406]

Examples of licenses that are not distinct include the following.

Type of license	Example
License that forms a component of a tangible good and is integral to the functionality of the good	Software embedded in the operating system of a car
License from which the customer can benefit only in conjunction with a related service	Software related to online storage services that can only be used by accessing the entity's infrastructure

If a license is distinct from the other promised goods or services, and is therefore a separate performance obligation, then an entity applies the criteria in the application guidance to determine whether the license transfers to a customer over time or at a point in time (see 8.3).

Observations

Assessing whether a license is distinct may require significant judgment

The evaluation of whether a license is distinct is often complex and requires assessment of the specific facts and circumstances that are relevant to a contract. The new standard provides illustrative examples that may be helpful in evaluating some specific fact patterns.

Example and industry	Type of contract	Description	Observations
606-10-55-141 to 55-150 [IFRS 15.IE49 to IE58] **Example 11** **Technology**	Contract to transfer a software license, installation services, and unspecified software updates and technical support	Two cases are provided to illustrate differences in identifying performance obligations depending on whether the software will be substantially customized or modified as part of the installation services	Installation services involving the customization or modification of a software license may result in a conclusion that the license is not distinct Determining whether installation services involve significant customization or modification may require significant judgment
606-10-55-364 to 55-366 [IFRS 15.IE278 to IE280] **Example 55** **Technology**	Contract to license IP related to the design and production processes for a good	The customer is contractually required to obtain updates for new designs or production processes The updates are essential to the customer's ability to use the license, the entity does not sell the updates separately, and the customer does not have the option to purchase the license without the updates The example concludes that the license and the updates are highly interrelated and that the promise to grant the license is not distinct	There may be diversity in views about the kinds of technology to which the fact pattern, analysis, and outcome may apply in practice

606-10-55-367 to 55-374
[IFRS 15.IE281 to IE288]

Example and industry	Type of contract	Description	Observations
Example 56 **Life sciences**	Contract to license patent rights to an approved drug, which is a mature product, and to manufacture the drug for the customer	Two cases are provided, to illustrate differences in identifying performance obligations depending on whether the manufacturing process is unique or specialized, whether the license can be purchased separately, or whether other entities can also manufacture the drug	Manufacturing services that can be provided by another entity are an indication that the customer can benefit from a license on its own

The examples highlight the potential difficulty of determining whether services and IP are highly dependent on, or highly interrelated with, each other. For example, an entity may license a video game and provide additional online services that are not sold on a stand-alone basis. The entity will need to determine the degree to which the service is interrelated with the video game. The entire arrangement may be a single performance obligation, or alternatively, if the video game can be used on a stand-alone basis without the additional online services, they may be separate performance obligations.

License may be primary or dominant component of goods or services transferred to customer

ASU 2014-09 BC406 to BC407
[IFRS 15.BC406 to BC407]

In some cases when a license is not distinct, the Boards believe that the combined goods or services transferred to the customer may have a license as their primary or dominant component. When the output that is transferred is a license, or when the license is distinct, the entity evaluates the nature of the license based on the new standard's application guidance. However, 'primary' and 'dominant' are not defined in the new standard, and there may be diversity in views about how this will be applied in practice. The TRG discussed this concept in its discussion of sales- or usage-based royalties at its first meeting in July 2014. For further discussion, see 8.4.

Comparison with current IFRS

Similarities to current practice

[IAS 11.7 to 10; IAS 18.13]

Current IFRS does not contain specific guidance on separating a license of IP from other components of an arrangement. Instead, a transaction involving a transfer of rights to IP is subject to the general guidance on combining and segmenting contracts, and identifying separate components within a contract that applies to other revenue-generating transactions.

As discussed in 5.2, the new standard's guidance on identifying distinct goods or services is more detailed and more prescriptive than the guidance on identifying separate components under current IFRS. This is likely to increase the consistency with which a license component is separated from other goods or services in the arrangement.

Comparison with current U.S. GAAP

Software licenses

985-605; 606-10-55-54 to 55-64

Under current U.S. GAAP, software licenses are potentially separate units of account unless the services constitute the significant modification, customization, or production of the software that are essential to the functionality of that software. If the separation criteria are met, the license may still not be separated from the other services unless the entity has VSOE of the stand-alone selling price of the undelivered elements.

It is unclear whether the new standard's guidance on whether a license is distinct within the context of the contract is intended to yield a similar analysis to the current evaluation of whether the services are essential to the functionality of the software. Therefore, it is possible that there will be instances in which services are combined with the license under the new standard where they are not combined under current U.S. GAAP.

If the services and license are determined to be distinct under the new standard, there is no additional requirement that the entity has VSOE of the stand-alone selling price of the undelivered elements – e.g., the implementation services, telephone support, or unspecified upgrades – to separate those services from the license. As a consequence, if the license and services are distinct, the new standard will result in more cases where the revenue attributable to a license is recognized separately from the other goods or services in an arrangement than under current U.S. GAAP.

Cloud-computing arrangements

985-605-55-121 to 55-123

Under current U.S. GAAP, an entity evaluates cloud-computing arrangements to determine whether the customer has the right to take possession of the software at any time without incurring a significant financial or functional penalty during the hosting period. If so, the arrangement includes both a software license and a hosting service. If not, the arrangement is entirely a hosting service.

The new standard, by way of an example, states that a license from which the customer can benefit only in conjunction with a related service – e.g., an online hosting service provided by the entity – is not distinct from the hosting service. In addition, it may be that the hosting service is highly interrelated with the software, even if the customer may take possession of the software. Depending on the specific facts and circumstances of an arrangement, it is possible that for some arrangements that are hosting services under current U.S. GAAP, the software license is not distinct from the hosting services under the new standard.

Pharmaceutical arrangements

Under current U.S. GAAP, a biotech entity evaluates whether a drug license has stand-alone value apart from R&D services. The analysis often requires an evaluation of any contractual limitations on the license – e.g., for sub-licensing – and whether the services are highly specialized or proprietary. If a customer is contractually restricted from reselling the technology, the fact that the R&D services are not proprietary and can be performed by other entities is an indication that the license has stand-alone value. Under the new standard, in arrangements to transfer a biotech license and provide R&D services, both the license and R&D services are evaluated to determine whether they are distinct. It is unclear whether the new standard's guidance on whether a license is distinct within the context of the contract will result in a conclusion similar to current practice – i.e., to what extent substantive contractual prohibitions on the ability to sub-license, and the requirement for the entity to provide R&D services, will impact the assessment.

8.3 Determining the nature of a distinct license

Requirements of the new standard

606-10-55-58 *[IFRS 15.B56]*

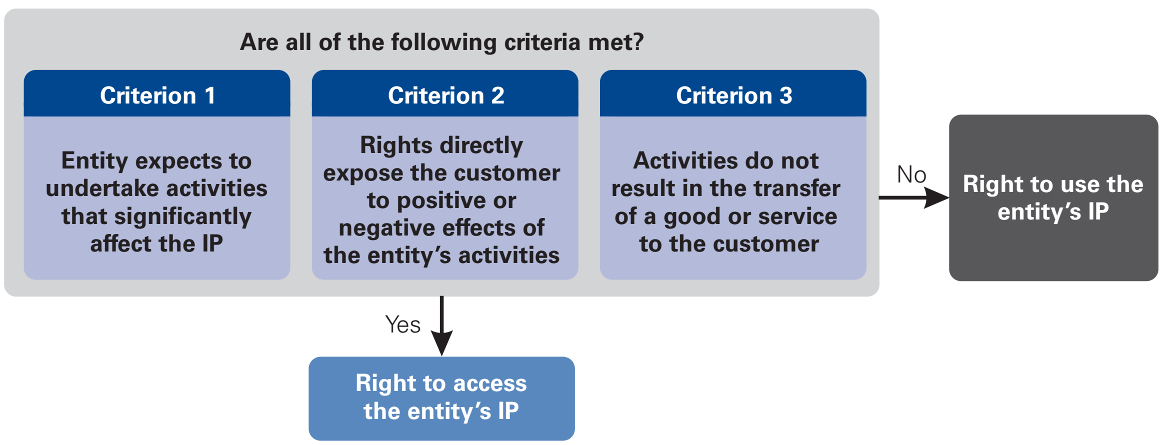
A distinct license of IP is treated as a separate performance obligation and an entity applies specific criteria to determine whether the license represents a right to:

- access the entity's IP as it exists throughout the license period; or
- use the entity's IP as it exists at a point in time.

606-10-55-59 *[IFRS 15.B57]*

To determine the nature of the license, an entity considers whether the entity continues to be involved with the IP and undertakes activities that significantly affect the IP to which the customer has rights. This is not the case when the customer can direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which it is granted. To make this assessment an entity considers three criteria. If all three are met, the nature of the entity's promise is to provide the customer with the right to access the entity's IP.

606-10-55-60 *[IFRS 15.B58]*



606-10-55-61 *[IFRS 15.B59]*

To determine whether a customer may reasonably expect the entity to undertake activities that significantly affect the IP, the entity should consider its customary business practices, published policies, and specific statements, and whether there is a shared economic interest between the entity and the customer.

606-10-55-64 *[IFRS 15.B62]*

The following factors are not considered when applying the above criteria:

- restrictions of time, geography, or use of the license; and
- guarantees provided by the licensor that it has a valid patent to the underlying IP and that it will maintain and defend that patent.

606-10-55-62 *[IFRS 15.B60]*

When the nature of the license is a right to access the entity's IP, it is a performance obligation satisfied over time. The guidance in Step 5 of the model is used to determine the pattern of transfer over time (see 5.5.3).

606-10-55-63 *[IFRS 15.B61]*

When the license represents a right to use the entity's IP, it is a performance obligation satisfied at the point in time at which the entity transfers control of the license to the customer. The evaluation of when control transfers is made using the guidance in Step 5 of the model (see 5.5.4). However, revenue cannot be recognized for a license that provides a right to use the entity's IP before the beginning of the period during which the customer is able to use and benefit from the IP.

Example 33

Assessing the nature of a license

Software Company X licenses a software application to Customer Y. Under the agreement, the underlying code and its functionality remain unchanged during the license period because they are saved and maintained by Customer Y for the duration of the license term. Software Company X issues regular updates or upgrades that Customer Y can choose to install. In addition, the activities of Software Company X in providing updates or upgrades transfer a promised good or service to Customer Y – i.e., when-and-if available upgrades – and are therefore not considered in determining the nature of the license granted to Customer Y. In this example, the software license is a right to use because the activities do not change Customer Y's IP under the current license and those activities transfer a promised good or service.

Observations

Some factors are not considered to differentiate the nature of a license

ASU 2014-09 BC411
[IFRS 15.BC411]

The Boards believe that provisions in a license arrangement relating to exclusive rights, restrictions relating to time, and extended payment terms will not directly affect the assessment as to whether the IP license is satisfied at a point in time or over time.

Franchise licenses may provide a right to access

606-10-55-375 to 55-382
[IFRS 15.IE289 to IE296]

It is generally believed that, under the new standard, franchise rights may be considered to provide a right to access the underlying IP. This is because the franchise right is typically affected to some degree by the licensor's activities of maintaining and building its brand. For example, the licensor generally undertakes activities to analyze changing customer preferences and enact changes to the IP – e.g., product improvements – to which the customer has rights. Example 57 of the new standard illustrates a 10-year franchise arrangement in which the entity concludes that the license provides access to its IP throughout the license period.

Significant complexity and judgment in assessing whether the ongoing activities of the licensor affect the IP licensed to the customer

The evaluation under the new standard of whether the ongoing activities of the licensor significantly affect the IP to which the customer has rights is complex, and requires significant judgment in evaluating the individual facts and circumstances.

The evaluation could be particularly challenging for entertainment and media companies. The following questions illustrate situations that may be complex and require significant judgment:

- whether the ongoing efforts to produce subsequent seasons of a television series are viewed as an activity that could significantly positively or negatively affect the licensed IP relating to completed seasons; and
- whether a license of a sports team's logo is impacted by its ongoing activities to field a competitive team during the license term.

Based on discussions at the first TRG meeting in July 2014, there appears to be some diversity in views about how this criterion should be evaluated. It is possible that the TRG will be asked to consider this issue at a subsequent meeting.

Does the licensor consider its cost and effort to undertake activities?

ASU 2014-09 BC409
[IFRS 15.BC409]

Criterion 2, which concerns the customer being exposed to the effects of the licensor's activities, emphasizes the fact that it is not sufficient for the entity to undertake significant activities as described in Criterion 1. These activities also have to directly expose the customer to their effects. When the activities do not affect the customer, the entity is merely changing its own asset – and although this may affect the entity's ability to provide future licenses, it does not affect the determination of what the license provides to the customer or what the customer controls. Because Criterion 2 focuses on shared risks between the entity and the customer, it further raises the question, discussed above, about whether Criterion 1's focus should be determined by whether the activities are changing the underlying IP or merely its value to the customer.

606-10-55-383 to 55-388
[IFRS 15.IE297 to IE302]

Example 58 of the new standard illustrates that when making this assessment, an entity should focus on whether its activities directly affect the IP already licensed to the customer – e.g., updated character images in a licensed comic strip – rather than the significance of the cost and effort of the entity's ongoing activities. Similarly, in the earlier observation involving a media company licensing completed seasons and simultaneously working on subsequent seasons, the evaluation would focus on whether those subsequent seasons affect the IP associated with the licensed season, and not merely on the significance of the cost or efforts involved in developing the subsequent seasons.

Only consider licensor's activities that do not transfer a good or service to the customer

ASU 2014-09 BC410
[IFRS 15.BC410]

Criterion 3, which concerns the licensor's activities not transferring a good or service to the customer, emphasizes the fact that the activities that may affect the IP do not by themselves transfer a separate good or service to the customer as they occur. In some respects, Criterion 3 might be seen as stress-testing the conclusion that the license is distinct from the other goods or services in the contract. If all of the activities that may significantly affect the IP are goods or services that are distinct from the license, it is more likely that the performance of those other goods or services will transfer a separate good or service to the customer, and that this criterion will not be met. This will result in the license being a point-in-time performance obligation.

For example, a contract that includes a software license and a promise to provide a service of updating the customer's software does not, without evaluating other factors, result in a conclusion that the licensor is undertaking activities that significantly affect the IP to which the customer has rights. This is because the provision of updates constitutes the transfer of an additional good or service to the customer.

Comparison with current IFRS

The pattern of revenue recognition from licenses may change

[IAS 18.IE18 to IE20]

Under current IFRS, license fees and royalties are recognized based on the substance of the agreement.

In some cases, license fees and royalties are recognized over the life of the agreement, similar to over-time recognition under the new standard. For example, fees charged for the continuing use of franchise rights may be recognized as the rights are used. IAS 18 gives the right to use technology for a specified period of time as an example of when, as a practical matter, license fees and royalties may be recognized on a straight-line basis over the life of the agreement.

In other cases, if the transfer of rights to use IP is in substance a sale, the entity recognizes revenue when the conditions for a sale of goods are met, similar to point-in-time recognition under the new standard. This is the case when the entity assigns rights for fixed consideration and has no remaining obligations to perform, and the licensee is able to exploit the rights freely. IAS 18 includes two examples of when this may be the case:

- a licensing agreement for the use of software when the entity has no obligations after delivery; and
- the granting of rights to distribute a motion picture in markets where the entity has no control over the distributor and does not share in future box office receipts.

Although these outcomes are similar to over-time and point-in-time recognition under the new standard, an entity is required to review each distinct license to assess the nature of the license under the new standard. It is possible that revenue recognition will be accelerated or deferred compared with current practice, depending on the outcome of this assessment.

Comparison with current U.S. GAAP

The pattern of revenue recognition from licenses may change

926-605; 928-605; 952-605; 985-605; SEC SAB Topic 13; 606-10-55-54 to 55-64

Current U.S. GAAP contains industry-specific guidance for licenses in certain industries – e.g., films, music, software, and franchise rights. For other licenses – e.g., patents, trademarks, copyrights, and pharmaceutical and biotechnology applications – and for other intangible assets, there is no specific U.S. GAAP guidance about whether license revenue is recognized over the license term or at inception of the license period. Current SEC guidance indicates that revenue for licenses of IP is recognized: "in a manner consistent with the nature of the transaction and the earnings process".

As a consequence, for licenses for which there is no specific current U.S. GAAP guidance, there is diversity in practice as entities evaluate their particular facts and circumstances to conclude what manner of revenue recognition is consistent with the nature of the transaction and the earnings process. Therefore, the new standard could change current practice for entities following specialized industry guidance, as well as other entities with an accounting policy for recognizing license revenue that differs from the application of Criteria 1, 2, and 3 in the new standard. In addition, because the criteria for concluding that a license is distinct in Step 2 of the model differ from some current industry-specific guidance, the outcome under the new standard could differ from current practice.

Industry	Guidance
Franchisors	Under current U.S. GAAP, the up-front franchise fee is recognized as revenue when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor (which is often when the store opens). Example 57 of the new standard suggests that distinct franchise licenses will often meet the access criteria, and therefore the up-front fee may be recognized over the term of the franchise agreement.

Industry	Guidance
Technology and software	If the license is distinct, applying the criteria in the new standard may often accelerate revenue because the entity no longer needs to have VSOE of the undelivered elements to separately recognize revenue for the delivered software license (which will generally be a right-to-use license under the new standard). If payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than 12 months after delivery, the arrangement fee under current U.S. GAAP is presumed not to be fixed or determinable, and revenue is generally recognized when the amounts are due and payable. Under the new standard, extended payment terms may not preclude up-front revenue recognition; however, entities will need to determine whether the arrangement contains a significant financing component (see 5.3.2).
Pharmaceutical arrangements	Under current U.S. GAAP, when an entity licenses a compound that has stand-alone value, revenue is recognized either at the point of delivery or over the license period, depending on the entity's assessment of the nature of the transaction and the earnings process. Under the new standard, if a pharmaceutical license is distinct, then determining its nature will likely involve significant judgment based on the characteristics of the licensing arrangement, including whether it is an early-stage or mature application related to the IP. Certain distribution licenses may be akin to franchise licenses if: • they require the distributor to sell and/or produce only the most recent version of the licensed drug product; but • the license is for a drug product that is not mature and the license will be satisfied over the license term. However, in some of these arrangements the other services – e.g., R&D – may not be distinct from the license, and therefore the guidance on licenses may not apply. Conversely, a license for a mature drug that is commercially ready for sale and requires no significant additional activities by the licensor may qualify as a license transferred at a point in time.
Entertainment and media companies	Under current U.S. GAAP, film licensors recognize revenue on: • the existence of persuasive evidence of an arrangement; • the film being complete and delivered or available for delivery; • the license period having commenced; • the arrangement fee being fixed or determinable; and • collection being reasonably assured. Under the new standard, significant judgment will be required to evaluate whether a distinct film or television show license qualifies as a right to use or a right to access the film-related IP.

8.4 Sales- or usage-based royalties

606-10-55-65
[IFRS 15.B63]

Requirements of the new standard

For sales- or usage-based royalties that are attributable to a license of IP, the amount is recognized at the later of:

- when the subsequent sale or usage occurs; and
- the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

Observations

Exception for sales- or usage-based royalties aligns accounting for different license types

A key practical effect of the exception for sales- or usage-based royalties is that it may reduce the significance of the distinction between the two types of licenses. In particular, if the consideration for a license consists solely of a sales- or usage-based royalty, then an entity is likely to recognize it in the same pattern, irrespective of whether the license is an over-time or point-in-time performance obligation.

Applicability of exception for sales- or usage-based royalty unclear

Licenses of IP are often bundled with other goods or services, with the consideration taking the form of a sales- or usage-based royalty for all goods or services in the contract. For example:

- software licenses are commonly sold with PCS, other services – e.g., hosting or implementation services – or hardware where there is a composite consideration in the form of a sales- or usage-based royalty;
- franchise licenses are frequently sold with consulting or training services or equipment, with ongoing consideration in the form of a sales-based royalty;
- biotechnology and pharmaceutical licenses are often sold with R&D services and/or a promise to manufacture the drug for the customer, with composite consideration in the form of a sales-based royalty; or
- licenses to digital media, with composite consideration in the form of a sales-based royalty.

At its first meeting in July 2014, the TRG discussed three possible alternative views on the applicability of the exception for sales- or usage-based royalties.

Alternative	Description
A	The exception applies to all licensing transactions, even if the royalty also relates to another non-license good or service
B	The exception only applies when the royalty relates solely to a license and that license is a separate performance obligation
C	The exception applies when the royalty relates: • solely to a license of IP; or • to a license and one or more other non-license goods or services, but the license is the primary or dominant component to which the royalty relates

In addition, when either the sales- or the usage-based royalty does not solely relate to the license, or the license is not a primary or dominant component, there are diverse views about whether that royalty needs to be allocated into portions that qualify for the exception and those that do not.

606-10-55-378 to 55-379
[IFRS 15.IE292 to IE293]

Example 57 of the new standard indicates that a sales- or usage-based royalty is allocated among the performance obligations in the contract using the guidance in Step 4 of the model (see 5.4).

Which payments qualify for the sale- or usage-based royalty exception?

In some cases, it may not be clear whether the payment structure qualifies for the sales- or usage-based royalty exception. For example, arrangements in the life sciences industry often include a license of IP to a drug and an obligation to perform R&D services, with a substantial portion of the fee being contingent on achieving milestones such as regulatory approval of the drug. The entity will need to determine whether the milestone fee falls within the exception from estimating a sales- or usage-based royalty, considering the diversity of views above.

A software entity may have an arrangement with payments that change depending on the usage by the customer or may be fixed for a wide range of users. For example, the royalty per user may be 10 for the first 1,000 users but then 8 for the next 1,000 users. Alternatively, the royalty may be fixed at 100,000 for the first 1,000 users and then increase to 190,000 for up to 2,000 users, etc. There seem to be differing views as to whether the usage-based exception was meant to apply to these fact patterns.

Comparison with current IFRS

[IAS 18.IE20]

Under current IFRS, if receipt of a license fee or royalty is contingent on a future event, an entity recognizes revenue only when it is probable that the fee or royalty will be received. This is normally when the future event triggering the payment of the fee or royalty occurs.

In many cases, the accounting outcome under the new standard's exception for a sales- or usage-based royalty will be the same as under current IFRS. However, the new standard prohibits the recognition of a sales- or usage-based royalty until the sale or usage occurs, even if the sale or usage is probable. Therefore, an entity that currently recognizes a sales- or usage-based royalty before the sale or usage occurs, on the grounds that receipt is probable, will recognize revenue later under the new standard.

As noted in the observation above, it is not always clear when the new standard's exception for a sales- or usage-based royalty will apply. This is not generally an issue under current IFRS, which applies more widely to any license fee or royalty that is contingent on a future event.

Comparison with current U.S. GAAP

SEC SAB Topic 13; 605-28

Under current U.S. GAAP, a sales- or usage-based royalty – irrespective of whether it relates to the licensing of IP or other goods or services – is recognized only on subsequent sale or usage. This is because the fee is not fixed or determinable until that point. In addition, current U.S. GAAP specifies that substantive milestone fees may be recognized once the milestone is achieved.

Under the new standard, the portion of the sales- or usage-based royalty that is attributable to the non-license element of the arrangement may be included in the arrangement consideration sooner than under current U.S. GAAP.

9 Sale or transfer of nonfinancial assets that are not part of an entity's ordinary activities

Overview

Certain aspects of the new standard apply to the sale or transfer of nonfinancial assets, such as intangible assets and property, plant, and equipment that are not an output of the entity's ordinary activities – i.e., transactions that are not with customers. Although the guidance under the new standard is converged, differences remain in the accounting for some sales and transfers of nonfinancial assets under IFRS and U.S. GAAP, including assessing when to apply the derecognition guidance.

9.1 General requirements

Requirements of the new standard

610-20
[IAS 16; IAS 38; IAS 40]

When an entity sells or transfers a nonfinancial asset that is not an output of its ordinary activities, it derecognizes the asset when control of that asset transfers to the recipient, using the guidance on transfer of control in the new standard (see 5.5.1).

The resulting gain or loss is the difference between the transaction price measured under the new standard (using the guidance in Step 3 of the model) and the asset's carrying amount. In determining the transaction price (and any subsequent changes to the transaction price), an entity considers the guidance on measuring variable consideration – including the constraint, the existence of a significant financing component, noncash consideration, and consideration payable to a customer (see 5.3).

The resulting gain or loss is not presented as revenue. Likewise, any subsequent adjustments to the gain or loss – e.g., as a result of changes in the measurement of variable consideration – are not presented as revenue.

Observations

Judgment required to identify ordinary activities

ASU 2014-09 BC53
[IFRS 15.BC53]

Under the new standard, a 'customer' is defined 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. Because 'ordinary activities' is not defined, evaluating whether the asset transferred is an output of the entity's ordinary activities may require judgment. An entity may consider how 'ordinary activities' is currently interpreted in the FASB's *Statements of Financial Accounting Concepts* and the IASB's *Conceptual Framework for Financial Reporting.*

In many cases, this judgment will be informed by the classification of a nonfinancial asset – e.g., an entity that purchases a tangible asset may assess on initial recognition whether to classify the asset as property, plant, and equipment or as inventory. Typically, the sale or transfer of an item that is classified as property, plant, and equipment will result in a gain or loss that is presented outside of revenue, while the sale or transfer of inventory will result in the recognition of revenue.

Accounting for a non-current or long-lived nonfinancial asset held for sale may result in a gain or loss on transfer of control because consideration may differ from fair value

360-10
[IFRS 5]

When the carrying amount of a non-current nonfinancial asset is expected to be recovered principally through a sale (rather than from continuing use), the asset is classified as held for sale if certain criteria are met.

610-20-55-2 to 55-4

The new standard does not amend the current measurement and presentation guidance applicable to non-current assets that are held for sale. Under this guidance, assets that are held for sale are measured at the lower of fair value less costs to sell and the carrying amount, which may differ from the expected transaction price as determined under the new standard. If the sale or transfer includes variable consideration that is constrained under the new standard, then the resulting transaction price that can be recognized could be less than fair value. This could result in the recognition of a loss when control of the asset transfers to the counterparty, even though the carrying amount may be recoverable through subsequent adjustments to the transaction price. In these situations, an entity may consider providing an early warning disclosure about the potential future recognition of a loss.

Little difference in accounting for sales of real estate to customers and noncustomers

610-20; 360-20
[IAS 16; IAS 40]

Because an entity applies the guidance to measure the transaction price for both customer and noncustomer transactions, the difference in accounting for an ordinary (customer) versus a non-ordinary (noncustomer) sale of real estate is generally limited to the presentation in the statement of comprehensive income (revenue and cost of sales, or gain or loss).

Until control of the asset transfers, current U.S. GAAP and IFRS guidance remains applicable for the initial recognition, measurement, and presentation of the assets.

9.2 Application under IFRS

Requirements of the new standard

[IAS 16; IAS 38; IAS 40]

Under the IFRS version of the new standard, the guidance on measurement and derecognition applies to the transfer of a nonfinancial asset that is not an output of the entity's ordinary activities, including:

- property, plant, and equipment in the scope of IAS 16;
- intangible assets in the scope of IAS 38; and
- investment property in the scope of IAS 40.

[IFRS 10; IAS 28]

When calculating the gain or loss on the sale or transfer of a subsidiary or associate, an entity will continue to refer to the guidance in IFRS 10 and IAS 28 respectively.

Example 34

Sale of a single-property real estate entity

[IFRS 3; IFRS 10; IAS 40]

Consulting Company X decides to sell an apartment building to Customer Y. Consulting Company X owns the building through a wholly owned subsidiary whose only asset is the building. The transaction is outside of its ordinary consulting activities. Title transfers to Customer Y at closing and Consulting Company X has no continuing involvement in the operations of the property – e.g., through a leaseback, property management services, or seller-provided financing.

The arrangement consideration includes a fixed amount paid in cash at closing, plus an additional 5% contingent on obtaining a permit to re-zone the property as a commercial property. Consulting Company X believes there is a 50% chance that the re-zoning effort will be successful.

Under IFRS, Consulting Company X applies the deconsolidation guidance in IFRS 10 because the apartment building is housed in a subsidiary.

In this example, the accounting under U.S. GAAP and IFRS may differ if the entity is deemed an in-substance nonfinancial asset under U.S. GAAP. Under IFRS, the seller follows the deconsolidation guidance and measures the contract consideration at fair value. Under U.S. GAAP, if the entity is an in-substance nonfinancial asset, the seller applies the new standard and the variable consideration is subject to the constraint (see 9.3).

Observations

Applying the new standard to the transfer of a group of nonfinancial assets that represents a business may result in different accounting

[IFRS 10.25]

IFRS does not explicitly address how to calculate the gain or loss on the sale of a group of nonfinancial assets that represents a business and is not housed in a subsidiary. Whether an entity currently applies the deconsolidation guidance or IAS 18 is not decisive, because the consideration is measured at fair value under both approaches. However, the approach may differ under the new standard, because an entity applies the guidance on the transaction price – i.e., variable consideration is subject to the constraint, and may therefore be measured at a lower amount than fair value.

No concept of in-substance nonfinancial assets, unlike U.S. GAAP

The consequential amendments to IFRS do not refer to in-substance nonfinancial assets. Therefore, unlike U.S. GAAP, the guidance on deconsolidation applies to a subsidiary and the entity does not assess whether it is an in-substance nonfinancial asset. This may result in different accounting under IFRS and U.S. GAAP for similar transactions.

Transfers to inventory still possible if specific criteria are met

[IAS 16.68A; IAS 40.58]

If an entity sells or transfers an item of property, plant, and equipment or an investment property, it recognizes a gain or loss on disposal outside of revenue. However, in limited circumstances it remains possible that an item may be transferred to inventory before sale, in which case an entity recognizes revenue on disposal – for example:

- an entity that, in the course of its ordinary activities, routinely sells items of property, plant, and equipment that it has held for rental to others transfers these assets to inventory when they cease to be rented and become held for sale; and
- an entity transfers investment property to inventory when there is a change of use evidenced by the start of development with a view to sale.

Comparison with current IFRS

Change in timing of derecognition

[IAS 16; IAS 18.14; IAS 38; IAS 40]

Under current IFRS, if an entity sells or transfers an item of property, plant, and equipment, an intangible asset, or an investment property, then it determines the date of disposal by applying the conditions for recognizing a sale of goods under IAS 18 – i.e., it applies a risk-and-reward test to identify the date of disposal. Changing to the new standard's control-based model may result in a change in the date of disposal, if risks and rewards transfer at a different date to control. This may be the case if the consideration includes a deferred or variable payment and the entity retains risks and rewards through that variability.

An entity may also need to assess when control passes in jurisdictions in which the legal process for the sale of real estate includes two or more stages. For example, in some jurisdictions the entity and the counterparty may initially commit to buy and sell a property and fix the transaction price. However, the counterparty will not gain physical possession of the property until a later date – typically, when some or all of the consideration is paid. In such cases, a risk-and-reward-based analysis may result in a different date of disposal than a control-based analysis.

Change in gain or loss on disposal

Under current IFRS, if an entity sells or transfers an item of property, plant, and equipment, an intangible asset, or an investment property, then it measures the consideration received or receivable at fair value. Under the new standard, the entity applies the guidance on the transaction price, including variable consideration and the constraint. This may result in the consideration initially being measured at a lower amount, with a corresponding decrease in any gain – particularly if the constraint applies. In extreme cases, an entity may recognize a loss on disposal even when the fair value of the consideration exceeds the carrying amount of the item immediately before disposal.

9.3 Application under U.S. GAAP

Requirements of the new standard

610-20-40-1

For non-ordinary sales or transfers of nonfinancial assets, an entity applies:

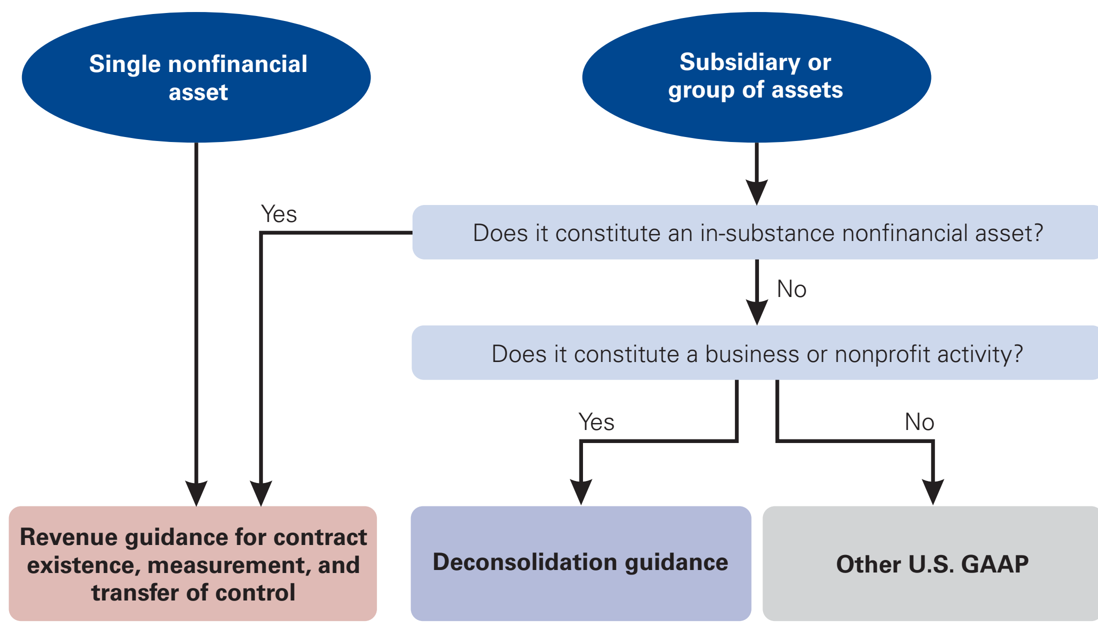
- the transfer of control and measurement guidance under the new standard; and
- the guidance in Step 1 of the model in the new standard to determine whether a contract exists (and, if not, the guidance on the accounting for consideration received in advance of having a contract – see 5.1.2).

610-20-15-2

The guidance for derecognizing nonfinancial assets under U.S. GAAP also extends to derecognizing an ownership interest in a subsidiary (or a group of assets) that is an in-substance nonfinancial asset – e.g., the sale of a subsidiary with just one nonfinancial asset, such as a building or a machine. If the transferred subsidiary (or group of assets) is not an in-substance nonfinancial asset, the entity assesses whether it constitutes a business or nonprofit activity. If it does, then the transaction is in the scope of the deconsolidation guidance.

Topic 860

If the transferred subsidiary (or group of assets) does not constitute an in-substance nonfinancial asset, a business or nonprofit activity, then other U.S. GAAP generally applies – e.g., it may constitute an in-substance financial asset for which the guidance on derecognition of financial assets applies. If no other guidance specifically applies, the deconsolidation guidance is generally applied.



Example 35

Sale of a single-property real estate entity with transaction price including variable consideration

360-10; 810-10

Consider the same fact pattern as presented in Example 34 of this publication.

Under U.S. GAAP, Company X first assesses whether the entity is an in-substance nonfinancial asset. If so, Company X applies the contract existence, measurement and transfer of control guidance in the new standard. Because the building is the entity's only asset, Company X concludes that it is an in-substance nonfinancial asset.

Company X concludes that a contract exists and that control transfers at closing, and therefore recognizes the sale (and derecognizes the building) at that time.

The 5% fee that is contingent on re-zoning is variable consideration that is subject to the constraint guidance. Company X cannot demonstrate that it is probable that a significant reversal of the transaction price will not occur if the contingent amount is recognized as profit at the date of the sale. Therefore, Company X limits the transaction price to the fixed amount received at closing. Company X will continue to evaluate the variable consideration until final resolution, and will adjust the transaction price (and ultimately true it up) when the contingency is resolved.

Observations

Contract existence may be difficult to establish for some contracts

610-20-40-1; 350-10-40-3; 360-10-40-3C

Contract existence (and the counterparty's commitment to perform under a contract) may be difficult to establish when the seller provides significant financing to the purchaser. If the arrangement does not meet the requirements for concluding that a contract exists in Step 1 of the model, then the entity continues to report the nonfinancial asset in its financial statements, recognize amortization or depreciation expense (unless it is held for sale), and apply the impairment guidance.

Determining when a subsidiary (or a group of assets) is an in-substance nonfinancial asset requires judgment

610-20; 810-10

The new standard's guidance on transfers of nonfinancial assets also applies to transfers of in-substance nonfinancial assets. However, it does not define 'in-substance nonfinancial asset' or provide guidance on how an entity should determine whether a subsidiary (or a group of assets) is an in-substance nonfinancial asset.

For example, it is unclear whether the evaluation should:

- be based on the relative fair values of the various assets in the subsidiary (or group of assets); or
- include unrecognized nonfinancial assets – e.g., internally developed intangible assets.

Therefore, this evaluation will often require significant judgment.

Additionally, in some cases a subsidiary (or a group of assets) may be both an in-substance nonfinancial asset and a business – e.g., an operating real estate or technology business. In this case, the guidance on sale or transfer of an in-substance nonfinancial asset appears to take precedence over the guidance on the derecognition of a business. It is therefore unclear when the guidance on the deconsolidation or derecognition of a business applies – i.e., under what circumstances a business will be neither an in-substance nonfinancial asset nor an in-substance financial asset.

Comparison with current U.S. GAAP

Lack of current derecognition guidance

Topic 610

Other than the guidance on the accounting for real estate sales, there is little guidance in current U.S. GAAP on the derecognition of nonfinancial assets that:

- are not an output of an entity's ordinary activities; and
- do not constitute a business or nonprofit activity accounted for under the deconsolidation guidance.

Transfer of in-substance nonfinancial assets

810-10

A sale or transfer of a subsidiary (or a group of assets) that constitutes a business or nonprofit activity continues to be accounted for using deconsolidation guidance only when it does not also constitute a transfer of an in-substance nonfinancial asset.

932-360

In these cases, portions of the new standard apply and may result in differences in the derecognition date and/or the measurement of the gain or loss. In addition, an entity does not apply the new standard to conveyances of oil and gas mineral rights.

Sale-leaseback transactions

360-20; 840-40

The current real estate sale guidance in U.S. GAAP continues to apply to sale-leaseback transactions involving real estate. The current leasing guidance applies to disposals through sale-leaseback transactions involving non-real-estate transactions.

Sales of real estate

360-20

The new standard differs significantly from current U.S. GAAP for sales of real estate. Current U.S. GAAP requires a number of criteria to be met in order to recognize the full amount of profit on a sale of real estate. For example, full profit recognition is not permitted if the seller finances the purchase price and the buyer's initial or continuing investment does not meet specified quantitative thresholds. Under the new standard, as long as it is probable that the seller will collect the consideration to which it expects to be entitled – i.e., a contract exists – revenue or a gain is recognized when control of the property transfers. Although there is no *prescribed* level of initial or continuing investment, the amount of initial or continuing investment will impact the assessment of whether a contract exists – i.e., as it increases there is a greater likelihood that the entity will conclude that a contract exists.

In addition, the new standard changes the effect of continuing involvement by the seller on profit recognition. Continuing involvement under current U.S. GAAP can prevent or delay derecognition of the property and/or affect the pattern of profit recognition on the overall arrangement. Under the new standard, continuing involvement with the transferred property will often be accounted for on its own as either:

- a separate unit of account that is subject to other guidance – e.g., seller guarantees; or
- a separate performance obligation from the transfer of the property – e.g., providing ongoing property management services, support operations, or development services.

For example, in a sale of land that includes a promise of future development, an entity evaluates whether each promise in the contract – i.e., delivery of the land and the development services – is distinct. If so, the revenue or gain related to the land sale is recognized when it is sold, and the revenue or gain allocated to the development performance obligation is recognized either over the development period or when development is completed, depending on whether the over-time criteria are met for the development performance obligation.

The new standard generally applies to real estate sales or transfers, including the sale or transfer of an in-substance nonfinancial asset. If selling real estate represents an ordinary activity of the seller, it recognizes revenue and expense based on the transaction price and the carrying amount of the asset, respectively. Conversely, if selling real estate is not an ordinary activity, the seller recognizes a gain or loss based on the difference between the transaction price and the carrying amount of the asset.

Accounting for sales of real estate may require more judgment than under current U.S. GAAP because the new standard is less prescriptive – e.g., in evaluating the effects of the buyer's investment and certain types of continuing involvement by the seller.

Partial sales

360-20; 970-323

Current U.S. GAAP defines a real estate sale as a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. An entity recognizes profit on the sale equal to the difference between the sales value and the proportionate cost of the partial interest sold if:

- the buyer is independent of the seller;
- collection of the sales price is reasonably assured; and
- the seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

If these conditions are not met, the seller may be unable to derecognize the property or may need to delay profit recognition – e.g., by applying either the installment or cost recovery method.

The new standard does not include amendments to the guidance in current U.S. GAAP on partial sales of real estate. Therefore, it is unclear whether *all* partial sales are to be accounted for similarly under the new standard. The FASB may further address issues related to partial sales of real estate, among others, in the context of its project on clarifying the definition of a business, although the timing of that project is unclear.

10 Other issues

10.1 Sale with a right of return

Overview

Under the new standard, when an entity makes a sale with a right of return it recognizes revenue at the amount to which it expects to be entitled by applying the variable consideration and constraint guidance set out in Step 3 of the model (see 5.3). The entity also recognizes a refund liability and an asset for any goods or services that it expects to be returned.

Requirements of the new standard

606-10-55-22
[IFRS 15.B20]

An entity applies the accounting guidance for a sale with a right of return when a customer has a right to:

- a full or partial refund of any consideration paid;
- a credit that can be applied against amounts owed, or that will be owed, to the entity; or
- another product in exchange (unless it is another product of the same type, quality, condition, and price – i.e., an exchange).

606-10-55-23 to 55-24
[IFRS 15.B21 to B22]

In addition to product returns, the guidance also applies to services that are provided subject to a refund. An entity does not account for its obligation to provide a refund as a performance obligation.

606-10-55-28 to 55-29
[IFRS 15.B26 to B27]

The guidance does not apply to:

- exchanges by customers of one product for another of the same type, quality, condition, and price; and
- returns of faulty goods or replacements, which are instead evaluated under the guidance on warranties (see 10.2).

606-10-55-23, 55-25, 55-27
[IFRS 15.B21, B23, B25]

When an entity makes a sale with a right of return, it initially recognizes the following.

Item	Measurement
Revenue	Measured at the gross transaction price, less the expected level of returns calculated using the guidance on estimating variable consideration and the constraint (see 5.3)
Refund liability	Measured at the expected level of returns – i.e., the difference between the cash or receivable amount and the revenue as measured above
Asset	Measured by reference to the carrying amount of the products expected to be returned, less the expected recovery costs
Cost of goods sold	Measured as the carrying amount of the products sold less the asset as measured above
Reduction of inventory	Measured as the carrying amount of the products transferred to the customer

606-10-55-26 to 55-27
[IFRS 15.B24 to B25]

The entity updates its measurement of the refund liability and asset at each reporting date for changes in expectations about the amount of the refunds. It recognizes:

- adjustments to the refund liability as revenue; and
- adjustments to the asset as an expense.

Example 36

Sale with a right of return

Retailer B sells 100 products at a price of 100 each and receives a payment of 10,000. Under the sales contract, the customer is allowed to return any undamaged products within 30 days and receive a full refund in cash. The cost of each product is 60. Retailer B estimates that three products will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

Retailer B estimates that the costs of recovering the products will not be significant and expects that the products can be resold at a profit.

Retailer B records the following entries on transfer of the products to the customer to reflect its expectation that three products will be returned.

	Debit	Credit
Cash	10,000	
Refund liability		300[a]
Revenue		9,700
To recognize the sale excluding revenue on products expected to be returned		
Asset	180[b]	
Costs of sales	5,820	
Inventory		6,000
To recognize the cost of sales and the right to recover products from customers		

Notes

(a) 100 x 3 (being the price of the products expected to be returned).

(b) 60 x 3 (being the cost of the products expected to be returned).

Observations

Change in estimation method, but end result broadly similar in many situations

605-15-25-1 to 25-4
[IAS 18.16, 17, IE2(b)]

Under current IFRS and U.S. GAAP, an entity records a provision for products that it expects to be returned when a reasonable estimate can be made. If a reasonable estimate cannot be made, then revenue recognition is deferred until the return period lapses or a reasonable estimate can be made.

The new standard's approach of adjusting revenue for the expected level of returns and recognizing a refund liability is broadly similar to current guidance. However, the detailed methodology for estimating revenue may be different. Although revenue could be constrained to zero under the new standard, it is likely that most entities will have sufficient information to recognize consideration for an amount greater than zero.

Net presentation no longer permitted

Under the new standard, the refund liability is presented gross as a refund liability and an asset for recovery. This will represent a change in practice for entities that currently present reserves or allowances for returns net.

Accounting for a sale with a right of return often relies on a portfolio-level estimate

The new standard is generally applied to individual contracts. It some cases, it may be challenging to apply the new standard's requirements on sales with a right of return at an individual contract level when:

- it is not known whether the good or service transferred under a specific contract will be returned; but
- the entity has evidence of returns at a portfolio level.

606-10-55-202 to 55-207
[IFRS 15.IE110 to IE115]

The new standard includes an example illustrating how to determine the transaction price for a portfolio of 100 individual sales with a right of return. In the example, the entity concludes that the contracts meet the conditions to be accounted for at a portfolio level, and determines the transaction price for the portfolio using an expected value approach to estimate returns. For discussion of the portfolio approach, see 4.4.

10.2 Warranties

Overview

Under the new standard, an entity accounts for a warranty or part of a warranty as a performance obligation if:

- the customer has an option to purchase the warranty separately; or
- additional services are provided as part of the warranty.

Otherwise, warranties will continue to be accounted for under existing guidance.

Requirements of the new standard

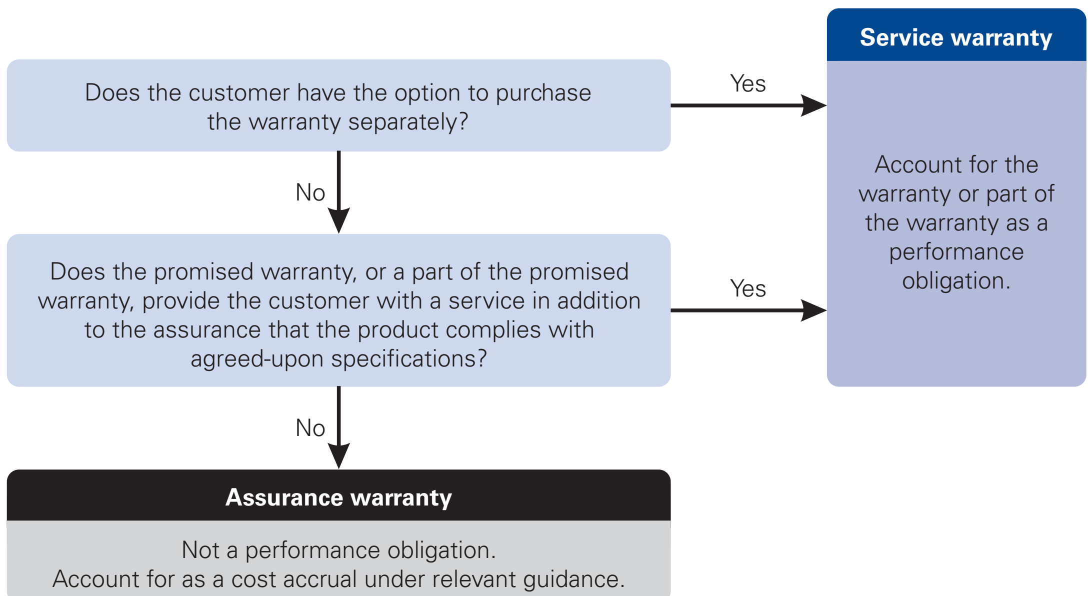
606-10-55-31
[IFRS 15.B29]

Under the new standard, a warranty is considered a performance obligation if the customer has an option to purchase the good or service with or without the warranty.

606-10-55-31 to 55-32; Topic 450
[IFRS 15.B29 to B30; IAS 37]

When a warranty is not sold separately, the warranty or part of the warranty may still be a performance obligation, but only if the warranty – or part of it – provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. A warranty that only covers the compliance of a product with agreed-upon specifications (an 'assurance warranty') is accounted for under other relevant guidance.

An entity distinguishes the types of product warranties as follows.



606-10-55-33
[IFRS 15.B31]

To assess whether a warranty provides a customer with an additional service, an entity considers factors such as:

- whether the warranty is required by law – because such requirements typically exist to protect customers from the risk of purchasing defective products;
- the length of the warranty coverage period – because the longer the coverage period, the more likely it is that the entity is providing a service, rather than just protecting the customer against a defective product; and
- the nature of the tasks that the entity promises to perform.

606-10-55-31
[IFRS 15.B29]

If the warranty – or part of it – is considered to be a performance obligation, then the entity allocates a portion of the transaction price to the service performance obligation by applying the requirements in Step 4 of the model (see 5.4).

606-10-55-34
[IFRS 15.B32]

If an entity provides a warranty that includes both an assurance element and a service element and the entity cannot reasonably account for them separately, then it accounts for both of the warranties together as a single performance obligation.

606-10-55-35; 450-20
[IFRS 15.B33; IAS 37]

A legal requirement to pay compensation or other damages if products cause damage is not a performance obligation, and is accounted for under other relevant guidance.

Example 37

Sale of a product with a warranty

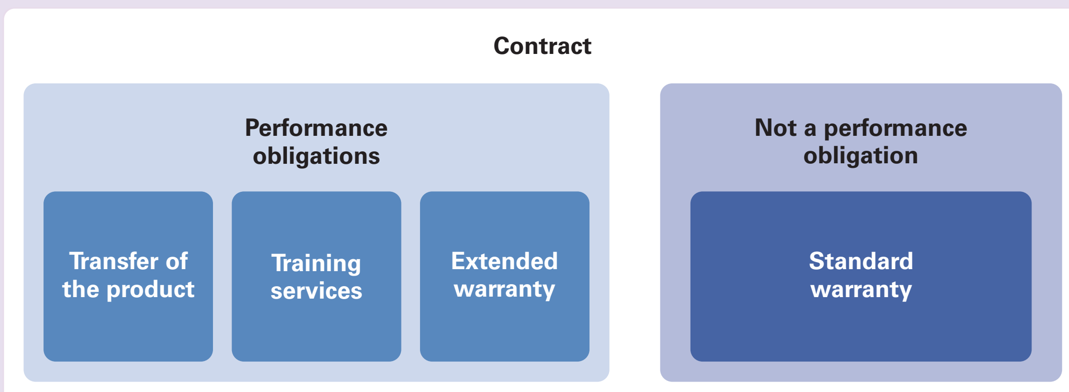
606-10-55-309 to 55-315
[IFRS 15.IE223 to IE229]

Manufacturer M grants its customers a standard warranty with the purchase of its product. Under the warranty, Manufacturer M:

- provides assurance that the product complies with agreed-upon specifications and will operate as promised for three years from the date of purchase; and
- agrees to provide up to 20 hours of training services to the customer.

In addition to the standard warranty, the customer also chooses to purchase an extended warranty for two additional years.

In this example, Manufacturer M concludes that there are three performance obligations in the contract, as follows.



The training services are a performance obligation because they provide a distinct service in addition to ensuring that the product complies with specifications.

The extended warranty is a performance obligation because it can be purchased separately.

The component of the standard warranty that provides assurance that the product complies with stated specifications is an assurance-type warranty, and therefore it is not a performance obligation. As a consequence, Manufacturer M accounts for it as a cost accrual when the product is sold under other relevant guidance.

Observations

'Reasonably account' threshold is undefined

The new standard requires an entity that cannot reasonably account for a service-type warranty and an assurance-type warranty separately to account for them together as a single performance obligation. It is not clear how the 'reasonably account' threshold is intended to be interpreted.

Limited discussion on applying the guidance to warranties on services

The guidance in the new standard on warranties is intended to apply to services as well as goods. However, the new standard does not further explain how the concept should be applied to services – e.g., when an entity offers a refund to customers who are dissatisfied with the service provided. For services, it may not always be clear how to determine whether the guidance on warranties or on sales with a right of return should apply.

Comparison with current IFRS

Presence of warranty clause does not preclude recognition of revenue

[IAS 18.16(a), 17; IAS 37.C4]

Under IAS 18, a standard warranty clause in a sales contract that does not result in the seller retaining significant risks does not preclude revenue recognition at the date of sale of the product. In this case, the entity recognizes a warranty provision under IAS 37 at the date of sale, for the best estimate of the costs to be incurred for repairing or replacing the defective products. However, an abnormal warranty obligation could indicate that the significant risks and rewards of ownership have not been passed to the buyer, and that revenue should therefore be deferred.

Unlike current IFRS, the new standard does not envisage that the presence of a warranty would ever preclude the recognition of all of the revenue associated with the sale. This could accelerate revenue recognition in some cases.

Comparison with current U.S. GAAP

Entities will be required to consider factors in addition to considering whether a warranty is separately priced

Topic 450; Topic 460

Under current U.S. GAAP, warranties that are not separately priced are accounted for when the goods are delivered, by recognizing the full revenue on the product and accruing the estimated costs of the warranty obligation. The warranty is only treated as a separate unit of account under current U.S. GAAP if it is separately priced. Under the new standard, an entity evaluates whether the warranty provides a service even when it is not separately priced – and if so, treats it (or part of it) as a separate performance obligation.

Amount of revenue allocated to a separately priced warranty may change

Topic 460; 605-20-25-1 to 25-6

The amount of revenue recognized for some separately priced extended warranties and product maintenance contracts may change if the transaction price is allocated on a relative stand-alone selling-price basis, rather than by deferring the contractually stated amount of the warranty, as required under current U.S. GAAP.

Product recalls

Topic 450

Product recalls occur when a concern is raised about the safety of a product and may be either voluntary or involuntary. These product recalls and liability claims will likely continue to be subject to the U.S. GAAP guidance for contingencies.

10.3 Principal versus agent considerations

Overview

When an entity obtains control of another party's goods or services before transferring control to the customer, the entity's performance obligation is to provide the goods or services itself. Therefore, the entity is acting as a principal.

However, if an entity's performance obligation is not to provide the goods or services itself, then the entity is acting as an agent. The new standard provides a list of indicators for evaluating whether this is the case.

Requirements of the new standard

606-10-55-36
[IFRS 15.B34]

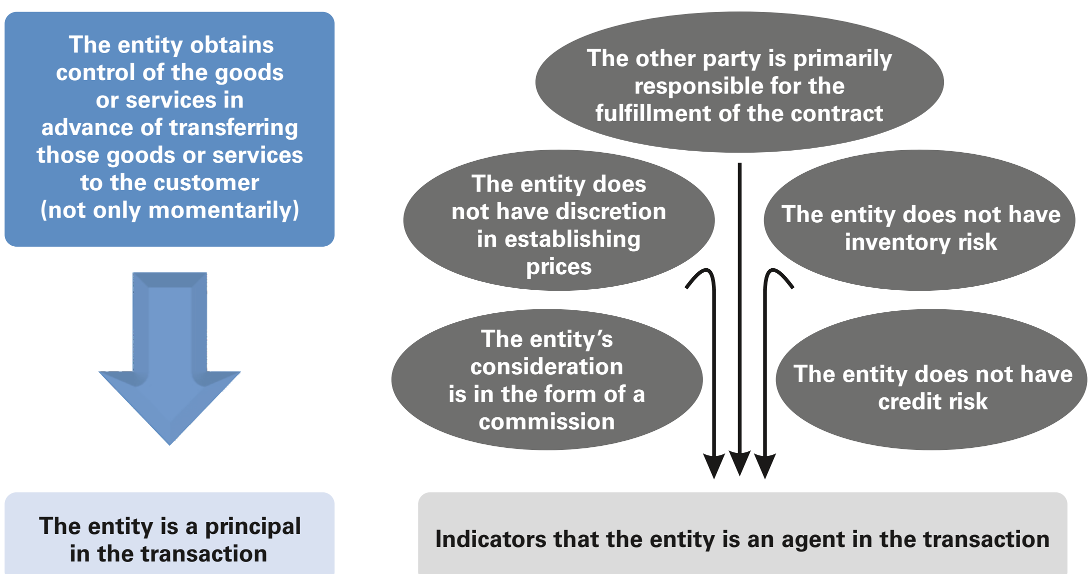
When other parties are involved in providing goods or services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself, or to arrange for another party to provide them – i.e., whether it is a principal or an agent.

606-10-55-37 to 55-38
[IFRS 15.B35 to B36]

If the entity is a principal, then revenue is recognized on a gross basis – corresponding to the consideration to which the entity expects to be entitled. If the entity is an agent, then revenue is recognized on a net basis – corresponding to any fee or commission to which the entity expects to be entitled. An entity's fee or commission might be the net amount of consideration that the entity retains after paying other parties.

606-10-55-39
[IFRS 15.B37]

To determine whether it is a principal or an agent, an entity assesses whether it controls a promised good or service before the good or service is transferred to the customer. The new standard also includes indicators of whether an entity is an agent, as follows.



606-10-55-37, 55-40
[IFRS 15.B35, B38]

An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party – e.g., a subcontractor – to satisfy some or all of a performance obligation on its behalf. However, if another party assumes an entity's performance obligation so that the entity is no longer obliged to satisfy the performance obligation, then the entity is no longer acting as the principal and therefore does not recognize revenue for that performance obligation. Instead, the entity evaluates whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party – i.e., whether the entity is acting as an agent.

Example 38

Entity arranges for the provision of goods or services

606-10-55-317 to 55-319
[IFRS 15.IE231 to IE233]

Internet Retailer B operates a website that enables customers to buy goods from a range of suppliers that deliver the goods directly to the customers. The website facilitates payment between the supplier and the customer at prices set by the supplier, and Retailer B is entitled to a commission calculated as 10% of the sales price. Customers pay in advance and all orders are nonrefundable.

Retailer B observes that each supplier delivers its goods directly to the customer, and that Retailer B itself does not obtain control of the goods. In addition, Retailer B notes that:

- the supplier is primarily responsible for fulfilling the contract – i.e., by shipping the goods to the customer;
- Retailer B does not take inventory risk at any time during the transaction, because the goods are shipped directly by the supplier to the customer;
- Retailer B's consideration is in the form of a commission (10% of the sales price);
- Retailer B does not have discretion in establishing prices for the supplier's goods and, therefore, the benefit that Retailer B can receive from those goods is limited; and
- neither Retailer B nor the supplier has credit risk with respect to the customer because customers' payments are made in advance (however, Retailer B may have credit risk with respect to the supplier).

Consequently, Retailer B concludes that it is an agent, and that its performance obligation is to arrange for the supplier to provide the goods. When Retailer B satisfies its promise to arrange for the supplier to provide the goods to the customer – which, in this example, is when the goods are purchased by the customer – Retailer B recognizes revenue at the amount of the commission to which it is entitled.

Observations

Control of inventory is the deciding factor

The model for evaluating whether an entity is a principal or an agent under the new standard focuses on whether the entity obtains control of goods or services from another party before transferring them to the customer. The new standard clarifies that if the entity obtains legal title to a product only momentarily before legal title transfers to the customer, then obtaining that legal title is not in itself determinative. However, if the entity has substantive inventory risk, then this may indicate that the entity is the principal, and should therefore recognize revenue on a gross basis.

If it is unclear whether the entity obtains control of the goods or services, then it should consider the new standard's indicators to determine whether it is acting as an agent and should therefore recognize revenue on a net basis, or as a principal and should therefore recognize revenue on a gross basis. When an entity sells a non-physical item – e.g., virtual goods or intellectual property – the question of whether the entity obtains control may be difficult to determine and the entity will need to evaluate all relevant facts and circumstances for the arrangement.

No specific guidance on allocation of discount when entity is principal for part of arrangement and agent for other part of arrangement

The new standard does not include specific guidance on how an entity allocates a discount in an arrangement in which it is a principal for some goods or services and an agent for others.

Comparison with current IFRS

From risk and reward to transfer of control

[IFRS 15.BC382; IAS 18.8, IE21]

There is a similar principle in current IFRS that amounts collected on behalf of a third party are not accounted for as revenue. However, determining whether the entity is acting as an agent or a principal under the new standard differs from current IFRS, as a result of the shift from the risk-and-reward approach to the transfer-of-control approach. Under current IFRS, the entity is a principal in the transaction when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. The Boards note that the indicators serve a different purpose from those in current IFRS, reflecting the overall change in approach. However, it is not clear whether the IASB expects this conceptual change to result in significant changes in practice.

Comparison with current U.S. GAAP

Less guidance under new standard

605-45

Some of the indicators in current U.S. GAAP for assessing whether a party is a principal or an agent are not included in the new standard – e.g., discretion in selecting a supplier or in determining the product or service specifications. It is unclear what effect, if any, these changes may have on the principal versus agent evaluation. Also, the new standard does not identify any of the agent indicators as being more important than others, whereas current U.S. GAAP specifies that the primary obligor is a strong indicator.

In addition, the new standard does not contain explicit principal versus agent guidance for shipping costs and cost reimbursement, as exists under current U.S. GAAP. Under the new standard, an entity may need to assess whether shipping is a separate performance obligation in a contract if it is determined to be the principal for this service.

Finally, an entity can no longer elect an accounting policy to present sales taxes on a gross or net basis. Instead, the entity applies the principal versus agent guidance under the new standard on a case-by-case basis in each jurisdiction.

10.4 Customer options for additional goods or services

Overview

An entity accounts for a customer option to acquire additional goods or services as a performance obligation if the option provides the customer with a material right. The new standard provides guidance on calculating the stand-alone selling price of a customer option.

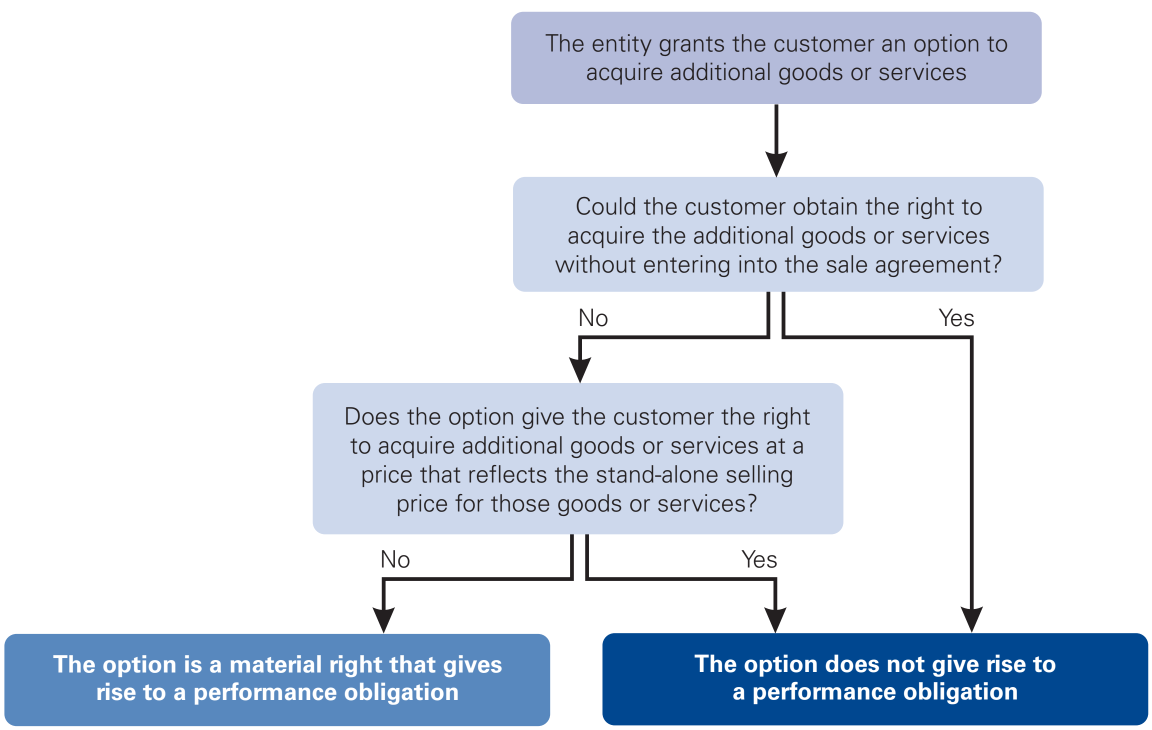
Requirements of the new standard

606-10-55-42 [IFRS 15.B40]

When an entity grants the customer an option to acquire additional goods or services, that option gives rise to a performance obligation in the contract if the option provides a material right that the customer would not receive without entering into that contract.

606-10-55-42 to 55-43 [IFRS 15.B40 to B41]

The following flow chart helps analyze whether a customer option is a performance obligation.



606-10-55-44 [IFRS 15.B42]

If the stand-alone selling price for a customer's option to acquire additional goods or services that is a material right is not directly observable, then an entity will need to estimate it. The estimate of the stand-alone selling price for a customer's option to acquire additional goods or services reflects the discount that the customer will obtain when exercising the option, adjusted for:

- any discount that the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

606-10-55-45
[IFRS 15.B43]

If the goods or services that the customer has a material right to acquire are similar to the original goods in the contract – e.g., when the entity has an option to renew the contract – then an entity may allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding consideration expected to be received.

Example 39

Customer loyalty points program

606-10-55-353 to 55-356
[IFRS 15.IE267 to IE270]

Retailer C offers a customer loyalty program at its store. Under the program, for every 10 that customers spend on goods, they will be rewarded with one point. Each point is redeemable for a cash discount of 1 on future purchases during the next six months. Retailer C expects 97% of customers' points to be redeemed. This estimate is based on Retailer C's historical experience, which is assessed as being predictive of the amount of consideration to which it will be entitled. During the reporting period, customers purchase products for 100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is 100,000.

The customer loyalty program provides the customers with a material right, because the customers would not receive the discount on future purchases without making the original purchase, and the price that they will pay on exercise of the points on future purchases is not the stand-alone selling price of those items. Because the points provide a material right to the customers, Retailer C concludes that the points are a performance obligation in each sales contract – i.e., the customers paid for the points when purchasing products. Retailer C determines the stand-alone selling price of the loyalty points based on the likelihood of redemption.

Retailer C allocates the transaction price between the products and the points on a relative selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation	
Products	100,000[(a)]	91%	91,000	(100,000 x 91%)
Points	9,700[(b)]	9%	9,000	(100,000 x 9%)
Total	**109,700**	**100%**	**100,000**	

Notes

(a) Stand-alone selling price for the products.

(b) Stand-alone selling price for the points (10,000 x 1 x 97%).

Observations

Customer loyalty programs that provide a material right are treated as a performance obligation

The new standard may significantly affect entities in industries that offer customer loyalty programs – e.g., retail, airline, and hospitality. This is because under the new standard, a customer loyalty program that provides a customer with a material right is a performance obligation of the contract. Entities will therefore need to consider whether their customer loyalty programs provide customers with a material right – if they do, then the entity will be required to allocate a portion of the consideration in a contract to that material right.

No specific guidance for credit card loyalty programs

The new standard does not provide any specific guidance on its application to credit card loyalty programs. Additional complexities can arise with credit card loyalty programs, as there are typically at least three parties involved: the card issuer, a retailer, and the end customer. Therefore, judgment will be required to determine whether a credit card loyalty program gives rise to a performance obligation of the card issuer. If it does, a portion of the interchange fee will need to be allocated to the performance obligation and deferred until redemption occurs.

Comparison with current IFRS

Treatment of customer loyalty programs broadly the same

[IFRIC 13]

The current IFRS guidance on customer loyalty programs is broadly similar to the guidance in the new standard. However, entities should consider whether the allocation method that they currently apply remains acceptable under the new standard. Under current IFRS, entities have a free choice of method to allocate the consideration between the sales transaction and the award credits. By contrast, under the new standard the residual approach can only be applied if certain criteria are met (see 5.4.1.2).

Comparison with current U.S. GAAP

Currently no authoritative guidance on accounting for customer loyalty programs

There is currently no authoritative U.S. GAAP guidance on the accounting for customer loyalty programs, and practice is mixed. Some companies accrue the direct and incremental costs of providing the goods or services underlying the loyalty program while recognizing the full amount of revenue at the point of the initial sale; others, however, defer a portion of the revenue from the transaction that generates the points. The new standard requires entities to follow the latter approach when the points or other benefits issued to customers constitute a performance obligation.

Options in software arrangements

985-605-55-82 to 55-85

The evaluation under the new standard of whether a discount offered on future purchases provides a customer with a material right is similar to, but not the same as, current U.S. GAAP – and could lead to different units of accounting. Under current U.S. GAAP, an offer of a discount on future purchases of goods or services in a software arrangement is accounted for separately if it is significant and incremental to both:

- the range of discounts reflected in the pricing of other elements in that contract; and
- the range of discounts typically given to other similarly situated customers in comparable transactions.

To assess whether an option gives the customer a material right under the new standard, an entity needs only to determine whether the discount on future purchases of goods or services is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market, and not whether the discount is also incremental to the discount in the current arrangement.

10.5 Customers' unexercised rights (breakage)

Overview

An entity may receive a nonrefundable prepayment from a customer that gives the customer the right to receive goods or services in the future. Common examples include gift cards or vouchers, and nonrefundable tickets. Typically, some customers do not exercise their right – this is referred to as 'breakage'.

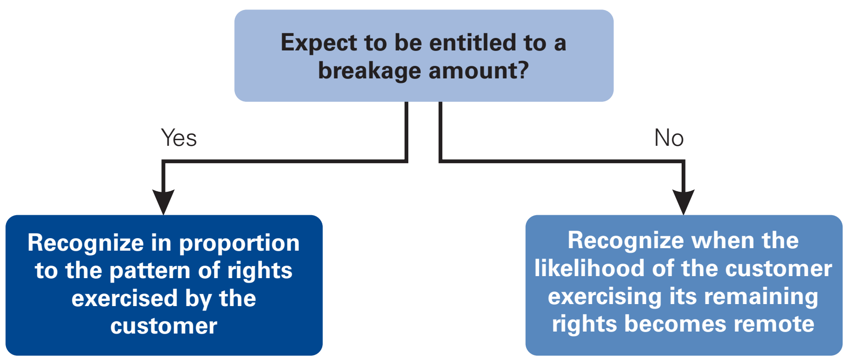
Requirements of the new standard

606-10-55-46 to 55-47
[IFRS 15.B44 to B45]

An entity recognizes a prepayment received from a customer as a contract liability, and recognizes revenue when the promised goods or services are transferred in the future. However, a portion of the contract liability recognized may relate to contractual rights that the entity does not expect to be exercised – i.e., a breakage amount.

606-10-55-48
[IFRS 15.B46]

The timing of revenue recognition related to breakage depends on whether the entity expects to be entitled to a breakage amount – i.e., if it is probable (highly probable for IFRS) that recognizing breakage will not result in a significant reversal of the cumulative revenue recognized.



606-10-55-48
[IFRS 15.B46]

An entity considers the variable consideration guidance to determine whether – and to what extent – the constraint applies (see 5.3.1.2). It determines the amount of breakage to which it is entitled as the amount for which it is considered probable (highly probable for IFRS) that a risk of significant reversal will not occur in the future.

606-10-55-49
[IFRS 15.B47]

If an entity is required to remit the amount that is attributable to customers' unexercised rights to a government entity – e.g., under applicable unclaimed property or escheatment laws – then it recognizes a financial liability until the rights are extinguished, rather than revenue.

Example 40

Sale of a gift card

Retailer R sells a gift card to Customer C for an amount of 100. On the basis of historical experience with similar gift cards, Retailer R estimates that 10% of the gift card balance will remain unredeemed and that the unredeemed amount will not be subject to escheatment. As Retailer R can reasonably estimate the amount of breakage expected, and it is probable (highly probable for IFRS) that including the amount in the transaction price will not result in a significant revenue reversal, Retailer R will recognize the breakage revenue of 10 in proportion to the pattern of exercise of the customer's rights.

Specifically, when it sells the gift card, Retailer R recognizes a contract liability of 100, as Customer C prepaid for a nonrefundable card. No breakage revenue is recognized at this time.

If Customer C redeems an amount of 45 in 30 days' time, then half of the expected redemption has occurred (45 / (100 - 10) = 50%). Therefore, half of the breakage – i.e., (10 x 50% = 5) – is also recognized. On this initial gift card redemption, Retailer R recognizes revenue of 50 – i.e., revenue from transferring goods or services of 45 plus breakage of 5.

Observations

Constraint applies even though consideration amount is known

If an entity does not have a basis for estimating breakage – i.e., the estimate is fully constrained – the entity recognizes the breakage as revenue only when the likelihood becomes remote that the customer will exercise its rights.

When the entity concludes that it is able to determine the amount of breakage to which it expects to be entitled, it estimates the amount of breakage. To determine the breakage amount, the entity assesses whether it is probable (highly probable for IFRS) that including revenue for the unexercised rights in the transaction price will not result in a significant revenue reversal. Applying the guidance on the constraint in this context is unique – the amount of consideration is known and has already been received, but there is uncertainty over how much of the consideration the customer will redeem for the transfer of goods or services in the future. Conversely, in other situations to which the constraint applies, the total amount of consideration is unknown.

Comparison with current IFRS

The timing of revenue recognition may change

Current IFRS does not contain specific guidance on the accounting for breakage. However, the new standard may result in changes in the timing of revenue recognition as compared with our current view that an unredeemed amount should be recognized as revenue if:

- the amount is nonrefundable; and
- an entity concludes, based on available evidence, that the likelihood of the customer requiring it to fulfill its performance obligation is remote.

For further discussion of this issue, see 4.2.440.20 of *Insights into IFRS,* 11th Edition.

Comparison with current U.S. GAAP

Removal of policy election

There is currently no authoritative guidance on the accounting for breakage in U.S. GAAP. Practice has developed based on an SEC speech from December 2005,[7] which stated that it is not acceptable for an entity to recognize breakage immediately on the sale of a gift card. The speech describes three acceptable methods to recognize breakage revenue:

- as the entity is legally released from its obligation – e.g., at redemption or expiration;
- at the point at which redemption becomes remote; or
- in proportion to actual gift card redemptions.

The new standard requires an entity to determine whether it expects to be entitled to a breakage amount and, if so, recognize the breakage amount in proportion to customer redemptions of the gift cards. Because the methods listed above are accounting policies rather than an analysis of the entity's specific facts and circumstances, some entities using either of the first two methods may be required to recognize revenue sooner than under their current accounting policy election.

10.6 Nonrefundable up-front fees

Overview

Some contracts include nonrefundable up-front fees that are paid at or near contract inception – e.g., joining fees for health club membership, activation fees for telecommunication contracts, and set-up fees for outsourcing contracts. The new standard provides guidance to determine the timing of recognition for such fees.

Requirements of the new standard

606-10-55-50 to 55-53
[IFRS 15.B48 to B51]

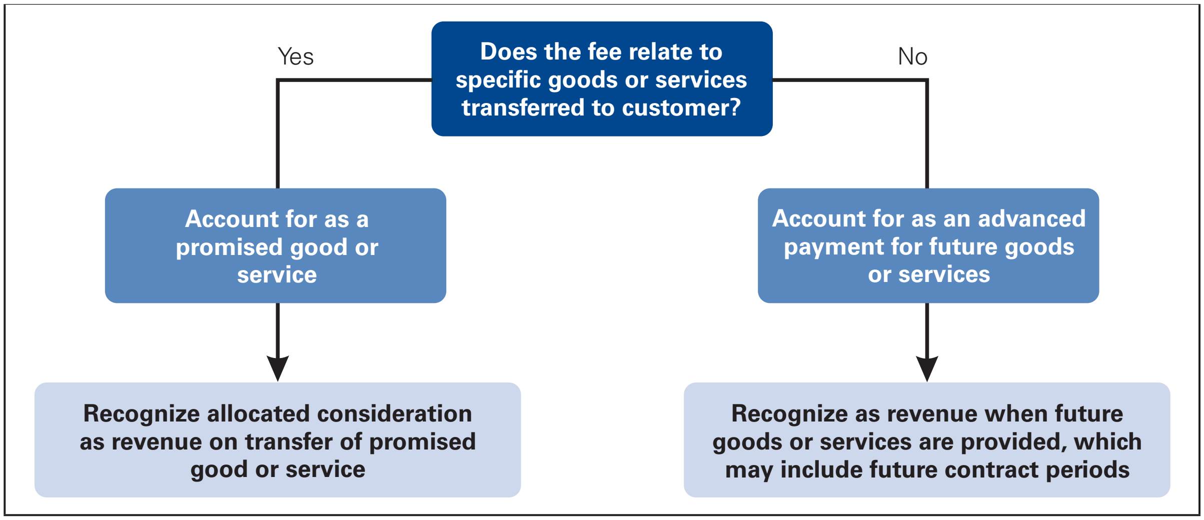
An entity assesses whether the nonrefundable up-front fee relates to the transfer of a promised good or service to the customer.

In many cases, even though a nonrefundable up-front fee relates to an activity that the entity is required to undertake in order to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, it is an administrative task. For further discussion on identifying performance obligations, see 5.2.

If the activity does not result in the transfer of a promised good or service to the customer, the up-front fee is an advance payment for performance obligations to be satisfied in the future and is recognized as revenue when those future goods or services are provided.

The revenue recognition period extends beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right (see 10.4).

7 SEC Speech, "*Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments*", by Pamela R. Schlosser, Professional Accounting Fellow at the SEC, available at www.sec.gov.



Example 41

Nonrefundable up-front fees

Cable Company C enters into a one-year contract to provide cable television to Customer A. In addition to a monthly service fee of 100, Cable Company C charges a one-time up-front installation fee of 10. Cable Company C has determined that its installation services do not transfer a promised good or service to the customer, but are instead a set-up activity that is an administrative task. Customer A can renew the contract each year for an additional one-year period at the then-current monthly service fee rate.

The significance of the up-front fee is considered when evaluating whether the contract renewal grants the customer a material right. By comparing the installation fee of 10 to the total one-year service fees of 1,200, Cable Company C concludes that the nonrefundable up-front fee does not grant Customer A a material right as it is not deemed significant enough to influence Customer A's decision to renew or extend the services beyond the initial one-year term.

As a result, the installation fee is treated as an advance payment on the contracted one-year cable services and is recognized as revenue over the one-year contract term.

Observations

Up-front fee may need to be allocated

Even when a nonrefundable up-front fee relates to a promised good or service, the amount of the fee may not equal the relative stand-alone selling price of that promised good or service, such that some of it may need to be allocated to other performance obligations. For further discussion on allocation, see 5.4.2.

Deferral period for nonrefundable up-front fees depends on whether they provide a material right

A nonrefundable up-front fee may provide the customer with a material right if that fee is significant enough that it would be likely to impact the customer's decision on whether to reorder a product or service – e.g., to renew a membership or service contract, or order an additional product.

If the payment of an up-front fee provides a material right to the customer, the fee is recognized over the period for which payment of the up-front fee provides the customer with a material right. Determining that period will require significant judgment, as it may not align with the stated contractual term or other information historically maintained by the entity – e.g., the average customer relationship period.

When the up-front fee is not deemed to provide a material right and the cost amortization period is determined to be longer than the stated contract period, the period over which a nonrefundable up-front fee is recognized as revenue differs from the amortization period for contract costs.

Principle of a material right builds on previous U.S. GAAP guidance

ASU 2014-09 BC387
[IFRS 15.BC387]

A key question when accounting for an up-front fee in a contract that includes a renewal option is whether the customer receives a material right. The Boards noted that the principle of a material right builds on previous U.S. GAAP guidance, under which the significance of the up-front fee and incremental discount received relative to other customers for a comparable transaction helps to differentiate between an option and a marketing or promotional offer.

Up-front fee may give rise to a significant financing component

Because the nonrefundable up-front fee represents an advance payment for future goods or services, an entity needs to consider whether receipt of the up-front fee creates a significant financing component in the contract. For further discussion on significant financing components, see 5.3.2.

Comparison with current IFRS

Accounting for nonrefundable up-front fees

[IAS 18.IE17]

Under current IFRS, any initial or entrance fee is recognized as revenue when there is no significant uncertainty over its collection and the entity has no further obligation to perform any continuing services. It is recognized on a basis that reflects the timing, nature, and value of the benefits provided. In our experience, such fees may be recognized totally or partially up-front or over the contractual or customer relationship period, depending on facts and circumstances. Under the new standard, an entity needs to assess whether a nonrefundable, up-front fee relates to a specific good or service transferred to the customer – and if not, whether it gives rise to a material right to determine the timing of revenue recognition.

Comparison with current U.S. GAAP

Accounting for nonrefundable up-front fees as a separate performance obligation

SEC SAB Topic 13

Concluding whether a nonrefundable up-front fee represents a payment for a promised good or service under the new standard may involve a similar analysis to that required when determining whether the up-front fee is payment for delivery of a good or service that represents the culmination of a separate earnings process under current SEC guidance. When performing the analysis under the new standard, an entity considers the integration guidance in Step 2 of the model, which is not necessarily the same as current U.S. GAAP.

Deferral period when nonrefundable up-front fees are recognized as advance payments

SEC SAB Topic 13

Under current SEC guidance, the up-front fee is deferred and recognized over the expected period of performance, which can extend beyond the initial contract period. In our experience, this has often resulted in entities recognizing nonrefundable up-front fees over the average customer relationship period.

Under the new standard, an entity assesses the up-front fee to determine whether it provides the customer with a material right – and, if so, for how long. This means that an entity no longer defaults to an average customer relationship period, which may be driven by factors other than the payment of an initial up-front fee – e.g., the availability of viable alternatives, the entity's customer service, the inconvenience of changing service providers, or the quality of the product or service offering.

Initial hookup fees in the cable television industry

922-430; 922-605

Under current industry-specific U.S. GAAP, initial hookup fees in the cable television industry are recognized as revenue to the extent of the direct selling costs incurred. The new standard has no industry-specific revenue recognition guidance, and so hookup fees are treated like any other nonrefundable up-front fees. In addition, the costs associated with the hookup activity need to be evaluated for deferral under the new standard's cost guidance. For further discussion on contract costs, see Section 6.

10.7 Onerous contracts

Requirements of the new standard

The new standard does not include specific guidance on the accounting for onerous revenue contracts or on other contract losses. Instead, an entity applies other applicable guidance in U.S. GAAP or IFRS as appropriate.

Observations

No convergence for onerous contracts

ASU 2014-09 BC296
[IFRS 15.BC296]

Although the new standard contains substantially converged guidance on the recognition and measurement of revenue, it does not include specific guidance on the accounting for onerous contracts. This is because the Boards concluded that the current guidance was adequate, and they were not aware of any pressing practice issues resulting from its application.

As a result, entities reporting under U.S. GAAP and IFRS may identify different contracts as being onerous, and may measure any required provisions for onerous contracts in different ways. Although the new standard will facilitate comparisons between the revenue reported under U.S. GAAP and IFRS, differences in accounting for costs and contract losses remain. For further discussion on contract costs, see Section 6.

Comparison with current IFRS

A single approach to onerous revenue contracts

[IAS 11.36; IAS 37.66 to 69]

Current IFRS deals with onerous revenue contracts in two standards.

- IAS 37 includes general guidance on the recognition and measurement of provisions for onerous contracts. An entity recognizes a provision when the unavoidable costs of meeting the obligations under a contract exceed the economic benefits to be received. However, IAS 37 also prohibits the recognition of a provision for future operating losses.
- IAS 11 requires that an expected loss on a construction contract is recognized immediately.

The new standard withdraws IAS 11 so that accounting for onerous contracts will now fall under a single standard – IAS 37.

For contracts other than construction contracts, there is no change in the overall approach to accounting for onerous contracts. However, the new standard is silent on the consequences of withdrawing the specific guidance in IAS 11 on contract losses. It is unclear whether the IASB expects to see a change in measurement for loss-making construction contracts.

Interpretative issues could arise in the following areas.

Unit of account	IAS 37 includes a specific prohibition on recognizing provisions for future operating losses. A common issue in applying IAS 37 is distinguishing between: • onerous obligations, for which the recognition of a provision is required; and • future operating losses, for which the recognition of a provision is prohibited. It is not clear how the prohibition on recognizing provisions will affect the current practice under IAS 11 of recognizing an expected contract loss immediately.
Costs	Under IAS 11, expected contract losses are identified by reference to expected contract costs, which are generally taken to be the full costs of fulfilling the contract – e.g., including attributable overheads etc. Under IAS 37, an entity considers the 'unavoidable costs' of fulfilling an obligation when identifying onerous contracts and measuring any required provision. IAS 37 does not explain what is meant by 'unavoidable costs'. It is unclear whether the IASB believes that the unavoidable costs of fulfilling an obligation are equivalent to the contract costs under IAS 11.

Comparison with current U.S. GAAP

Different onerous contract guidance for different contracts

605-10-05-4

The current guidance on onerous revenue contracts remains applicable under the new standard. Current U.S. GAAP does not contain general guidance for recognizing a provision for onerous contracts, but instead focuses either on types of contracts or on industry-specific arrangements. Because U.S. GAAP does not provide general guidance on the accrual of losses on onerous contracts, an entity will only accrue such losses when a contract is in the scope of current U.S. GAAP Topics that contain requirements for the accrual of a loss on a contract. The new standard applies to all contracts with customers, such that some entities will need to apply its requirements on the recognition of revenue and certain costs under the new standard, and then also consider the scope of current U.S. GAAP for loss recognition on certain contracts. Current U.S. GAAP addresses the recognition of losses on the following types of arrangements.

ASC reference	Losses on …
605-20	Separately priced extended warranty and product maintenance
605-35	Construction- and production-type contracts
985-605	Certain software arrangements
954-440-35-1 to 35-3	Continuing care retirement community contracts
954-450-30-3 to 30-4	Prepaid health care services
980-350-35-3	Certain long-term power sales contracts
912-20-45-5	Certain federal government contracts

An entity with contracts that are subject to existing industry- or transaction-specific guidance that contains requirements for loss recognition will continue to apply that specific guidance to determine whether a loss should be recognized. Although the specific provisions for loss recognition have not changed, the amount and timing may change if there are differences in the accounting or timing of revenue and costs recognized or the performance obligations identified. For example, a loss on a separately priced extended warranty contract may differ from current practice because under the new standard revenue may be allocated to it based on its relative selling price rather than the stated contractual amount as required by current U.S. GAAP.

In addition, an entity will need to evaluate whether a contract is in the scope of the current U.S. GAAP Codification Topics that are brought forward, even though these Topics no longer apply for determining revenue recognition. An entity with contracts that are not in the scope of any of these industry- or transaction-specific requirements is not permitted to recognize an onerous contract loss provision.

Warranties

605-20-25-6;
606-10-55-30 to 55-35

The current guidance applies to:

- separately priced contracts for extended warranty; and
- product maintenance contracts that provide warranty protection or product services, and whose contract price is not included in the original price of the product covered by the warranty or service.

These warranties are service-type warranties, and therefore a performance obligation, under the new standard. However, not all service-type warranties under the new standard are in the scope of the current onerous contracts guidance, because warranties can constitute a separate performance obligation without being separately priced under the new standard.

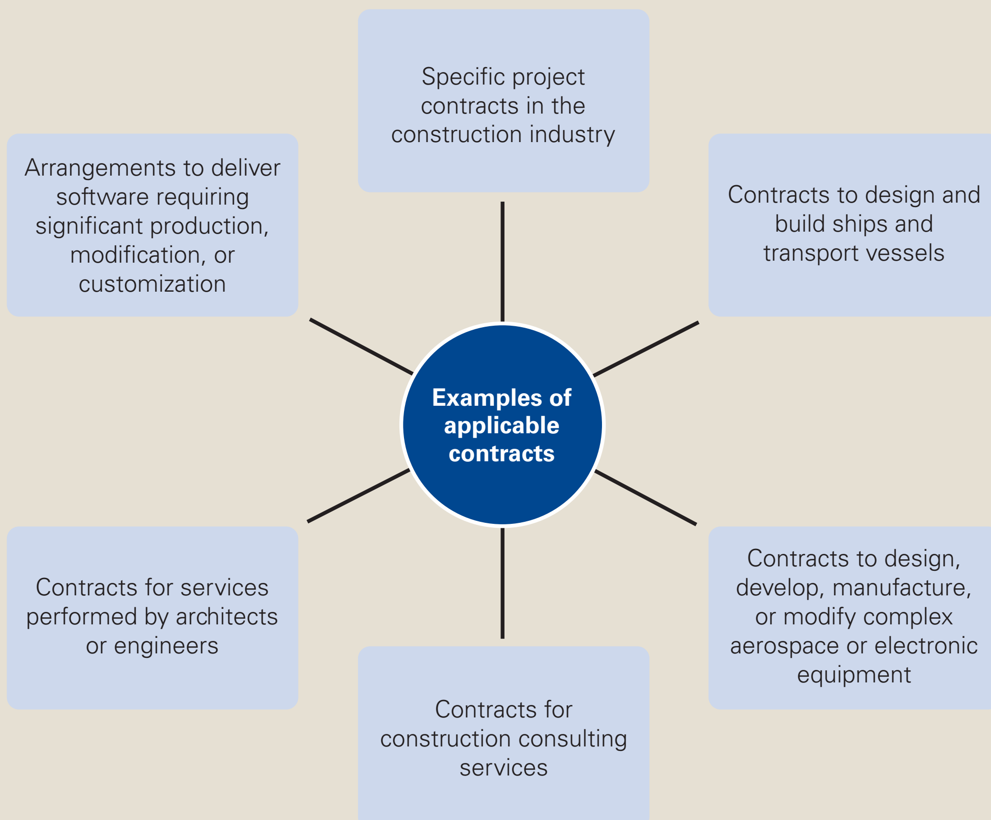
The current onerous contract guidance specifies that: "a loss shall be recognized on extended warranty or product maintenance contracts if the sum of the expected costs of providing services under the contracts and any asset recognized for the incremental cost of obtaining a contract exceeds the related unearned revenue (contract liability)." Losses are first charged directly to operating expense by writing off any assets relating to acquisition costs. Any additional loss is accrued as a liability.

Current U.S. GAAP requires that costs of services performed for separately priced extended warranty and product maintenance contracts are expensed as incurred. Although the consequential amendments remove the cost guidance for separately priced extended warranties, the new standard will likely result in similar accounting for contracts in the scope of this onerous contract guidance, because the costs will likely not meet the criteria for capitalization of fulfillment costs.

When an entity has a separate performance obligation for a service-type warranty that is not separately priced, the onerous contracts guidance does not apply.

Construction- and production-type contracts

605-35-05-1, 15-3 to 15-4 The onerous contracts guidance for construction- and production-type contracts applies to contracts for which the customer provides specifications for the construction of facilities, the production of goods, or the provision of related services.



605-35-25-46 to 25-47 A loss is recognized when the current estimate of the consideration that an entity expects to receive is less than the current estimate of total costs. The unit of account for the provision is the performance obligation. An entity applies the guidance in the new standard on combining contracts (see 5.1.3) and identifying the performance obligations in a contract (see 5.2).

605-35-25-46 to 25-46A, 25-49

The consideration to be received is based on the guidance in the new standard for determining the transaction price (see 5.3); however, the guidance on constraining estimates of variable consideration is not applied. Instead, current loss guidance has been amended to include variable consideration as a factor to be considered in arriving at the projected loss on a contract. In addition, an entity applies the contract modifications guidance in the new standard to change orders and claims (see Section 7).

The loss on a contract is reported as an operating expense (contract cost) and not as a reduction of revenue or a non-operating expense. For a contract on which a loss is anticipated, recognition of the entire anticipated loss is required as soon as the loss becomes evident.

The scope of the loss guidance on construction- and production-type contracts only applies to the contracts specified above, while the scope of the new standard applies broadly to contracts with customers. Entities are required to assess the scope of the guidance on construction- and production-type contracts when determining the need for a loss provision on a contract with a customer. Because the guidance on combining contracts and segmenting contracts – i.e., identifying performance obligations – differs from current U.S. GAAP, the evaluation may differ under the new standard. In addition, because the scope is limited to construction- and production-type contracts, not all over-time performance obligations are in the scope of the current guidance.

Software

985-605-25-7

For software requiring significant production, modification, or customization, a loss is determined by applying the guidance on loss provisions for construction- and production-type contracts described above. The software guidance specifies that a loss is recognized when it is probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation will result in a loss on that performance obligation.

To determine whether the guidance on loss provisions applies, an entity is still required to determine whether a good or service is software that requires significant production, modification, or customization. Current U.S. GAAP specifies that when a service is essential to the functionality of software, an entity treats the software and service as a single unit of account and applies construction- and production-type contract accounting. However, it is unclear whether the separation guidance in the new standard will result in the same determination as to whether the software is a separate performance obligation from the services. For additional observations on the separation guidance related to software arrangements, see 5.2 and Section 8.

Continuing care retirement community (CCRC) contracts

954-440-35-1 to 35-3

There is specific loss guidance for contracts with CCRC residents. That guidance requires that the obligation to provide future services and the use of facilities to current residents is calculated annually to determine whether a liability is recognized. If the advanced fees and periodic fees charged to the customer are insufficient to meet the costs of providing future services and the use of facilities, the CCRC recognizes a liability for the excess of the anticipated costs over the anticipated revenue. This amount is generally recognized as an operating expense in the income statement.

Although the calculation for a potential loss on CCRC contracts has not changed, the deferred revenue included in that calculation could change as a result of applying the new standard – e.g., if an entity determines that there is a significant financing component in the contract because the customer pays an up-front fee.

Prepaid health care service contracts

954-450-30-3 to 30-4

There is also specific guidance on loss provisions for prepaid health care service contracts. That guidance uses the 'probable' threshold for recognizing losses when future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums, and stop-loss insurance recoveries on those contracts. These losses are generally recognized as an operating expense in the income statement.

Long-term power sales contracts

980-350-35-3

Under the guidance for long-term power sales contracts, if such a contract is not accounted for as a derivative, then it is periodically reviewed to determine whether it is a loss contract. If it is determined to be a loss contract, the loss is recognized immediately – generally as an operating expense.

Federal government contracts

912-20-45-5

The guidance on federal government contracts requires a loss on the termination of a contract for default to be presented as a separate item in the income statement, or disclosed under the loss contingency guidance. These losses are generally recognized as an operating expense in the income statement.

11 Presentation

Overview

This section addresses the presentation requirements for the statement of financial position.

Requirements of the new standard

606-10-45-1 [IFRS 15.105]

An entity presents a contract liability or a contract asset in its statement of financial position when either party to the contract has performed. The entity performs by transferring goods or services to the customer, and the customer performs by paying consideration to the entity.

606-10-45-1 to 45-3 [IFRS 15.105 to 107]

Any unconditional rights to consideration are presented separately as a receivable.

'Contract liabilities' are obligations to transfer goods or services to a customer for which the entity has received consideration, or for which an amount of consideration is due from the customer.

'Contract assets' are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time.

606-10-45-4; Topic 310 [IFRS 15.108; IFRS 9]

'Receivables' are unconditional rights to consideration. A right to consideration is 'unconditional' if only the passage of time is required before payment of that consideration is due. Receivables are presented separately from contract assets. An entity accounts for receivables, including their measurement and disclosure, using current guidance. On initial recognition of a receivable, any difference between the measurement of the receivable and the corresponding amount of revenue recognized is presented as an expense. Any subsequent impairment of the receivable is also accounted for as an expense.

606-10-45-5 [IFRS 15.109]

An entity may use alternative captions for the contract assets and contract liabilities in its statement of financial position. However, it should provide sufficient information to distinguish a contract asset from a receivable.

Example 42

Contract liability and receivable for a cancelable contract

606-10-55-284 [IFRS 15.IE198]

On January 1, 2019, Manufacturer D enters into a cancelable contract to transfer a product to Customer E on March 31, 2019. The contract requires Customer E to pay consideration of 1,000 in advance on January 31, 2019. Customer E pays the consideration on March 1, 2019. Manufacturer D transfers the product on March 31, 2019. Manufacturer D accounts for the contract, excluding contract costs, as follows.

March 1, 2019	Debit	Credit
Cash	1,000	
Contract liability		1,000
To record the cash of 1,000 received (cash is received in advance of performance)		
Contract liability	1,000	
Revenue		1,000
To record Manufacturer D's satisfaction of the performance obligation		

Example 43

Contract liability and receivable for a non-cancelable contract

606-10-55-285 to 55-286
[IFRS 15.IE199 to IE200]

Continuing Example 42 in this publication, assume that Manufacturer D's contract is non-cancelable. Manufacturer D recognizes a receivable on January 31, 2019, because it has an unconditional right to consideration. Manufacturer D accounts for the contract, excluding contract costs, as follows.

January 31, 2019	Debit	Credit
Receivable	1,000	
Contract liability		1,000
To record the amount of consideration due		
Cash	1,000	
Receivable		1,000
To record Manufacturer D's receipt of the cash		
Contract liability	1,000	
Revenue		1,000
To record Manufacturer D's satisfaction of the performance obligation		

Observations

Contract asset and contract liability – based on past performance

606-10-55-285 to 55-286
[IFRS 15.IE199 to IE200]

The new standard requires that an entity presents a contract asset or contract liability after at least one party to the contract has performed. However, Example 38 in the new standard suggests that an entity recognizes a receivable when it is due if the contract is non-cancelable, because the entity has an unconditional right to consideration. Therefore, an entity may recognize a receivable and a corresponding contract liability before performance occurs.

Receivable – based on unconditional right to consideration

606-10-55-287 to 55-290
[IFRS 15.IE201 to IE204]

The new standard includes an illustrative example on the difference between a contract asset and a receivable, which portrays a situation where the right to consideration for a delivered product is conditional on the delivery of a second product. Because the right to consideration for the first product is not unconditional, an entity recognizes a contract asset instead of a receivable.

ASU 2014-09 BC326
[IFRS 15.BC326]

The Boards believe that an entity's possible obligation to refund consideration to a customer in the future will not affect the entity's present right to the gross amount of consideration – e.g., when a right of return exists, an entity recognizes a receivable and a refund liability for the amount of the estimated refund.

Some guidance provided on presentation of contract assets and contract liabilities

ASU 2014-09 BC317
[IFRS 15.BC317]

A single contract is presented either as a net contract asset or as a net contract liability. However, total contract assets are presented separately from total contract liabilities. An entity does not net the two to present a net position on contracts with customers.

ASU 2014-09 BC301
[IFRS 15.BC301]

An asset arising from the costs of obtaining a contract is presented separately from the contract asset or liability.

ASU 2014-09 BC320 to BC321
[IFRS 15.BC320 to BC321]

The new standard does not specify whether an entity is required to present its contract assets and contract liabilities as separate line items. Therefore, an entity should apply the general principles for the presentation of financial statements.

Comparison with current IFRS

A consistent, systematic approach to presentation

[IAS 11.42 to 44]

Under current IFRS, entities applying the percentage-of-completion method under IAS 11 present the gross amount due from customers for contract work as an asset, and the gross amount due to customers as a liability. For other contracts, entities present accrued or deferred income, or payments received in advance or on account, to the extent that payment is received before or after performance.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers.

Comparison with current U.S. GAAP

605-35-45-3 to 45-4

Under current U.S. GAAP for construction- and production-type contracts, an entity applying the percentage-of-completion method recognizes:

- an asset for costs and recognized income not yet billed; or
- a liability for billings in excess of costs and recognized income.

An entity applying the completed-contract method recognizes:

- an asset for the excess of accumulated costs over related billings; or
- a liability for an excess of accumulated billings over related costs.

For other contracts, an entity presents accrued or deferred income, or payments received in advance or on account, to the extent that payment is received before or after performance.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers. In addition, for performance obligations that are satisfied over time, an entity would not recognize work in progress or its equivalent because the customer controls the asset as it is created or enhanced.

12 Disclosure

Overview

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. There are some differences between the disclosures required in interim financial statements for entities reporting under IFRS and U.S. GAAP. In addition, certain entities applying U.S. GAAP are provided with relief from some of the disclosure requirements.

12.1 Annual disclosure

Requirements of the new standard

606-10-50-1 [IFRS 15.110]

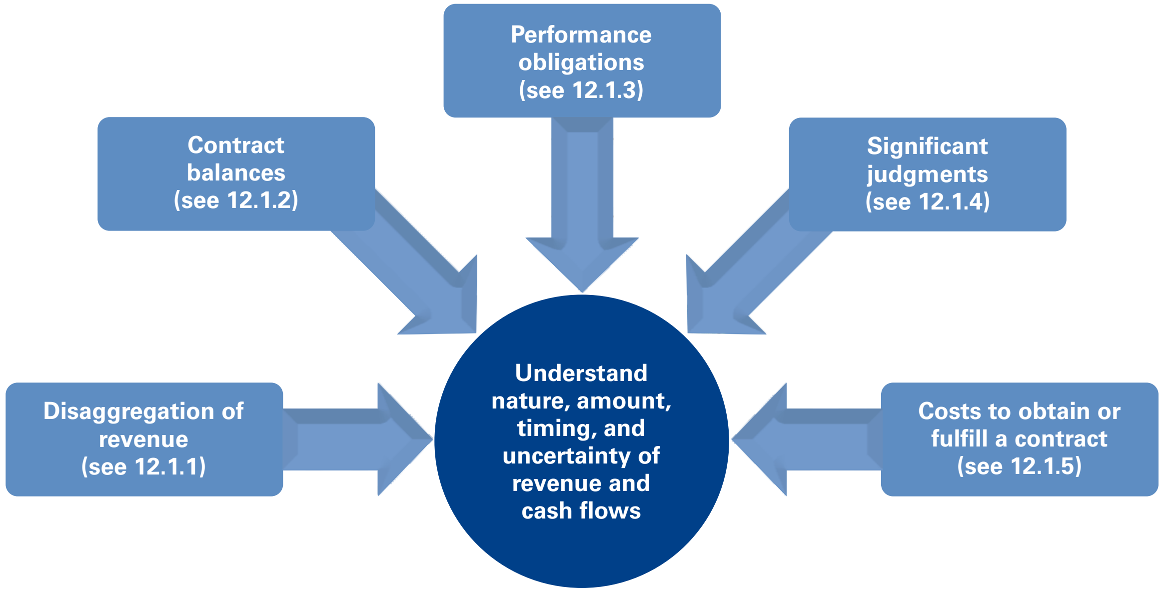
The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

606-10-50-4, 50-22 [IFRS 15.113, 129]

An entity is required to disclose, separately from other sources of revenue, revenue recognized from contracts with customers, and any impairment losses recognized on receivables or contract assets arising from contracts with customers. If an entity elects either the practical expedient not to adjust the transaction price for a significant financing component (see 5.3.2) or the practical expedient not to capitalize costs incurred to obtain a contract (see 6.1), then it discloses that fact.

606-10-50-5 to 50-6, 55-89 to 55-91 [IFRS 15.114 to 115, B87 to B89]

The new standard includes disclosure requirements on the disaggregation of revenue, contract balances, performance obligations, significant judgments, and assets recognized to obtain or fulfill a contract. For further discussion on the required transition disclosures, see Section 13.



Observations

Extensive new disclosures introduced

Under the new standard, an entity discloses more information about its contracts with customers than is currently required, including more disaggregated information about revenue and more information about its performance obligations remaining at the reporting date. For entities applying U.S. GAAP, much of this disclosure is also required in interim financial statements for public business entities, and not-for-profit entities that are conduit bond obligors. For entities applying IFRS, less extensive disclosures are required in interim financial statements than for public business entities applying U.S. GAAP (see 12.2).

Entities will need to assess whether their current systems and processes are capable of capturing, tracking, aggregating, and reporting information to meet the disclosure requirements of the new standard. For many entities, this may require significant changes to existing data-gathering processes, IT systems, and internal controls.

Entities need to consider the internal controls necessary to ensure the completeness and accuracy of the new disclosures – especially if the required data was not previously collected, or was collected for purposes other than financial reporting. Because the new standard may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls.

Disclosure of potential effects of the new standard required before adoption

SEC SAB Topic 11.M
[IAS 8.30 to 31]

IFRS and SEC guidance require entities to disclose the potential effects that recently issued accounting standards will have on the financial statements when adopted. Therefore, for reporting periods after the issuance of the new standard, entities will be required to provide disclosures about the new standard's potential effects. These disclosures are likely to become more detailed as the effective date approaches.

Comparison with current IFRS

Additional disclosures

[IAS 11.39 to 45;
IAS 18.35 to 36]

The new standard's disclosures are significantly more extensive and detailed than the current requirements in IAS 18 and IAS 11. For example, detailed disclosures about an entity's performance obligations – e.g., when an entity expects to satisfy its performance obligations – and significant payment terms at the level of performance obligations, are currently not required.

Comparison with current U.S. GAAP

Disclosures apply to all industries

605-25-50, 35-50;
952-605-50;
954-605-50

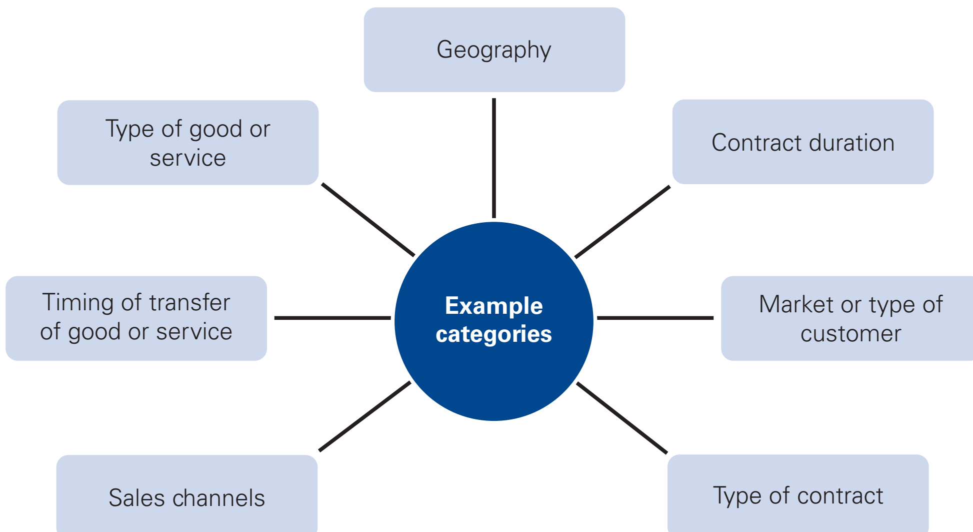
U.S. GAAP includes disclosure requirements in the general revenue topic and in specific industry revenue topics. For example, specific disclosures are required for multiple-element arrangements, construction- and production-type contracts, franchisors, and health care entities. The disclosure requirements in the new standard apply to all in-scope revenue contracts, regardless of the transaction or industry, and are generally more extensive than the transaction- and industry-specific disclosure requirements.

12.1.1 Disaggregation of revenue

Requirements of the new standard

606-10-50-5, 55-91
[IFRS 15.114, B89]

The new standard requires the disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors, and includes examples of such categories.



606-10-50-6, 55-89 to 55-90
[IFRS 15.115, B87 to B88]

An entity also discloses the relationship between the disaggregated revenue and the entity's segment disclosures.

In determining these categories, an entity considers how revenue is disaggregated, in:

a. disclosures presented outside of the financial statements – e.g., earnings releases, annual reports, or investor presentations;

b. information reviewed by the chief operating decision maker for evaluating the financial performance of operating segments; and

c. other information similar to (a) and (b) that is used by the entity or users of the entity's financial statements to evaluate performance or make resource allocation decisions.

Example 44

Disaggregation of revenue

Topic 280; 606-10-55-295 to 55-297
[IFRS 8; IFRS 15.IE210 to IE211]

Company X reports the following segments in its financial statements: consumer products, transportation, and energy. When Company X prepares its investor presentations, it disaggregates revenue by primary geographical markets, major product lines, and the timing of revenue recognition – i.e., separating goods transferred at a point in time and services transferred over time.

Company X determines that the categories used in the investor presentations can be used for the disaggregation disclosure requirement. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition. It includes a reconciliation showing how the disaggregated revenue ties in with the consumer products, transportation, and energy segments.

Segments	Consumer products	Transporta-tion	Energy	Total
Primary geographical markets				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	1,990	**3,260**	**6,250**	**11,500**
Major goods/service lines				
Office supplies	600	-	-	600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	1,990	**3,260**	**6,250**	**11,500**

Segments	Consumer products	Transporta-tion	Energy	Total
Timing of revenue recognition				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	-	-	5,250	5,250
	1,990	**3,260**	**6,250**	**11,500**

Observations

No minimum number of categories required

Although the new standard provides some examples of disaggregation categories, it does not prescribe a minimum number of categories. The number of categories required to meet the disclosure objective will depend on the nature of the entity's business and its contracts.

12.1.2 Contract balances

Requirements of the new standard

606-10-50-8 to 50-10
[IFRS 15.116 to 118]

An entity is required to disclose all of the following:

- the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if not otherwise separately presented or disclosed);
- the amount of revenue recognized in the current period that was included in the opening contract liability balance;
- the amount of revenue recognized in the current period from performance obligations satisfied (or partially satisfied) in previous periods – e.g., changes in transaction price;
- an explanation of how the entity's contracts and typical payment terms will affect its contract asset and contract liability balances; and
- an explanation of the significant changes in the balances of contract assets and contract liabilities, which should include both qualitative and quantitative information – examples could include:
  - changes arising from business combinations;
  - cumulative catch-up adjustments to revenue (and to the corresponding contract balance) arising from a change in the measure of progress, a change in the estimate of the transaction price, or a contract modification;
  - impairment of a contract asset; or
  - a change in the time frame for a right to consideration becoming unconditional (reclassified to a receivable) or for a performance obligation to be satisfied (the recognition of revenue arising from a contract liability).

Observations

Required disclosures already made in some industries

ASU 2014-09 BC346
[IFRS 15.BC346]

Some entities with long-term contracts – e.g., construction contracts – already provide disclosures on unbilled accounts receivable or deferred revenue, which may limit the amount of new information those entities have to gather in order to comply with the new disclosure requirements for contract balances.

12.1.3 Performance obligations

Requirements of the new standard

606-10-50-12 to 50-13
[IFRS 15.119 to 120]

An entity describes the following information about its performance obligations:

- when the entity typically satisfies its performance obligations – e.g., on shipment, on delivery, as services are rendered, or on completion of service;
- significant payment terms – e.g., whether the contract has a significant financing component, the consideration is variable, and the variable consideration is constrained;
- the nature of the goods or services that it has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent);
- obligations for returns, refunds, and other similar obligations;
- types of warranties and related obligations; and
- the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the reporting date. The entity also provides either a quantitative (using time bands) or a qualitative explanation of when it expects that amount to be recognized as revenue.

606-10-50-14
[IFRS 15.121]

As a practical expedient, an entity is not required to disclose the transaction price allocated to unsatisfied (or partially unsatisfied) performance obligations if:

- the contract has an original expected duration of one year or less; or
- the entity applies the practical expedient to recognize revenue at the amount to which it has a right to invoice, which corresponds directly to the value to the customer of the entity's performance completed to date – e.g., a service contract in which the entity bills a fixed hourly amount.

606-10-50-15
[IFRS 15.122]

The entity should also disclose whether it is applying the practical expedient and whether any consideration from contracts with customers is not included in the transaction price – e.g., whether the amount is constrained and therefore not included in the disclosure.

Observations

Remaining performance obligation disclosures may differ from current backlog disclosures

ASU 2014-09 BC349
[IFRS 15.BC349]

Some entities, including those with long-term contracts, currently disclose backlog (i.e., contracts received but incomplete or not yet started) either in the footnotes to the financial statements or elsewhere (e.g., management's discussion and analysis). However, the remaining performance obligation disclosure may differ from that which some entities currently disclose as backlog, because it does not include orders for which neither party has performed. Under SEC regulations, backlog is subject to legal interpretation, but the disclosure for remaining performance obligations is based on a GAAP determination of the transaction price for unsatisfied (or partially unsatisfied) performance obligations, which may be different.

Contract renewals only included if they provide a material right

The new standard requires that passive and active renewals are accounted for in the same way, because the customer is making the same economic decision. For example, a one-year service contract with an option to renew for an additional year at the end of the initial term is economically the same as a two-year service contract that allows the customer to cancel the contract at the end of the first year and avoid payment for the second year.

Contracts with passive or active renewals that do not give the customer a material right are not included in the disclosure of remaining performance obligations, but a one-year contract with a renewal period that is a material right will be included. Similarly, a two-year contract that provides the customer with a cancelation provision after the first year will be included in the disclosure of remaining performance obligations if the second year of the contract provides the customer with a material right.

Certain contracts can be excluded from remaining performance obligation disclosures

The practical expedient allows an entity to exclude from the remaining performance obligations disclosure contracts that have an original expected duration of one year or less. However, an entity is not precluded from including all contracts in the disclosure.

Constrained transaction price used in remaining performance obligation disclosures

The transaction price used in the remaining performance obligations disclosure is the constrained amount. An entity also explains qualitatively whether any consideration is not included in the transaction price – e.g., constrained variable consideration – and, therefore, is not included in the remaining performance obligations disclosure.

12.1.4 Significant judgments when applying the new standard

Requirements of the new standard

606-10-50-17 [IFRS 15.123]

An entity discloses the judgments and changes in judgments made in applying the new standard that affect the determination of the amount and timing of revenue recognition – specifically, those judgments used to determine the timing of the satisfaction of performance obligations, the transaction price, and amounts allocated to performance obligations.

606-10-50-18 [IFRS 15.124]

For performance obligations that are satisfied over time, an entity describes the method used to recognize revenue – e.g., a description of the output or input method and how those methods are applied – and why such methods are a faithful depiction of the transfer of goods or services.

606-10-50-19 [IFRS 15.125]

For performance obligations that are satisfied at a point in time, the new standard requires a disclosure about the significant judgments made to evaluate when the customer obtains control of the promised goods or services.

606-10-50-20 [IFRS 15.126]

An entity also discloses information about the methods, inputs, and assumptions used to:

- determine the transaction price, which includes estimating variable consideration, assessing whether the variable consideration is constrained, adjusting the consideration for a significant financing component, and measuring noncash consideration;
- allocate the transaction price, including estimating the stand-alone selling prices of promised goods or services and allocating discounts and variable consideration; and
- measure obligations for returns and refunds, and other similar obligations.

Observations

Greater specificity provided

ASU 2014-09 BC355
[IFRS 15.BC355]

IFRS and U.S. GAAP currently have general requirements for disclosing an entity's significant accounting estimates and judgments, but the new standard provides specific areas where disclosures about the estimates used and judgments made in determining the amount and timing of revenue recognition should be provided.

12.1.5 Assets recognized for costs to obtain or fulfill a contract with a customer

Requirements of the new standard

340-40-50-1 to 50-3
[IFRS 15.127 to 128]

An entity discloses the closing balance of assets that are recognized from the costs incurred to obtain or fulfill a contract with a customer, separating them by their main category – e.g., acquisition costs, pre-contract costs, set-up costs, and other fulfillment costs – and the amount of amortization and any impairment losses recognized in the reporting period. An entity describes the judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer and the method used to determine the amortization for each reporting period.

12.2 Interim disclosures

Requirements of the new standard

270-10-50-1A
[IAS 34.16A(g)]

Both IFRS and U.S. GAAP require entities to include information about disaggregated revenue in their interim financial reporting. U.S. GAAP further requires public business entities, not-for-profit entities that are conduit bond obligors, and employee benefit plans that file or furnish financial statements with the SEC to provide the following disclosures for interim financial reporting, if they are material:

- the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if they are not otherwise separately presented or disclosed);
- the amount of revenue recognized in the current period that was included in the opening contract liability balance;
- the amount of revenue recognized in the current period from performance obligations that were satisfied (or partially satisfied) in previous periods – e.g., changes in transaction price; and
- information about the entity's remaining performance obligations.

Observations

Different interim disclosure requirements under IFRS and U.S. GAAP

Topic 270
[IAS 34]

IFRS and U.S. GAAP on interim reporting require, as a general principle, an entity to disclose information about significant changes in its financial position and performance since the last annual reporting period. However, the Boards reached different conclusions on the extent to which disclosures required by the new standard in the annual financial statements should also be required in interim financial statements. The IASB is currently undertaking a 'disclosure initiative', which includes a number of implementation and research projects on disclosures, and decided not to make extensive changes to the disclosure requirements of IAS 34 at this time. The FASB decided to require more extensive disclosures in interim financial statements, stating that the information was useful for investors and that the disclosures would not involve significant incremental cost for preparers.

12.3 Disclosures for all other entities (U.S. GAAP only)

Requirements of the new standard

Disaggregation of revenue

606-10-50-7, 50-11, 50-16, 50-21; 340-40-50-4

All other entities that apply U.S. GAAP – i.e., other than public business entities and not-for-profit entities that are conduit bond obligors – can elect not to provide the quantitative disaggregation of revenue disclosures that is required for public business entities (see 12.1.1).

However, they are still required to disclose, at a minimum, information about the disaggregation of revenue, including:

- the timing of the transfer of goods or services – e.g., revenue from goods or services that are transferred to customers at a point in time and revenue from goods or services that are transferred over time; and
- qualitative information about how economic factors – e.g., type of customer, geographical location of customers, and type of contract – and significant changes in those economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Contract balances and contract costs

All other entities can elect not to provide the disclosures about contract balances and the costs to obtain or fulfill a contract with a customer. These entities are required to disclose the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers if they are not otherwise separately presented or disclosed in the statement of financial position.

Performance obligations

All other entities can elect not to disclose the amount of the transaction price allocated to remaining performance obligations, including the explanation of when those amounts are expected to be recognized as revenue.

Significant judgments in applying the guidance

All other entities disclose the significant judgments and any changes in judgments when applying the new standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. In meeting this requirement, they explain those judgments that are made in determining:

- the timing of the satisfaction of performance obligations, the transaction price, and the amounts allocated to performance obligations;
- the methods used to recognize revenue – e.g., a description of the output or input methods and how those methods are applied for performance obligations that are satisfied over time; and
- the methods, inputs, and assumptions used when determining whether an estimate of variable consideration is constrained.

These entities can elect not to provide the other qualitative disclosures about their judgments that significantly affect the determination of the amount and timing of revenue from contracts with customers described in 12.1.4.

Interim disclosures

All other entities are not required to apply the revenue-specific interim disclosures described in 12.2.

13 Effective date and transition

Overview

The following table sets out the effective date of the new standard for IFRS and U.S. GAAP entities.

Type of entity	Annual periods commencing on or after
IFRS entities	January 1, 2017
Public business entities and not-for-profit entities that are conduit bond obligors applying U.S. GAAP	December 16, 2016
All other U.S. GAAP entities	December 16, 2017

An entity can elect to adopt the new standard a variety of ways, including retrospectively with a choice of three optional practical expedients (see 13.2), or from the beginning of the year of initial application with no restatement of comparative periods (see 13.3).

The examples used to illustrate the application of the transition methods in this section reflect a calendar year-end entity that applies the new standard as of January 1, 2017 and includes two years of comparative financial statements.

For additional examples on applying the transition methods, refer to our publication Transition to the new revenue standard.

13.1 Effective date

Requirements of the new standard

606-10-65-1(a) to 65-1(b)
[IFRS 15.C1]

The new standard is effective for annual periods beginning after December 15, 2016, and interim reporting periods therein, for public business entities and not-for-profit entities that are conduit bond obligors applying U.S. GAAP[8] and for annual periods beginning on or after January 1, 2017 for entities applying IFRS.

Difference between IFRS and U.S. GAAP

Early adoption only permitted for IFRS entities

606-10-65-1(a) to 65-1(b)
[IFRS 15.C1]

An entity that applies IFRS may elect to apply the new standard for an annual reporting period beginning earlier than January 1, 2017. If an entity early adopts the new standard, it discloses that fact. Public business entities and not-for-profit entities that are conduit bond obligors applying U.S. GAAP are not permitted to early adopt the new standard. However, other entities applying U.S. GAAP may elect to apply the new standard as of the effective date for public business entities.

8 There is a one-year deferral for annual reporting and a two-year deferral for interim reporting for other entities applying U.S. GAAP (see 13.1.1).

Different effective dates

IFRS has one effective date for all entities adopting the new standard, whereas U.S. GAAP has different effective dates depending on the entity. Entities that are not public business entities or not-for-profit entities that are conduit bond obligors have the option to defer application of the new standard for one year for annual reporting purposes. The effective date of the U.S. GAAP version of the new standard is consistent with its typical mid-month convention, which requires entities with fiscal year-ends near the end of the calendar year – e.g., 52/53 week reporting entities – to adopt the new standard at about the same time as entities with calendar year-end financial reporting dates. The effective date of the IFRS version of the new standard is consistent with its typical beginning-of-year convention.

Observations

Boards reached different decision on early adoption

In deciding to prohibit early adoption for public business entities and not-for-profit entities that are conduit bond obligors, the FASB prioritized comparability between entities reporting under U.S. GAAP. In particular, the FASB wanted to avoid having public business entities in the same line of business reporting under different revenue recognition requirements before 2017.

By contrast, the IASB prioritized the improvements in financial reporting that it believes will be achieved by the new standard. In particular, the IASB believes that the new standard will help resolve certain application issues that arise under current IFRS – e.g., application issues associated with IFRIC 15. On balance, the IASB concluded that the potential improvements in financial reporting outweighed the reduction in comparability between entities before 2017.

13.1.1 All other entities (U.S. GAAP only)

Requirements of the new standard

606-10-65-1(b)

All other entities applying U.S. GAAP – i.e., all entities other than public business entities and not-for-profit entities that are conduit bond obligors – have a one-year deferral for annual reporting on applying the new standard and a two-year deferral for interim reporting. For these entities, the new standard is effective for annual reporting periods beginning after December 15, 2017, and interim reporting periods in fiscal years beginning after December 15, 2018. These entities may elect to early adopt the requirements of the new standard, but no earlier than the effective date for public business entities.

Observations

Multiple adoption date options for all other entities under U.S. GAAP

Entities other than public business entities and not-for-profit entities that are conduit bond obligors may elect to start applying the requirements of the new standard for:

- the annual reporting period beginning after December 15, 2016, including interim reporting periods within that year or interim reporting periods beginning in the following year; or
- the annual reporting period beginning after December 15, 2017, including interim reporting periods within that year or interim reporting periods beginning in the following year.

13.2 Retrospective method

Requirements of the new standard

606-10-65-1(c)(1), 65-1(d)(1) [IFRS 15.C2(a), C3(a)]

Under the retrospective method, an entity is required to restate each period before the date of initial application that is presented in the financial statements. The 'date of initial application' is the start of the reporting period in which an entity first applies the new standard. For example, if an entity first applies the new standard in its financial statements for the year ended December 31, 2017, then the date of initial application is January 1, 2017. The entity recognizes the cumulative effect of applying the new standard in equity (generally, retained earnings or net assets) at the start of the earliest comparative period presented.

606-10-65-1(f) [IFRS 15.C5]

An entity that elects to apply the new standard using the retrospective method can choose to do so on a full retrospective basis or with one or more of the three available practical expedients. The practical expedients provide relief from applying the requirements of the new standard to certain types of contracts in the comparative periods presented. For further discussion on the expedients, see 13.2.1 to 13.2.3.

606-10-65-1(g) [IFRS 15.C6]

If an entity applies one or more practical expedients, then it needs to do so consistently for all goods or services for all periods presented. In addition, the entity discloses the following information:

- the expedients that have been used; and
- to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

606-10-65-1(e) [IFRS 15.C4]

An entity is also required to comply with applicable disclosure requirements for a change in accounting principle, including the amount of the adjustment to the financial statement line items and earnings per share amounts affected.

Difference between IFRS and U.S. GAAP

Quantitative disclosure only required for immediately preceding annual period under IFRS

606-10-65-1(e); 250-10-50-1(b)(2) [IFRS 15.C4; IAS 8.28(f)]

Under U.S. GAAP, the change in accounting principle disclosure for the amount of the adjustment to the financial statement line items and earnings per share amounts affected are presented for the year of initial application and for each prior period presented. However, under IFRS only the equivalent disclosures for the period immediately preceding the year of initial application are required, regardless of the number of comparative periods presented.

Example 45

Full retrospective method

Software Company Y enters into a contract with a customer to provide a software term license and telephone support for two years for a fixed amount of 400. The software is delivered and operational on July 1, 2015.

Under current GAAP, Software Company Y recognizes revenue for the arrangement on a straight-line basis over the 24-month contract term.

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Under the new standard, Software Company Y determines that the contract consists of two performance obligations: the software license and the telephone support. Software Company Y allocates 300 of the transaction price to the software license and 100 to the telephone support.

Software Company Y determines that the telephone support is a performance obligation satisfied over time, and its progress is best depicted by direct labor hours as follows: 2015: 30; 2016: 50; and 2017: 20. The software license is a point-in-time performance obligation, and the 300 is recognized as revenue on the delivery date of July 1, 2015.

Software Company Y decides to apply the retrospective method and therefore presents the following amounts.

	2015	2016	2017
Revenue	330[(a)]	50	20

Note

(a) Calculated as 300 for the software license plus 30 for the telephone support.

Software Company Y does not need to make an opening adjustment to equity at January 1, 2015, because the contract began on July 1, 2015. Software Company Y also considers the effect of the change in revenue recognition on related cost balances, and makes appropriate adjustments.

Observations

All contracts open and closed under current GAAP require consideration

If an entity applies the new standard on a full retrospective basis, then all contracts with customers are potentially open – even if they are considered closed under current GAAP.

For example, entities with contracts that included after-sale services accounted for as sales incentives will be required to re-analyze those contracts, to:

- determine whether the after-sale service is a performance obligation under the new standard; and
- assess whether any performance obligations identified have been satisfied.

Cost line items may also require adjustment

When making adjustments, the entity may also be required to adjust some cost balances in the financial statements if these are affected by the new requirements – e.g., if the entity is required under the new standard to capitalize and amortize the costs of acquiring a contract, whereas under current GAAP the entity had expensed those costs as incurred.

Regulatory requirements need to be considered

Entities that elect the retrospective method may also need to consider the effect on any additional historical data that forms part of, or accompanies, the financial statements, or that is filed in accordance with regulatory requirements.

Under Regulation S-K,[9] domestic SEC registrants are required to disclose at least five years of selected financial data to highlight significant trends in financial conditions and the results of operations. The SEC staff recently stated that it will not object if registrants that elect to apply the new standard retrospectively choose to do so only to the periods covered by the financial statements when preparing their selected financial data, provided that they clearly indicate that the earlier periods are prepared on a different basis than the most recent periods.

13.2.1 Practical expedient 1 – Contracts that begin and complete in the same annual reporting period

Requirements of the new standard

606-10-65-1(c)(2), 65-1(f)(1)
[IFRS 15.C2(b), C5(a)]

Under practical expedient 1, for contracts that are completed under current GAAP – i.e., for which the entity has fully performed its obligations under the revenue guidance that is in effect before the date of initial application – an entity need not restate contracts that begin and complete within the same annual reporting period.

Example 46

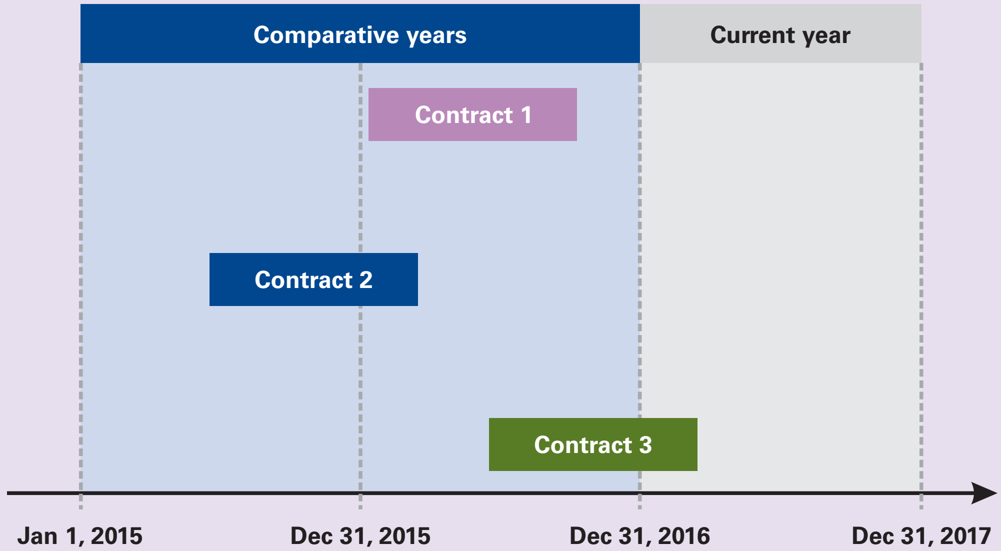
Applying practical expedient 1

Contract Manufacturer X has the following contracts with customers, each of which runs for eight months.

Contract	Starts	Completes
1	January 1, 2016	August 31, 2016
2	May 1, 2015	February 28, 2016
3	May 1, 2016	February 28, 2017

9 SEC Regulation S-K, Item 301, *Selected Financial Data*, available at www.sec.gov.

Contract timelines



Contract Manufacturer X determines that practical expedient 1:

- applies to Contract 1, because Contract 1 begins and completes in an annual reporting period before the date of initial application;
- does not apply to Contract 2, because even though Contract 2 is for a period of less than 12 months, it is not completed within a single annual reporting period; and
- does not apply to Contract 3, because Contract 3 is not completed under current GAAP by the date of initial application.

Observations

What relief does practical expedient 1 provide?

This practical expedient might seem to be of limited benefit, because any adjustments are made in the same period as the contract begins and completes, and therefore revenue for the annual period is not affected. However, it can provide relief for some types of transactions – e.g., when:

- additional performance obligations are identified in a contract under the new standard, as compared to current GAAP – e.g., some automotive sales in which the manufacturer provides a free service to the end purchaser of a car and treats this as a sales incentive under current GAAP;
- a contract that was treated as a point in time transaction under current GAAP is treated as an over-time obligation under the new standard – e.g., some construction contracts for apartment sales; and
- a contract begins and completes in the same annual reporting period, but spans one or more interim periods (although in these situations the entity will also need to consider the importance of comparability from one interim period to another).

13.2.2 Practical expedient 2 – Exemption from applying variable consideration requirements

Requirements of the new standard

606-10-65-1(f)(2)
[IFRS 15.C5(b)]

Under practical expedient 2, an entity may use the transaction price at the date on which the contract was completed, rather than estimating the variable consideration amounts in each comparative reporting period.

Example 47

Applying practical expedient 2

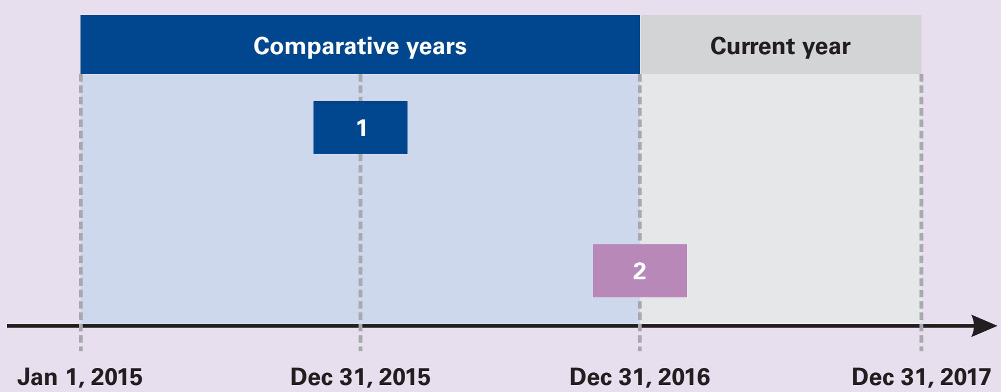
Manufacturer X enters into the following contracts.

Contract	Starts	End of return period	Description
1	October 1, 2015	December 29, 2015	A contract to sell 1,000 products to Customer Y
2	October 1, 2016	December 29, 2016	A contract to sell 2,000 products to Customer Z

Manufacturer X also grants Customer Y and Customer Z the right to return any unused product within 90 days.

In February 2016, Customer Y returns 200 unused products, and in February 2017, Customer Z returns 300 unused products.

Contract timelines



Manufacturer X considers the application of practical expedient 2 to its contracts and determines that:

- it can use the final transaction price for Contract 1; therefore, Manufacturer X recognizes revenue for 800 products (being 1,000 products delivered less 200 products returned) on October 1, 2015 rather than estimating the consideration under Step 3 of the model, because the contract was completed before the date of initial application; and
- it is required to apply the new standard (including Step 3 of the model) to Contract 2, because this contract was not completed under current GAAP before the date of initial application.

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Observations

Limited hindsight allowed

Practical expedient 2 only exempts an entity from applying the requirements on variable consideration, including the constraint in Step 3 of the model. The entity is still required to apply all other aspects of the model when recognizing revenue for the contract.

Use of practical expedient may bring forward revenue recognition

The use of this practical expedient will accelerate revenue recognition as compared with the full retrospective approach if the constraint in Step 3 of the model would otherwise have applied. This is because the final transaction price is used from inception of the contract.

13.2.3 Practical expedient 3 – Disclosure exemption

Requirements of the new standard

606-10-65-1(f)(3)
[IFRS 15.C5(c)]

Under practical expedient 3, for all reporting periods presented before the date of initial application an entity need not disclose:

- the amount of the transaction price allocated to the remaining performance obligations; nor
- an explanation of when the entity expects to recognize that amount as revenue.

Example 48

Applying practical expedient 3

Property Developer X has a contract with Customer C, to construct a building on Customer C's land for a fixed amount of 20 million. Construction starts on January 1, 2015 and is expected to take five years to complete. Property Developer X determines that it satisfies its performance obligation over time, and that the cost-to-cost method best depicts performance.

606-10-50-13
[IFRS 15.120]

If Property Developer X elects to apply the retrospective method including practical expedient 3, then its annual financial statements for the year ended December 31, 2017 are not required to comply with the remaining performance obligation disclosure requirements for the comparative periods presented (December 31, 2016 and December 31, 2015). Assume that the building is 80% complete on December 31, 2017.

Example disclosure

Transaction price allocated to remaining performance obligations

At December 31, 2017, Property Developer X has yet to recognize as revenue 4 million of the 20 million transaction price for the construction of the building. Property Developer X expects to recognize this amount evenly over the next two years in line with the planned schedule for completion of its construction.

In accordance with the transition requirements of the new standard, Property Developer X has elected not to provide information on the transaction price allocated to remaining performance obligations at December 31, 2016 and December 31, 2015.

Observations

Disclosure relief only

This expedient is a disclosure exemption only – it does not grant an entity any relief from applying the requirements of the new standard to its contracts retrospectively.

13.3 Cumulative effect method

Requirements of the new standard

606-10-65-1(d)(2), 65-1(h)
[IFRS 15.C3(b), C7]

Under the cumulative effect method, an entity applies the new standard as of the date of initial application, without restatement of comparative period amounts. The entity records the cumulative effect of initially applying the new standard – which may affect revenue and costs – as an adjustment to the opening balance of equity at the date of initial application.

Under the cumulative effect method, the requirements of the new standard apply only to contracts that are open – i.e., not complete – under current GAAP at the date of initial application.

606-10-65-1(i)
[IFRS 15.C8]

An entity that elects this method is also required to disclose the following information:

- the amount by which each financial statement line item is affected in the current period as a result of applying the new standard; and
- an explanation of the significant changes between the reported results under the new standard and those under current GAAP.

Example 49

Cumulative effect method

Modifying Example 45 in this publication, Software Company Y decides to apply the cumulative effect method, with the following consequences.

- Software Company Y does not adjust the comparative periods, but records an adjustment to opening equity at the date of initial application (January 1, 2017) for the additional revenue related to 2015 and 2016 that would have been recognized if the new standard had applied to those periods.
- Software Company Y also considers the effects of the revenue adjustments on related cost balances, and adjusts them accordingly.
- Software Company Y discloses the amount by which each financial statement line item is affected in the current period as a result of applying the new standard.

The following table illustrates the revenue amounts presented in Software Company Y's financial statements.

	2015	2016	2017
Revenue	100[(a)]	200[(a)]	20
Adjustment to opening equity	-	-	80[(b)]

Notes

(a) Amounts are not restated, and represent the amounts recognized under current GAAP for those periods.

(b) Calculated as 300 for the software license plus 80 for the telephone support (for 2015 and 2016) minus 300 recognized under current GAAP (being 400 x 18 / 24).

Observations

Dual reporting still required

Because of the requirement to disclose the difference between:

- revenue and costs that would have been recognized under current GAAP in the current period; and
- the amounts that are recognized under the new standard,

an entity electing the cumulative effect method will still be required to maintain dual reporting for the year of initial application of the new standard.

13.4 First-time adoption (IFRS only)

Requirements of the new standard

[IFRS 1.D34 to D35]

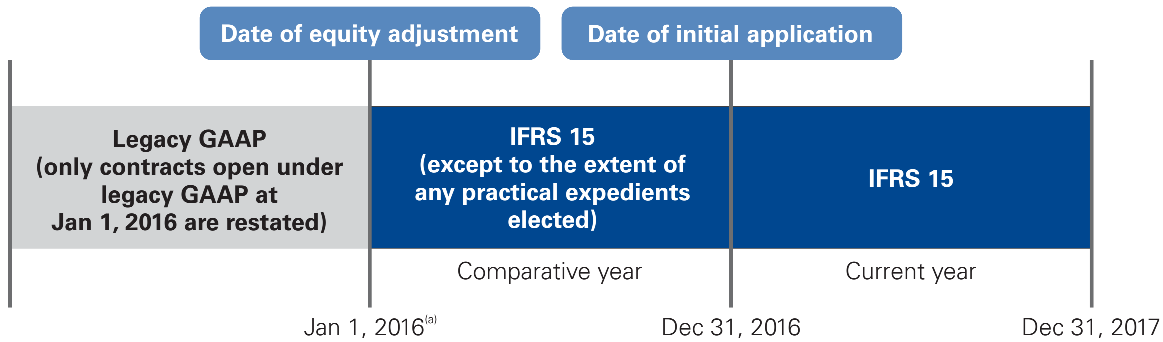
A first-time adopter of IFRS may adopt the new standard when it adopts IFRS. It is not required to restate contracts that were completed[10] before the date of transition to IFRS – i.e., the earliest period presented.

A first-time adopter may apply the practical expedients available to an entity already applying IFRS that elects the retrospective method. In doing so, it interprets references to the 'date of initial application' as the beginning of its first IFRS reporting period. If a first-time adopter decides to apply any of the practical expedients, then it discloses:

- the expedients that have been used; and
- to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

10 For a first-time adopter, a completed contract is a contract for which the entity has transferred all of the goods or services identified under current GAAP.

Timeline for a first-time adopter



Note

(a) Date of transition to IFRS.

Example 50

First-time adopter of IFRS

Car Manufacturer M applies IFRS for the first time in its annual financial statements for the year ended December 31, 2016. Car Manufacturer M presents one year of comparative information in its financial statements, and therefore its date of transition to IFRS is January 1, 2015.

Car Manufacturer M sells cars to dealers with a promise to provide one free maintenance service to the end purchaser of a car.

Under current GAAP, Car Manufacturer M treats the free servicing component of the arrangement as a sales incentive, recognizing a provision with a corresponding expense when the vehicle is sold to the dealer. In addition, it recognizes revenue at the invoice price when the car is delivered to the dealer.

Under the new standard, Car Manufacturer M determines that the arrangement consists of two performance obligations – the sale of the car and a right to one free maintenance service. This treatment results in a different pattern of revenue recognition from current GAAP, because a portion of the transaction price is allocated to the free service and recognized as the performance obligation is satisfied.

If Car Manufacturer M elects to apply the new standard only to contracts that are not completed under current GAAP at the date of transition to IFRS, then it applies the new standard to its contracts for the sales of cars as follows.

- Car Manufacturer M makes no opening adjustments at the date of transition for contracts relating to cars that have already been delivered to the dealer, because a first-time adopter is not required to analyze contracts that are completed under current GAAP before the date of transition. This is because the cars have all been delivered and the free services are not considered to be part of the revenue transaction under current GAAP.
- If Car Manufacturer M elects to apply practical expedient 1, it does not restate the comparative period because the car sales were recognized as point-in-time sales under current GAAP.
- If Car Manufacturer M does not elect to apply practical expedient 1, then it restates sales in the comparative period for the effect of allocating the transaction price between the car and the free maintenance service.

- Car Manufacturer M applies the new standard to all car sales, starting on January 1, 2016.

An IFRS entity could achieve the same outcome as described above for a first-time adopter in two ways:

- electing a practical expedient and therefore not restating contracts that begin and complete in the same annual reporting period before the date of initial application; or
- electing to apply the cumulative effect method.

Observations

IFRS 15 can be applied in an entity's first IFRS financial statements

If an entity adopts IFRS before the mandatory effective date of IFRS 15, it will have the option to adopt:

- IAS 18, IAS 11, and related interpretations; or
- IFRS 15

in its first IFRS financial statements. However, it is likely that many first-time adopters will elect to apply IFRS 15 in their first financial statements under IFRS. Given the similarities in transition methods for first-time adopters and entities already applying IFRS, there does not appear to be any significant advantage in adopting IAS 18 and/or IAS 11 first and then transitioning to the new standard shortly afterwards.

A first-time adopter that applies the new standard in its first IFRS financial statements will have to decide precisely how to apply it. Although the cumulative effect method is not available, relevant practical expedients under the retrospective method may be used.

14 Next steps

Overview

The new standard could have far-reaching impacts – not just changing the amounts and timing of revenue, but potentially requiring changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates. The change in revenue recognition resulting from implementing the new standard could also impact income tax reporting.

Although the effective date seems a long way off, now is the time for entities to assess how the new requirements will affect their organization. At a minimum, all entities will need to re-evaluate their accounting policies and will be subject to new qualitative and quantitative disclosures. For some, the new standard will have a significant impact on how and when they recognize revenue, while for others the transition may be less noticeable. One key decision that needs to be made soon is how to transition to the new standard.

The next steps that an entity should consider taking are illustrated below, and are discussed in further detail in the sections that follow.

Gain an understanding of the new standard

↓

Assess its impact on your organization

Accounting and disclosure (see 14.1)	Tax (see 14.2)	Systems and processes (see 14.3)	Internal control (see 14.4)

↓

Identify areas requiring further analysis or changes to be implemented

↓

Determine a transition method (see 14.5)

↓

Communicate with key stakeholders (see 14.6)

14.1 Accounting and disclosure

Observations

Identifying information gaps for applying new requirements

After gaining an understanding of the new standard, entities should perform an analysis to identify accounting policies that may need to change and additional disclosures that will be required. Factors to consider include:

- customer contracts with unique revenue recognition considerations or terms and conditions;
- the degree of variation in the nature and type of goods or services being offered;
- the degree to which contracts include multiple performance obligations, variable consideration, or licenses of intellectual property;
- the pattern in which revenue is currently recognized – i.e., point-in-time versus over-time;
- the current accounting treatment of costs incurred to acquire or fulfill a contract with a customer;
- arrangements with customers that are currently using transaction- or industry-specific revenue guidance that is being superseded; and
- additional disclosure requirements.

The new standard will require new judgments, estimates, and calculations. For example, entities may need to make judgments about whether a contract exists, the number of performance obligations in a contract, the transaction price when consideration is variable, the stand-alone selling price of performance obligations, whether performance obligations are satisfied over time or at a point in time, and the measure of progress on performance obligations that are satisfied over time. As changes in accounting policies and data availability are identified in the gap analysis, the areas that will require new judgments, estimates, and calculations will need to be identified.

14.2 Tax

Observations

Evaluating tax implications

The change in revenue recognition could impact tax reporting and the related financial reporting for taxes. Examples of impacts include:

- changes in the amount or timing of revenue or expense recognition for financial reporting purposes, which may result in changes to the recognition of taxes or deferred taxes;
- accounting for financial reporting purposes that may not be acceptable for tax purposes, resulting in changes in existing temporary differences or the creation of new temporary differences;
- revisions being required to transfer pricing strategies and documentation;
- changes being required to update policies, systems, processes, and controls surrounding income tax accounting and financial accounting; and
- revisions to sales or excise taxes because revenue may be recharacterized between product and service revenue.

Entities should therefore include representatives from their tax department in their implementation project team. Some next steps to consider may include:

- reviewing expected accounting changes with tax personnel and evaluating the extent to which tax resources will need to be involved in implementation; and
- determining the effects on income tax reporting, compliance, and planning.

For a more detailed discussion on how the new standard may affect the calculation of and financial reporting for income taxes and other types of taxes, particularly in the United States, refer to our publication Defining Issues No. 14-36, *New Revenue Recognition Standard: Potential Tax Implications*.

14.3 Systems and processes

Observations

Updating accounting processes and IT systems

The new requirements will require some entities to gather information that has not historically been required for financial reporting purposes – e.g., costs incurred in obtaining a customer contract or when performance obligations are expected to be satisfied. Processes may also need to be reconsidered to ensure that management judgment is exercised at key points as financial information is prepared.

Preparing an inventory of the incremental information needed and mapping those needs to existing sources will be critical steps early on in the implementation process. Entities should consider what new IT reporting packages, if applicable, may need to be developed to meet the requirements of the new standard and what additional data needs to be captured. To achieve a cost-effective solution, entities could evaluate the best way to source incremental information by:

- establishing the level of effort required to obtain new information from existing feeder systems; and
- determining additional system requirements that might be required.

Entities should also assess how applying the new standard will affect existing processes, including how new contracts or modifications to existing contracts are reviewed and accounted for, and how sales are invoiced.

In particular, changes may arise related to accounting for multiple performance obligations, determining stand-alone selling prices, accounting for variable consideration, adjusting for a significant financing component, identifying and tracking contract modifications, and accounting for contract costs.

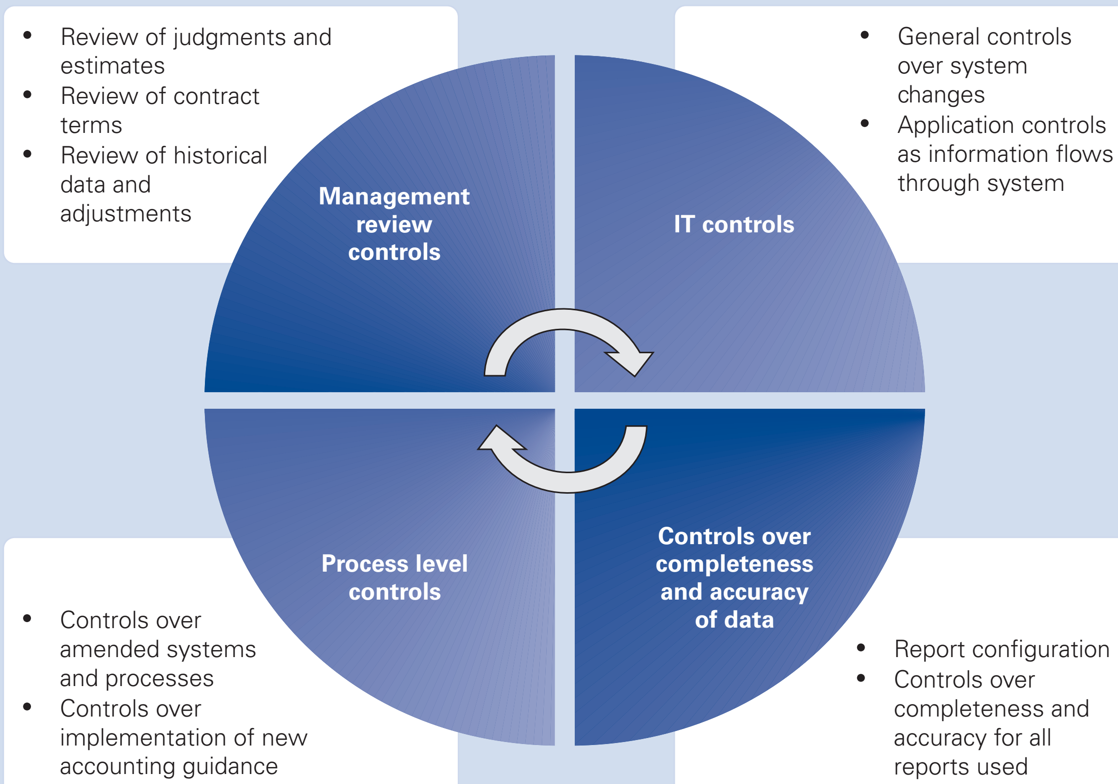
14.4 Internal control

Observations

Design and implementation of new internal controls or modification of existing controls

Entities will need to consider the potential effect of required changes to their systems and processes on their internal control environment, including internal controls over financial reporting. Some entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates.

New risk points may arise from changes to IT systems and reports that provide data inputs used to support the new estimates and judgments. To the extent that data is needed in order to comply with the new standard, entities will need to consider the internal controls necessary to ensure the completeness and accuracy of this information – especially if it was not previously collected, or was collected outside of the financial reporting system (e.g., projections made by the financial planning and analysis department for estimating variable consideration). Because the new standard may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls.



SEC registrants will need to consider the potential effect of any changes in internal controls on management's requirement to make certain quarterly and annual disclosures and certifications about disclosure controls, procedures, and internal controls.

Early in their implementation plan, entities should also consider what processes and related internal controls should be designed and implemented to assess the impact of, and record accounting adjustments arising upon, application of the new standard. For example, new internal controls may be required relating to:

- identifying changes to existing accounting policies;
- reviewing contracts for accounting adjustments on application of the new standard;
- recording accounting adjustments that have been identified; and
- preparing new qualitative and quantitative disclosures.

14.5 Determine a transition method

Observations

Early decision needed in developing an efficient implementation plan

The expected transition method (see Section 13) will have a significant impact on the timing of system and process changes. Therefore, determining which transition method should be adopted should be one of the first steps in the implementation process.

An entity should consider both the quantitative effects of each transition method and the relevant qualitative factors. Advanced planning will allow time to address unanticipated complexities and will offer greater flexibility in maximizing the use of internal resources by spreading the implementation effort over a longer period.

Entities should therefore take steps to understand the new standard and then to evaluate the effects of the transition methods on their financial reporting. Some entities may quickly decide that the impacts are minimal, in which case it may be appropriate to wait longer to evaluate the transition options. However, others will be faced with substantial impacts requiring major effort, and should therefore start planning as soon as possible. Entities should consider the following actions during 2014 and early 2015.

Perform a high-level gap analysis to identify potential drivers of accounting change

↓

Determine the population of contracts that may need to be restated

↓

Begin assessing the information that will be needed and compare this to currently available information to identify potential data gaps

↓

Identify the qualitative factors that may influence the choice of transition methods and consider engaging key stakeholders to understand which factors are valued most

↓

Ensure that transition methods are evaluated in conjunction with the broader implementation effort for the new standard

↓

Monitor the activities of implementation groups established by the FASB/IASB and AICPA

Entities may want to consider implementing a sub-group within the overall project team responsible for implementation to focus on transition options.

For additional examples on applying the transition methods, refer to our publication Transition to the new revenue standard.

14.6 Other considerations

Observations

Impact broader than just accounting

Entities should evaluate how the new standard will affect their organization and the users of their financial statements. Among other things, management should consider:

- what training will be required for both finance and non-finance personnel, including the board, audit committee, senior management, and investor relations;
- the potential need to renegotiate current business contracts that include financial measures driven by revenue – e.g., a debt agreement with loan covenants;
- the effect on management compensation metrics if they will be affected by the new standard;
- what changes may be required to forecasting and budgeting processes; and
- communication plans to stakeholders – e.g., investors, creditors, customers, and suppliers.

In situations where there is a significant impact on the entity, effective governance will be a key element of a successful implementation. This includes input from and involvement of the audit committee, a steering committee, and a program management team.

Communication with key stakeholders

Communication between management, the audit committee, and the external auditor is key to ensuring successful implementation. Management may want to discuss key transition considerations with the audit committee, including:

- whether the entity expects a significant change to its current accounting policies and disclosures;
- historical data availability and the importance of showing a consistent story about revenue trends;
- investors' perceptions about revenue that bypasses profit or loss or is reported twice, or about one-time acceleration of an existing trend;
- the entity's readiness for change, including IT systems and accounting, legal, sales, and tax knowledge of the new standard;
- whether the entity has long-term contracts, including their volume, duration, uniqueness, and significance; and
- comparability with industry peers.

As entities proceed with implementing the new standard, they should also consider the timing and content of communications to investors, analysts, and other key stakeholders, including:

- the expected impact of the new standard on the entity;
- the transition method that will be applied; and
- when the new standard will be adopted.

Detailed contents

Index of examples

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IFRS guidance referenced in this publication	
The Conceptual Framework for Financial Reporting	
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IFRS 2	Share-based Payment
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IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
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SEC Staff Accounting Bulletin Topic 11.M, Miscellaneous Disclosures: Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period
SEC Staff Accounting Bulletin Topic 13, Revenue Recognition
SEC Regulation S-K, Item 301, Selected Financial Data
SEC Regulation S-X, Rule 5-03(b), Income Statements

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We have a range of U.S. GAAP publications that can assist you further, including the *Derivatives and Hedging Accounting Handbook*, *Share-Based Payment*, and *Accounting for Business Combinations and Noncontrolling Interests*. In addition to our handbooks, we provide information on current accounting and reporting issues through our Defining Issues, Issues In-Depth, and CFO Financial Forum webcasts, which are available at www.kpmginstitutes.com/financial-reporting-network/.

Offering	Details
Executive Accounting Update	A high-level overview document with industry-specific supplements that identify specific industry issues to be evaluated and a transition supplement that provides considerations for evaluating the transition options.
Defining Issues	A periodic newsletter that explores current developments in financial accounting and reporting on U.S. GAAP.
Issues In-Depth	A periodic publication that provides a detailed analysis of key concepts underlying new or proposed standards and regulatory guidance.
CFO Financial Forum Webcast	Live webcasts, which are subsequently available on demand, that provide an analysis of significant decisions, proposals, and final standards for senior accounting and financial reporting personnel.
Podcasts	A five- to ten-minute audio file of some potential impacts of the new standard on specific industries.
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All of these publications are relevant for those involved in external IFRS reporting. The *In the Headlines* series and *Insights into IFRS: An overview* provide a high-level briefing for audit committees and boards.

Your need	Publication series	Purpose
Briefing	In the Headlines	Provides a high-level summary of significant accounting, auditing and governance changes together with their impact on entities.
	IFRS Newsletters	Highlights recent IASB and FASB discussions on the insurance and leases projects. Includes an overview, analysis of the potential impact of decisions, current status and anticipated timeline for completion.
	The Balancing Items	Focuses on narrow-scope amendments to IFRS.
	New on the Horizon	Considers the requirements of consultation documents such as exposure drafts and provides KPMG's insight. Also available for specific sectors.
	First Impressions	Considers the requirements of new pronouncements and highlights the areas that may result in a change in practice. Also available for specific sectors.
Application issues	Insights into IFRS	Emphasizes the application of IFRS in practice and explains the conclusions that we have reached on many interpretative issues. The overview version provides a high-level briefing for audit committees and boards.
	IFRS Practice Issues	Addresses practical application issues that an entity may encounter when applying IFRS. Also available for specific sectors.
	IFRS Handbooks	Includes extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard.
Interim and annual reporting	Guide to financial statements – Illustrative disclosures	Illustrates one possible format for financial statements prepared under IFRS, based on a fictitious multinational corporation. Available for annual and interim periods, and for specific sectors. To start answering the question 'How can I improve my business reporting?', visit kpmg.com/betterbusinessreporting.
	Guide to financial statements – Disclosure checklist	Identifies the disclosures required for currently effective requirements for both annual and interim periods.
GAAP comparison	IFRS compared to U.S. GAAP	Highlights significant differences between IFRS and U.S. GAAP. The overview version provides a high-level briefing for audit committees and boards.
Sector-specific issues	IFRS Sector Newsletters	Provides a regular update on accounting and regulatory developments that directly impact specific sectors.
	Application of IFRS	Illustrates how entities account for and disclose sector-specific issues in their financial statements.
	Impact of IFRS	Provides a high-level introduction to the key IFRS accounting issues for specific sectors and discusses how the transition to IFRS will affect an entity operating in that sector.

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We would like to acknowledge the efforts of the main contributors to this publication:

Members of the Department of Professional Practice of KPMG LLP

Michael P. Breen

Paul H. Munter

Arturis I. Spencer III

Members of the KPMG International Standards Group

Glenn D'souza

Amy Luchkovich

Brian O'Donovan

Henrik Parker

Anthony Voigt

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Past and present members of the Department of Professional Practice of KPMG LLP

Brian K. Allen

Narayanan Balakrishnan

Mark M. Bielstein

Valerie Boissou

Shoshana H. Feldman

Prabhakar Kalavacherla (PK)

Sam O. Kerlin

Scott A. Muir

Benjamin B. Reinhardt

Brian J. Schilb

Angie S. Storm

Lauren P. Thomas

Christopher Van Voorhies

Billy G. Williams Jr.

Jennifer A. Yruma

Members of the KPMG Global IFRS Revenue Recognition and Provisions Topic Team

Brian K. Allen

Riaan Davel

Phil Dowad

Kim Heng

Prabhakar Kalavacherla (PK)

Graciela Laso

Vijay Mathur

Annie Mersereau

Catherine Morley

Carmel O'Rourke

Thomas Schmid

Sachiko Tsujino

kpmg.com

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cutting through complexity

Building a Bridge from Statement 66: Real Estate Sales Under the New Revenue Standard

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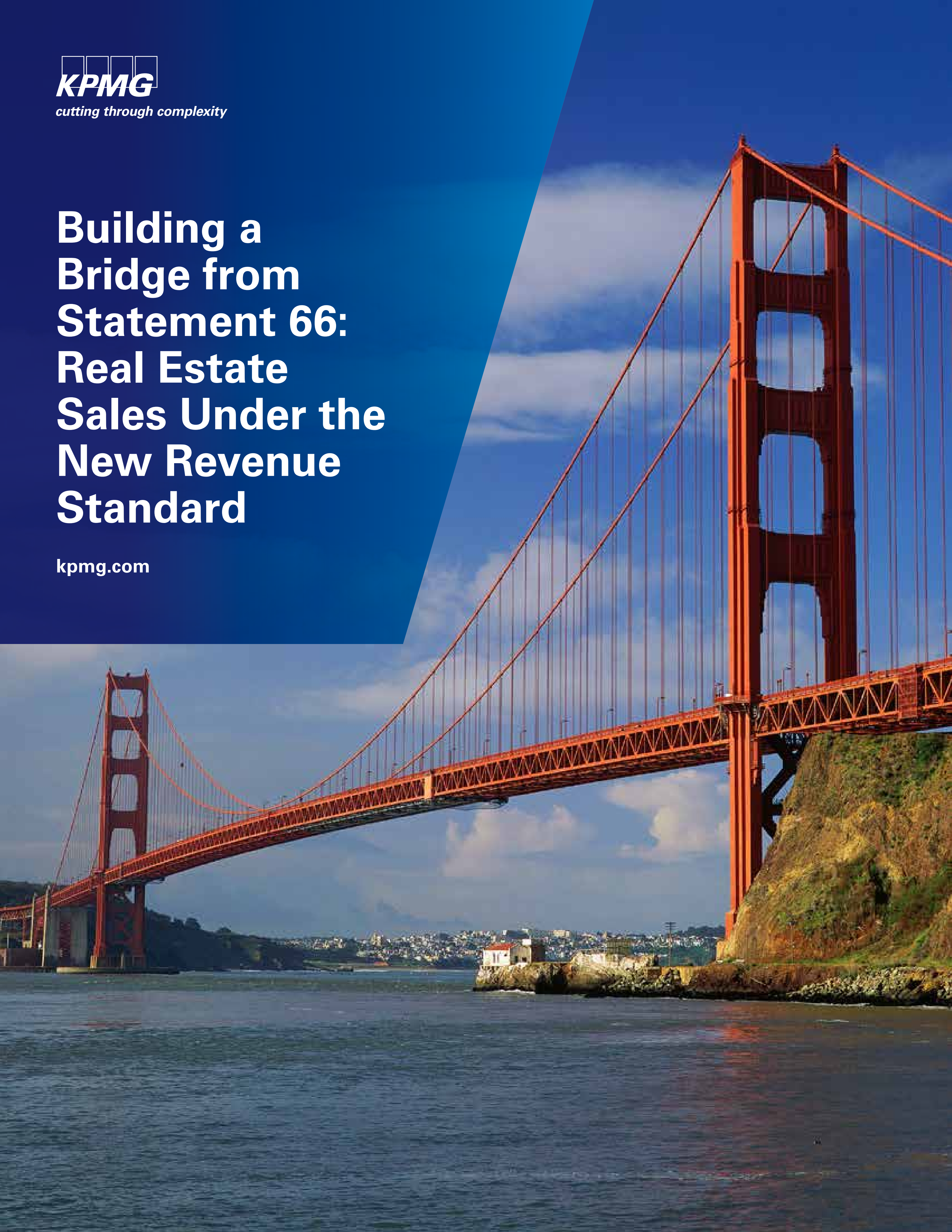


In May 2014, the IASB and the FASB published their new joint standard on revenue recognition. This replaces, among other things, most of the guidance on profit recognition for real estate sales that currently exists under U.S. GAAP. The 2017 effective date may seem a long way off (and the Boards are expected to announce their decision about deferring the effective date in the early part of the second quarter of 2015), but already many real estate companies are analyzing the implications and are finding that they are impacted in some way. The impacts to individual real estate companies vary widely depending on the nature of their business and how they contract with their customers and buyers.

In September 2014, we published Issues In-Depth: *Revenue from Contracts with Customers*.[1] That publication illustrates the main points of the new standard and includes examples, explains our emerging thinking on key interpretative issues and compares current IFRS and U.S. GAAP requirements. This publication is designed to provide supplemental technical guidance on key issues when applying the new revenue model to sales of real estate, focusing on the implications to U.S. GAAP reporting entities. This publication addresses some of the common questions about the new standard's effects on sales of real estate and we hope it will provide a starting point to advance the dialogue on these and other issues.

The guidance is organized in the form of questions with interpretive responses and illustrative examples. The citations refer to paragraphs from the FASB's Accounting Standards Codification (the Codification) added by Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*. We also cite paragraphs from existing Codification sections, most frequently ASC Subtopic 360-20, *Property, Plant, and Equipment-Real Estate Sales*, which includes most of the guidance that originally was issued in Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, and other related guidance.

Unless otherwise indicated explicitly or by comparison, the terms "customer" and "buyer" are used interchangeably in this publication to refer to the purchaser in a transaction involving the sale of real estate. This is because the guidance in this publication addresses both the requirements of ASC Topic 606 on revenue recognition from sales to customers, and the requirements of ASC Subtopic 610-20 on recognition of gains and losses from the derecognition of nonfinancial assets in transactions with parties other than customers.

This publication is intended for use by preparers and other interested parties with a working knowledge of the existing real estate sales literature and an understanding of the new model. These interpretations have been developed using the existing literature and our understanding to date on its application. As every day brings new questions and new insights, particularly as the FASB/IASB Transition Resource Group for Revenue Recognition (TRG) continues its work, we expect to update and supplement this with future publications as our understanding of the new requirements and practice evolves.

[1] Issues In-Depth: Revenue from Contracts with Customers, available on KPMG's Financial Reporting Network at www.kpmg-institutes.com

Index of Questions and Answers

SCOPE

Question 0.1: When are sales of real estate and in substance real estate (including financial assets that are in substance real estate) in the scope of Topic 606, *Revenue from Contracts with Customers,* versus Subtopic 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*?

Background:
Determining whether the buyer of real estate is a "customer" is important as it affects whether the seller reports revenue and cost of sales or gain/loss on sale and may, in some circumstances, affect the amount and timing of revenue/profit recognition (see additional discussion in **Question 0.2**).

Sales to Customers
Customer sales are accounted for under Topic 606 and the seller recognizes revenue and cost of sales on the statement where net income is reported (i.e., income statement), regardless of whether the sale takes the form of a:

a. direct sale of real estate or in substance real estate (i.e., real estate with non-real estate components like the ski resort example described in paragraph 360-20-15-2),

b. sale of a financial asset (e.g., an ownership interest in an entity) that is in substance real estate (e.g., an entity that holds only land), or

c. sale of a financial asset comprising an interest in an entity that holds an operating real estate asset that is a business (as defined under Topic 805).

Under Topic 606, when a contract exists and the performance obligation is satisfied, the seller derecognizes the real estate (or in substance real estate) and recognizes as revenue the *transaction price*. Otherwise, the entity continues to report the real estate in its financial statements, depreciate it (if it is not held for sale under paragraphs 360-10-45-9 and 45-10) and test it for impairment under Section 360-10-35.

Sales to Noncustomers
Noncustomer sales (including any of the forms of sales described in (a) through (c) above) are accounted for under Subtopic 610-20 (unless they are not considered sales of nonfinancial assets, or in substance nonfinancial assets, see additional discussion in **Question 0.2**) and the seller recognizes gain or loss on the sale on the statement where net income is reported.

Subtopic 610-20 (in addressing real estate sales to noncustomers) incorporates many of the revenue recognition principles of Topic 606 (that addresses sales to customers)[2]. Specifically, paragraphs 610-20-32-1 and 40-1 require a seller of a nonfinancial asset (or an in substance nonfinancial asset) to a noncustomer to apply Subtopic 606-10's guidance on:

a. the existence of a contract (paragraphs 606-10-25-1 through 25-8),

b. determining the transaction price (paragraphs 606-10-32-2 through 32-27 and 32-42 through 32-45) including estimating variable consideration, constraining that consideration, evaluating whether there is a significant financing component, noncash consideration and consideration payable to the customer, and

c. when an entity satisfies a performance obligation by transferring control of an asset (paragraph 606-10-25-30).

Under Subtopic 610-20, when a contract exists and the performance obligation is satisfied, the seller derecognizes the real estate (or in substance real estate) and recognizes as a gain or loss the difference between the *transaction price* and the carrying amount of the real estate. Otherwise, like Topic 606, the entity continues to report the real estate in its financial statements, depreciate it (if it is not held for sale) and test it for impairment.

Answer 0.1: Paragraph 360-10-40-3A states Subtopic 610-20 applies to sales of nonfinancial assets (which would include property, plant and equipment) unless the entity sells or transfers the nonfinancial asset to a customer. Customer transactions are accounted for under Topic 606. A customer is defined in the Master Glossary 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." Accordingly, an entity needs to determine if the real estate being sold or transferred is an "output" of its ordinary activities.

An example of an entity that likely is selling real estate as an "output" of its ordinary activities could be a developer predominantly in the business of selling retail land or residential units. An example of when an entity likely is not selling an "output" of its ordinary activities could be a real estate investment trust (REIT) that is involved primarily in leasing real estate. While some REITs often sell properties as part of their overall investment strategy, the "output" of their normal activities is typically identified as the service they provide to their tenants as lessors. This conclusion is consistent with how these entities are operated for U.S. federal income tax purposes. Under U.S. tax law, while a REIT's income generally is tax-free (assuming all the REIT qualification criteria are met), sales of property held primarily for sale to customers in the ordinary course of business are prohibited transactions and would be taxable. Accordingly, in order to preserve the maximum tax advantage to the REIT and its investors, REITs generally do not sell property to customers in the ordinary course of business.

[2] While Subtopic 610-20 does not specifically incorporate Topic 606's guidance on identifying performance obligations (Step 2) and allocating transaction price (Step 4), we believe those principles often may be applicable by analogy to multi-element noncustomer real estate sales (as discussed in more detail throughout the remainder of this document).

Question 0.2: When is a real estate sale considered a sale of an in substance nonfinancial asset (sales to noncustomers accounted for under Subtopic 610-20) versus a sale of a business (sales to noncustomers accounted for under Subtopic 810-10)?

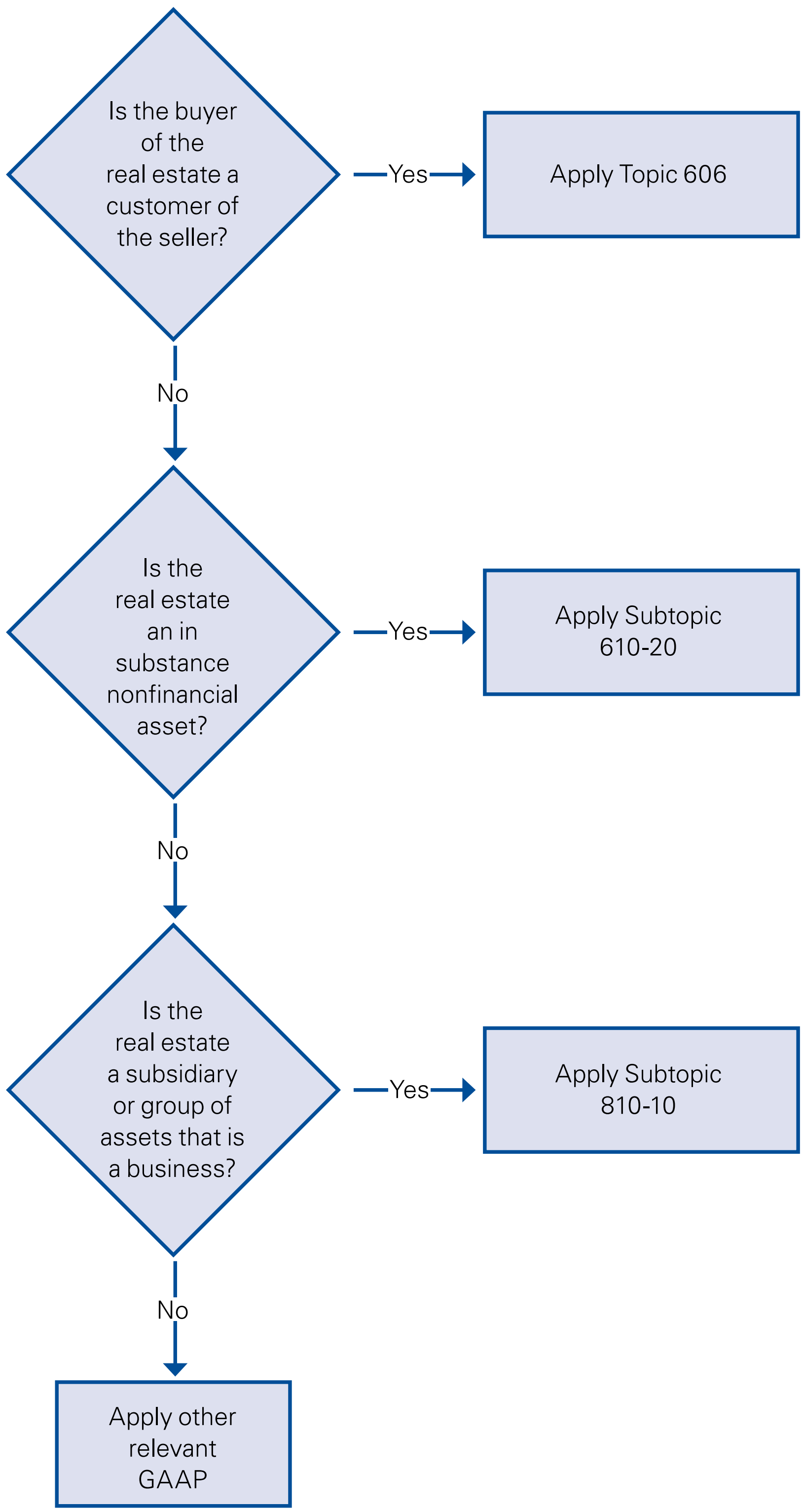
Background:
In some cases, a noncustomer sale involving real estate-related assets (or a group/subsidiary holding real estate assets) may be the sale of a business but not the sale of an in substance nonfinancial asset subject to Subtopic 610-20. In those situations, Subtopic 810-10 generally applies (or other GAAP, like Topic 860, *Transfers and Servicing*, may apply if the group of assets is neither an in substance nonfinancial asset nor a business). This distinction is important as it may affect the amount and timing of profit recognition.

Profit Recognition under Subtopic 610-20
Under Subtopic 610-20, when a contract exists and the performance obligation is satisfied, the seller derecognizes the real estate (or in substance real estate) and recognizes as a gain or loss the difference between the transaction price and the carrying amount of the real estate (otherwise the entity continues to report the real estate in its financial statements as discussed in **Question 0.1**).

Profit Recognition under Subtopic 810-10
Under Subtopic 810-10, when the seller/parent no longer has a controlling financial interest, it deconsolidates/derecognizes the subsidiary/group of assets and recognizes as a gain or loss the difference between the fair value of the consideration received (including the fair value of any noncontrolling interest retained post-sale) and the carrying amount of the subsidiary's assets and liabilities (as well as the carrying amount of any noncontrolling interest existing just before the sale). Alternatively, under Subtopic 810-10, when the seller/parent's ownership decreases (but it retains a controlling financial interest post-transaction), it recognizes an adjustment to equity equal to the difference between the fair value of the consideration received and the amount by which the noncontrolling interest is adjusted (i.e., there is no gain or loss recognized in consolidated net income or comprehensive income).

Answer 0.2: Paragraphs 810-10-40-3A and 810-10-45-21A exclude the transfer of in substance nonfinancial assets from Subtopic 810-10's deconsolidation and decreases in ownership guidance. Similarly, paragraphs 360-10-40-3A and 40-3B (applicable to property, plant and equipment) state that derecognition of an in substance nonfinancial asset should be accounted for under Topic 606 (if the sale is to a customer) or Subtopic 610-20 (if the sale is to a noncustomer). That guidance also says that derecognition of a subsidiary or group of assets is accounted for under Subtopic 810-10 only if that subsidiary is (a) not an in substance nonfinancial asset, and (b) not sold to a customer. Therefore, the guidance on sales of an in substance nonfinancial asset takes precedence over the deconsolidation/derecognition guidance for sales of a business.

This flowchart depicts the decision sequence:



While "in substance nonfinancial asset" is not defined, the legacy guidance in paragraph 360-20-15-2 on identifying in substance real estate (including the requirement to consider the nature of the entire real estate component being sold) was retained (both in Subtopic 360-20 and paragraphs 978-10-15-7 through 15-12). While this guidance was retained to identify the scope of sale-leaseback transactions that remain subject to the guidance in Subtopic 360-20 and timeshare transactions within the scope of Topic 978, we believe this discussion of what constitutes in substance real estate remains relevant for concluding whether a sale of an asset with a real estate component to a noncustomer is in the scope of Subtopic 610-20 (for in substance nonfinancial assets) or Subtopic 810-10 (for businesses).

Under paragraph 360-20-15-2, land plus property improvements and integral equipment are collectively considered "in substance real estate," so sales of those assets to noncustomers are accounted for under Subtopic 610-20. As discussed above, this applies even if all (or part) of the operations of the property otherwise meet the definition of a business for which derecognition would normally be accounted for under Subtopic 810-10. Conclusions on whether an operating real estate property or an ownership interest in an entity with significant real estate assets is in substance real estate (sales to noncustomers accounted for under Subtopic 610-20) or a business (sales to noncustomers accounted for under Subtopic 810-10) is a matter of judgment and all facts and circumstances should be considered. We believe generally the sale of a single real estate property should be accounted for as the sale of a nonfinancial asset under Subtopic 610-20. Further, we believe if an entity has an ownership interest in an entity that holds a single real estate property or substantially all of a multi-asset entity's value comprises real estate assets, a sale of that ownership interest likely is a sale of an in substance nonfinancial asset and is subject to Subtopic 610-20 (see paragraph 610-20-15-2(b)).

Question 0.3: How is Topic 606 applied when an entity sells property improvements (or integral equipment) to a customer and leases the underlying land to the buyer of the improvements? Does the answer differ if the transaction is with a noncustomer?

Answer 0.3: When a contract contains elements covered by different Codification Topics, paragraph 606-10-15-4 states that if those other Topics specify how to separate and/or initially measure one or more parts of the contract, then the entity first applies those requirements. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity applies the separation/measurement guidance in Subtopic 606-10.

Paragraphs 840-10-15-17 through 15-19 require the seller/lessor to separate lease and non-lease components based on relative stand-alone selling price. This requirement is consistent with the guidance in paragraphs 606-10-15-4 and 32-28 through 32-41. Accordingly, the seller/lessor separates the transaction into the lease of the land and the sale of the improvements and accounts for each separately. Revenue is recognized on the sale of the property improvements (or integral equipment) when control transfers to the buyer (based on the requirements of Topic 606) and the lease of the land is accounted for under Topic 840. Topic 840 requires lessors to classify land leases as operating leases if there is no automatic transfer of title to the lessee by the end of the lease term.

Because Topic 840 generally addresses separation and measurement in transactions with lease and non-lease components regardless of whether the lessee is a customer, we believe the guidance above is applicable equally to similar transactions involving noncustomers (with the difference being presentation – gain/loss presentation for noncustomer transactions under Subtopic 610-20 versus revenue and cost of sales presentation for customer transactions on the sale of the property improvements or integral equipment).

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-56 through 40-59 and 55-33 through 55-43 address the sale of property improvements with an accompanying lease of the underlying land. That guidance requires the transaction to be accounted for on a combined basis as a lease of both the land and the improvements if the term of the land lease either (a) does not cover substantially all of the economic life of the improvements, or (b) is not for a substantial period (e.g., 20 years). Under Topic 606 and the related amendments to Topic 840, the seller will account for the sale of the improvements and the lease of the land separately.

Even in cases where the sale of the improvements and lease of the land currently are accounted for separately under Subtopic 360-20 (i.e., when the land lease does cover substantially all of the economic life of the improvements and extends for a "substantial period"), the profit recognized on the sale of the improvements is a function of the present value of the rental payments, the term of the primary indebtedness on the improvements (if any), the sales value of the improvements and the carrying amount of the improvements and the land. Under Topic 606 and the related amendments to Topic 840, profit on the sale of the improvements is more simply a function of the consideration allocated to the sale (based on the relative stand-alone selling prices of the two elements) and the carrying amount of the improvements.

Question 0.4: How is Topic 606 applied when a seller guarantees the return of the buyer's investment (or a return on that investment) for a limited or extended period in connection with the sale of real estate? Is the answer different if the transaction is with a noncustomer?

Answer 0.4: When a contract with a buyer contains elements addressed by different Topics, paragraph 606-10-15-4 states that if the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity first applies those separation and/or initial measurement requirements. Accordingly, the seller first determines whether Topic 460, Topic 815, or another Topic, applies to the guarantee (note that contracts accounted for under Topics 460 and 815 are scoped out of Topic 606 under paragraph 606-10-15-2). If the guarantee is within the scope of Topic 460 or Topic 815, the seller/guarantor initially recognizes and measures it at fair value under the initial measurement guidance in the applicable Topic. The remainder of the consideration would be allocated to the sale of the property.

Paragraph 460-10-15-4 lists the following types of guarantee contracts that are within the scope of Topic 460:

a. Contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party

b. . . . .

c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party

Paragraph 460-10-55-2(b) states that a market value guarantee on a nonfinancial asset owned by the guaranteed party is an example of the type of contract described in paragraph 460-10-15-4(a). Seller guarantees similar to market value guarantees (like the one described above) therefore generally are separated from the sale transaction and initially measured at fair value. The remainder of the contract consideration is then allocated to the sale of the real estate and is subject to Topic 606's guidance on determining the *transaction price*. Because the guarantee is accounted for separately, it does not affect the seller's ability to recognize revenue (gain/loss) under Topic 606 (Subtopic 610-20) when or as the seller transfers control of the real estate to the buyer. Guarantee-like arrangements not within the scope of Topic 460 or other Topics remain combined with the sale transaction accounted for under Topic 606 (or Subtopic 610-20) and may affect the amount and timing of revenue recognition on that sale as they may result in the transaction price being variable or may preclude control transfer (see **Question 5.6** for discussion of put options).

While Subtopic 610-20 does not address separating noncustomer multi-element transactions, we believe an entity selling to a noncustomer applies the same guidance because Subtopic 610-20 refers to Topic 606's transaction price and control transfer principles (the two areas most likely to be affected by the existence of a guarantee in connection with a sale).

Comparison to Legacy U.S. GAAP

A guarantee of a buyer's return on/of investment in connection with a real estate sale, while generally meeting the definition of a guarantee in Topic 460, currently is accounted for in combination with the real estate sale under Subtopic 360-20 because it is scoped out of Topic 460 (see paragraphs 460-10-15-17(g) and 55-17(a)). Paragraph 360-20-40-41 requires a seller that guarantees the return of the buyer's investment (or a return on that investment) for an extended period to account for the transaction as a financing, leasing, or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the seller accounts for the transaction under the deposit method until operations of the property cover all operating expenses, debt service, and contractual payments. At that time, profit is recognized on the basis of performance of the required services.

Topic 606 changes this accounting because the existence of the guarantee does not, in and of itself, preclude the seller from recognizing a sale of the real estate; rather the guarantee is accounted for separately under Topic 460 (if it is within its scope). The existence of the guarantee does, however, result in a reduction of profit on the sale of the real estate under Topic 606 because the fair value of the guarantee reduces the contract consideration allocated to the sale of the real estate (which serves as the basis for determining the *transaction price* for the sale of the real estate). If the guarantee is not within the scope of Topic 460 or other Topics, then the transaction price is variable and the guidance on variable consideration, including the constraint (see paragraphs 606-10-32-11 through 32-13), applies for determining the amount of revenue or gain/loss.

Question 0.5: How is Topic 606 applied when a seller is required to initiate or support the operations of a property being sold to a customer (e.g., the seller agrees to support the operations of a property up to a breakeven level of cash flows for a period of time)? Is the answer different if the transaction is with a noncustomer?

Answer 0.5: If the seller's obligation to support the operations of the property is within the scope of Topic 460 (i.e., it has the characteristics of a guarantee as described in Section 460-10-15), the seller separates the support obligation and initially recognizes and measures it at fair value under Topic 460's initial measurement guidance (see paragraph 460-10-30-2). The remainder of the contract consideration is then allocated to the sale of the real estate and is subject to Topic 606's guidance on determining the *transaction price*.

In our experience, support obligations generally have the characteristics of a guarantee, as they are analogous to a guarantee of the collection of scheduled contractual cash flows from financial assets (paragraphs 460-10-15-4(a) and 460-10-55-2(e)) or a guarantee of the revenue of a business (paragraphs 460-10-15-4(a) and 460-10-55-2(d)). Accordingly, we believe most seller support obligations will be within the scope of Topic 460 and therefore will be separated from the sale transaction. When the support obligation is accounted for separately, it does not affect the seller's ability to recognize revenue under Topic 606 when or as the seller transfers control of the real estate to the buyer. Guarantee-like arrangements not within the scope of Topic 460 or other Topics remain combined with the sale transaction accounted for under Topic 606 and may affect the amount and timing of revenue recognition on that sale as they may result in the transaction price being variable or may preclude control transfer (see **Question 5.6** for discussion of put options).

While Subtopic 610-20 does not address separating noncustomer multi-element transactions, we believe an entity selling to a noncustomer applies the same guidance because Subtopic 610-20 refers to Topic 606's transaction price and control transfer principles (the two areas most likely to be affected by the existence of a guarantee in connection with a sale).

Comparison to Legacy U.S. GAAP

An agreement to initiate or support the operations of a property in connection with a sale of that property, while generally meeting the definition of a guarantee in Topic 460, currently is accounted for in combination with the real estate sale under Subtopic 360-20 and therefore is scoped out of Topic 460 (see paragraphs 460-10-15-17(g) and 55-17(b)). Paragraph 360-20-40-43 requires a seller to account for a sale transaction as a financing, leasing, or profit-sharing arrangement if it is required to initiate or support operations or continue to operate the property at its own risk (or may be presumed to have such a risk) for an extended period of time and provides conditions that, if present, presume support for an extended period of time. If support is required (or presumed to be required) for a limited time, paragraph 360-20-40-44 requires a seller to recognize profit on a proportional performance basis as the services are provided. Performance of those services is measured by the costs incurred and to be incurred over the period during which the services are performed (i.e., on a cost-to-cost basis). The seller begins to recognize profit when there is reasonable assurance that the future rent receipts will cover operating expenses and debt service including payments due to the seller under the terms of the transaction.

Topic 606 changes the accounting for these arrangements because the existence of the support obligation does not, in and of itself, preclude the seller from recognizing a sale of the real estate; rather the guarantee is accounted for separately under Topic 460 (if it is within its scope). The existence of the guarantee does, however, result in a reduction of profit on the sale of the real estate under Topic 606 because the fair value of the support obligation reduces the contract consideration allocated to the sale of the real estate (which serves as the basis for determining the *transaction price*). If the support obligation is not within the scope of Topic 460 or other Topics, then the transaction price is variable and the guidance on variable consideration, including the constraint, applies for determining the amount of revenue or gain/loss.

EXAMPLE 0.1: Property Sale with Support Obligation

Description of the Arrangement

ABC Corp. sells a newly-constructed property with a cost of $1,200,000 to DEF Corp. for $2,000,000 in cash. ABC guarantees the cash flows of the property will be sufficient to meet all the property's operating needs for the first three years after the sale date. The fair value of the guarantee at the sale date is $30,000 and there is no other variable consideration.

Evaluation

Because the support obligation is a guarantee within the scope of Topic 460, it is initially separated from the real estate sale and measured at fair value. Accordingly, $30,000 of the total $2,000,000 contract consideration is allocated to the guarantee and $1,970,000 ($2,000,000 contract consideration less the fair value of the guarantee of $30,000) is allocated to the sale of the property and represents the *transaction price*. A gain of $770,000 ($1,970,000 less $1,200,000 cost) is recognized on transfer of control of the property if the transaction is with a noncustomer. The guarantee continues to be accounted for separately under Topic 460 and therefore does not affect the gain on sale (i.e., the income statement effect of subsequent remeasurements of the guarantee would be recognized separately from the gain on sale).

Question 0.6: What is the unit of account under Topic 606 for sales of condominium *units* within a condominium *project* (or similar structure)?

Answer 0.6: Topic 606 generally specifies the unit of account is an individual contract with a customer. Further, paragraph 606-10-55-180 contemplates that individual contracts with customers to construct individual units in a multi-unit residential complex are accounted for separately. Paragraph 606-10-10-4 does, however, provide a practical expedient allowing an entity to apply the guidance to a portfolio of contracts (or performance obligations) with similar characteristics but only if the entity reasonably expects the effect on the financial statements to not differ materially from applying the guidance to the individual contracts. We believe it may be difficult for entities to demonstrate a reasonable expectation that the effect of using a project approach is materially the same as the effect of using an individual contract approach because (a) the control of the individual units likely will transfer at different points in time (see **Question 5.4** for additional discussion of the pattern of control transfer in unit sales), and (b) the transaction prices of (and the costs to fulfill) individual units within a project are likely to be different.

Comparison to Legacy U.S. GAAP

If individual units in condominium projects or time-sharing interests are being sold separately, paragraph 360-20-40-50 requires profit to be recognized using the percentage-of-completion method on the sale of individual units or interests if construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest, sufficient units have already been sold to assure that the entire property will not revert to rental property, sales prices are collectible, and aggregate sales proceeds and costs can be reasonably estimated.

Sellers/developers may have historically applied the percentage-of-completion method under paragraph 360-20-40-50 by measuring progress on a cost-to-cost basis relative to the project as a whole and applying that measure of progress to the estimated gross profit (revenue and expense) on an individual unit sold. The unit is considered "sold" for this purpose if the criteria in paragraph 360-20-40-50 are met (which is typically before closing has occurred).

Under Topic 606, sellers/developers generally are required to separately account for each contract with an individual customer unless the entity reasonably expects the effect on the financial statements of using a portfolio (or project) approach not to differ materially from applying the guidance to the individual contracts. See section *Step 5: Recognize Revenue* for discussion of the pattern of control transfer of real estate sales and **Question 5.4** specifically for discussion of unit sales.

STEP 1: IDENTIFY THE CONTRACT

Question 1.1: What consideration, if any, should be given to the buyer's initial and continuing investments when evaluating if a seller of real estate has a contract with a buyer?

Answer 1.1: Unlike Subtopic 360-20, there are no explicit initial or continuing investment requirements for the buyer under Topic 606. However, paragraph 606-10-25-1 requires the seller to evaluate, among other things, whether the parties are "committed to perform their respective obligations" and whether it is "probable [the seller] will collect the consideration to which it will be entitled" in exchange for property transferred to the buyer. Assessing collectibility involves evaluating the customer's ability and intention to pay. In evaluating whether collectibility is *probable*, the seller may need to consider factors such as:

- Payment Terms – Do the payment terms reflect inherent uncertainty about the buyer's intent on fulfilling its obligations? Payment terms that may suggest a significant uncertainty about the buyer's intent and ability to fulfill its obligations may include:
  - Small down payment relative to the overall contracted price;
  - Nonrecourse, seller-provided financing;
  - Customer-provided collateral or guarantees that are not highly liquid or have highly variable or unobservable fair value;
  - Continuing periodic payments that extend beyond a customary financing period for similar transactions (or beyond the estimated useful life of the property) or no periodic payments until maturity;
  - Guarantees provided by non-highly rated counterparties.
- Importance of the property to the buyer's operations – Does the buyer's business model and reasons for entering into the transaction raise doubt about the buyer's intent to follow through with its obligations? For example, a buyer may be more committed to perform if it is purchasing property necessary to operate a particular line of business versus making a speculative investment not part of its ordinary business activities.
- Prior Experience – Does the seller have prior experience with the buyer (or a similar class of buyer) for the same or similar transactions that calls into question the intent and ability of the buyer to perform? Or similarly, has the seller previously chosen not to enforce its contractual rights in similar contracts with the buyer (or buyer class) under similar circumstances?
- Whether the seller's receivable is subject to future subordination.

None of these factors should be viewed in isolation; instead, they should be evaluated collectively based on all relevant facts and circumstances. No single factor is determinative as to whether the customer is committed to perform or collectibility is probable. An entity that refers to the legacy initial and continuing investments guidance in Subtopic 360-20 as an indicator of whether collectibility is probable under Topic 606 should not consider these thresholds as safe-harbors or bright lines and all facts and circumstances should be considered.

If the paragraph 606-10-25-1 criteria are not met, the arrangement is not considered a *contract* and is accounted for under paragraphs 606-10-25-6 through 25-8. That guidance requires the seller to account for any cash collected as a deposit liability until:

a. the seller has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the promised consideration has been received and is nonrefundable,

b. the contract has been terminated and the consideration received is nonrefundable, or

c. the paragraph 606-10-25-1 criteria are subsequently met (in which case, revenue or gain is recognized by applying the guidance in Topic 606 or 610).

Paragraphs 606-10-55-95 through 55-98 illustrate the collectibility analysis in the context of a real estate sale whereby a real estate developer sells a building and provides long-term, nonrecourse financing for 95% of the sales price. The buyer expects to repay the loan primarily from income derived from its restaurant business (which is a business facing significant risks because of the high competition in the industry and the customer's limited experience) and lacks other income or assets that could be used to repay the loan. Because of the uncertainty associated with the buyer's ability and intention to pay, the seller concludes the paragraph 606-10-25-1 criteria are not met and therefore recognizes the nonrefundable deposit received from the buyer as a deposit liability, does not derecognize the asset and does not recognize a receivable for the remainder of the sales price. The seller continues to assess the contract to determine whether the paragraph 606-10-25-1 criteria are subsequently met or the other events in paragraph 606-10-25-7 have occurred.

The guidance on evaluating the existence of a contract (and the accounting if a contract does not exist) applies to both customer and noncustomer transactions. In addition, paragraph 360-10-40-3C states that if a *contract* for the transfer of a nonfinancial asset does not exist, the seller needs to continue to report the nonfinancial asset in its financial statements, depreciate it (if it is not held for sale under paragraphs 360-10-45-9 and 45-10) and evaluate it for impairment under the guidance in Section 360-10-35.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-5 requires, among other things, that a buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property in order to recognize profit by the full accrual method. Adequacy of the buyer's initial investment is measured both by its composition (see paragraphs 360-20-40-10 and 40-13) and its size compared with the sales value of the property (see paragraph 360-20-40-18). The buyer's continuing investment does not qualify under paragraph 360-20-40-19 unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than 20 years for land or the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. If the buyer's initial or continuing investment is not adequate, paragraph 360-20-40-31 requires the seller to apply the installment, cost recovery or deposit method to account for the sale, depending on the likelihood of recovering the cost of the property if the buyer defaults.

Topic 606 changes the accounting for those transactions where a contract exists (based on the qualitative considerations previously discussed), but would not otherwise meet the initial and continuing investment requirements of Subtopic 360-20. Under Topic 606, those contracts result in revenue recognition (or gain recognition in a noncustomer transaction) when or as control transfers to the buyer whereas under Subtopic 360-20, they result in application of the installment, cost recovery or deposit method. The results of applying Topic 606 may also differ from the current accounting under Subtopic 360-20 even when a contract does not exist because Topic 606 does not permit application of the installment or cost recovery methods; it requires accounting similar to the deposit method.

Question 1.2: What consideration, if any, should be given to the future subordination of a seller's receivable when evaluating if a seller of real estate has a contract with a buyer?

Answer 1.2: Like **Question 1.1** on the buyer's initial and continuing investments, there is no explicit guidance on future subordination of the seller's receivable in Topic 606. However, the seller is required to evaluate, among other things, whether the parties are "committed to perform their respective obligations" and whether it is "probable [the seller] will collect the consideration to which it will be entitled" in exchange for property transferred to the buyer. If those criteria are not met, the arrangement is not a *contract* and the seller applies the guidance in paragraphs 606-10-25-6 through 25-8 and 360-10-40-3C.

Evaluating whether the parties are committed to perform and collectibility is probable requires an analysis of all relevant facts and circumstances. Refer to **Question 1.1** for additional discussion of factors to consider. While the seller's receivable being subject to future subordination is one factor to consider, it is not itself determinative that the parties are not committed to perform or collectibility is not probable. If, after having considered all the factors, the seller concludes it does have a contract with the buyer (i.e., the buyer is committed to perform on its obligations and collectibility is probable), revenue (or gain in a noncustomer transaction) will be recognized in accordance with the recognition and measurement provisions of Topic 606 and any future uncollectibility arising as a result of the subordination of the receivable will be recognized based on the impairment guidance applicable to financial instruments in Section 310-10-35.

As discussed in **Question 1.1**, the guidance on evaluating the existence of a contract (and the accounting if a contract does not exist) applies to both customer and noncustomer transactions. In addition, paragraph 360-10-40-3C states that if a *contract* for the transfer of a nonfinancial asset does not exist, the seller continues to report the nonfinancial asset in its financial statements, depreciate it (if it is not held for sale under paragraphs 360-10-45-9 and 45-10) and evaluate it for impairment under the guidance in Section 360-10-35.

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-5 and 40-25 preclude a seller from recognizing profit on a real estate sale if the seller's receivable from the buyer is subject to future subordination, except if it is subordinate only to a first mortgage on the property existing at the time of sale or to a future loan (including an existing permanent loan commitment) provided the terms of the sale require that the proceeds of that loan will first be applied to the payment of the seller's receivable. If the seller's receivable is subject to future subordination, paragraph 360-20-40-36 requires that profit be recognized using the cost recovery method.

Topic 606 changes the accounting for those transactions where a contract exists (based on the qualitative considerations previously discussed) and the seller's receivable from the buyer is subject to future subordination. Under Topic 606, those contracts result in revenue recognition (or gain recognition in a noncustomer transaction) when or as control transfers to the buyer whereas under Subtopic 360-20, they result in application of the cost recovery method. The results of applying Topic 606 may also differ from the current accounting under Subtopic 360-20 even when a contract does not exist because Topic 606 does not permit application of the cost recovery method; it requires accounting similar to the deposit method.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS

Question 2.1: Is the sale of an undivided interest in the common areas on which future amenities may be built considered a separate performance obligation from the sale of a condominium unit or residential lot when the undivided interest is transferred in connection with the sale of the unit or lot?

Answer 2.1: Under paragraph 606-10-25-14, a seller accounts for a separate performance obligation if the good or service is distinct from other goods or services in the contract. Under paragraph 606-10-25-19(a) and (b), a good or service is distinct if:

a. 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 (that is, the good or service is capable of being distinct), and

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct in the context of the contract).

Paragraph 606-10-25-20 provides additional guidance on what makes a good or service capable of being distinct (criterion (a)). A good or service is capable of being distinct if it could be "used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits." In addition, "the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources." Paragraph 606-10-25-21 provides factors indicating a good or service is distinct in the context of the contract (criterion (b)), including that the entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract, the good or service does not significantly modify or customize another good or service promised in the contract, or the good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract.

Because an undivided interest in the common areas (with or without completed amenities) that is transferred in connection with the sale of a unit or lot generally (a) cannot generate independent economic benefits to the buyer (the undivided interest is not practically or legally separable from the fee interest in the unit or lot), and (b) the buyer is unable to purchase (or not purchase) the undivided interest without the unit or lot, we do not believe it is capable of being distinct (i.e., the undivided interest cannot generate economic benefits on its own or with other readily available resources) or distinct in the context of the contract (i.e., the undivided interest is highly dependent on and highly interrelated with the unit/lot because the customer cannot purchase the unit/lot without the undivided interest). Therefore the sale of the unit/lot and the accompanying undivided interest in the common area is a single performance obligation. We believe this conclusion is consistent with the discussion in paragraph 606-10-55-180 which states that depending on the nature of the construction, the developer's performance in the construction of common areas (and the initial construction, like the foundation and basic structure) may need to be reflected when measuring its progress toward complete satisfaction of a performance obligation to construct an individual unit within a multi-unit residential complex.

See additional discussion in **Question 5.4** on the timing of revenue recognition for sales of condominium units (and other similar structures).

Question 2.2: Does the sale of land together with an agreement to construct property improvements comprise multiple performance obligations? Is the analysis different if the buyer is not a customer?

Answer 2.2: It depends. As discussed in **Question 2.1**, a seller accounts for a separate performance obligation under paragraph 606-10-25-19 only if the goods or services are distinct from other goods or services in the contract. A good or service is distinct if:

a. 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 (that is, the good or service is capable of being distinct), and

b. The entity's promise to transfer the good or service to the customer is separable from other promises in the contract (that is, the good or service is distinct in the context of the contract).

In evaluating whether the transfer of the land and the construction contract are *capable of being distinct*, the seller/developer considers whether the land alone (and/or the property improvements that are the output of the construction contract) can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits for the customer (paragraph 606-10-25-20). For example, could the land alone be sold, developed by another party, or leased to others? Could the property improvements alone be sold (perhaps if the buyer leased the underlying land), used to generate other revenue, or leased to others? Does the seller/developer (or another similarly-situated party) separately sell land or construction services?

In evaluating whether the purchase of the land and the construction contract are *distinct in the context of the contract,* the seller/developer considers the guidance in paragraph 606-10-25-21. Indicators a good or service is *distinct in the context of the contract* include (but are not limited to):

a. The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.

While land seems to be an input to deliver any property-improvement output, the land with the property improvement may not be a "combined output" specified by the customer in the contract. The land transfer and property-improvement construction may be separate promises in the contract and not otherwise linked. For example, the stated contract consideration (not necessarily the *transaction price*) for the land sale may be independent of the consideration for the construction service, the timing for delivery of each promise may be different (e.g., title to the land transfers to the buyer before construction begins) and/or the dispute resolution and/or default provisions associated with the land sale, the construction contract, or both, may not affect the terms of the other promise.

b. The good or service does not significantly modify or customize another good or service promised in the contract.

Whether property improvements significantly modify or customize the land on which they are built may depend, in part, on the nature of the improvement and the characteristics of the land. For example, certain parcels of land may be expected to have largely the same value with or without the property improvements (e.g., one in a unique location and/or zoned for a particular use) or may not require significant site preparation (demolition, clearing, grading, excavation, etc.) so the construction of the improvements may not significantly modify or customize the land.

c. The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

Whether the land sale and construction contract are highly dependent or highly interrelated may, like indicator (a), depend on if (and how) the contract terms of each promise relate to each other. For example, if land and construction services are separately sold by the seller/developer, an entity may look to the consideration in the combined contract relative to the stand-alone selling prices of its components to determine whether it is economically feasible for the customer to purchase the land and construction services separately. If the combined terms suggest a deep discount to the aggregate of the stand-alone selling prices, it may suggest the customer could not decide to purchase one component separately without significantly affecting the others. In other words, if the buyer is compelled to purchase both the land and the construction services together from the seller because to purchase one without the other (and presumably purchase the second from another party) would be so economically disadvantageous, then the seller may conclude the sale of the land is highly dependent on, or highly interrelated, with the construction services. If the combined terms suggest a premium to the aggregate stand-alone selling prices, it also may suggest the components are highly dependent, or highly interrelated, because the customer is willing to pay a premium to obtain the land and the construction services from a single seller/developer.

Careful consideration of the contract in its totality is critical in evaluating the above indicators and, more broadly, whether a promise is distinct in the context of the contract. All facts and circumstances should be considered.

We believe the guidance on identifying performance obligations for a customer transaction also is applicable by analogy to noncustomer transactions even though Subtopic 610-20 does not specifically reference paragraphs 606-10-25-14 through 25-22.

See additional discussion in **Question 5.3** on the timing of revenue recognition for land sales with accompanying construction contracts.

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-61 through 40-64 address real estate sale contracts with future development required by the seller. If the future costs of development can be reasonably estimated at the time of sale, profit allocable to performance before the sale of the land and the sale of the land are recognized at the time of sale (assuming the other criteria for recognition of profit by the full accrual method are satisfied) and profit allocable to performance after the sale is recognized by the percentage-of-completion method as development and construction proceed. This results in the same rate of profit being attributed to each activity.

Under Topic 606, a seller/developer must first determine if the contract comprises one or two performance obligations (*Step 2*, as discussed in **Question 2.2**). After the performance obligations are identified and the overall *transaction price* is determined (*Step 3*), the seller/developer needs to allocate the *transaction price* to the performance obligations (*Step 4*) and then evaluate, for each performance obligation, if revenue is recognized over time or at a point in time (*Step 5*, see additional discussion in **Question 5.3**). This process may result in differences from the accounting prescribed by paragraphs 360-20-40-61 through 40-64 because (a) Subtopic 360-20 requires identification of a single unit of account compared to the Step 2 process in Topic 606 (that may result in more than one unit of account), (b) Step 3 of Topic 606 defines the overall *transaction price* differently than Subtopic 360-20 (specifically it requires an entity to estimate variable consideration up-front if certain criteria are met), (c) Subtopic 360-20 requires an entity to recognize the same rate of profit on the land sale and the development contract whereas Step 4 of Topic 606 requires the entity to allocate the transaction price to the performance obligations (if there is more than one) based on relative stand-alone selling prices, and (d) Subtopic 360-20 requires the use of percentage-of-completion to recognize revenue whereas Step 5 of Topic 606 requires an entity to evaluate each performance obligation to determine if it is satisfied over time, and if not, it is satisfied at a point in time. These differences may result in differences in the amount and timing of revenue recognized on the property sale and the development contract; however, if the sale and development are a single performance obligation satisfied over time and the seller/developer uses a cost-to-cost input method for measuring the progress, the accounting under Topic 606 and Subtopic 360-20 may be similar (see **Question 5.3**).

STEP 3: DETERMINE THE TRANSACTION PRICE

Question 3.1: How does a seller's right to participate in a property's future profits affect the determination of the transaction price for the sale of that property?

Answer 3.1: The right to future profits is variable consideration and is estimated upfront to determine the *transaction price* (the amount of consideration to which the entity expects to be entitled). Variable consideration included in the transaction price is subject to a constraint (see paragraphs 606-10-32-11 through 32-14) and is reassessed on an ongoing basis until the uncertainty is resolved. An entity may only include estimates of variable consideration in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Accordingly, a seller will include in the total transaction price its expectations of its share of future profits to the extent that it concludes it is probable a significant reversal in the amount of cumulative revenue recognized will not occur. Paragraph 606-10-32-12 requires a seller to consider both the likelihood and the magnitude of a potential revenue reversal and includes the following factors that could increase the likelihood or the magnitude of a revenue reversal:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience or other evidence with similar types of contracts is limited, or that experience or other evidence has limited predictive value.

d. 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.

e. The contract has a large number and broad range of possible consideration amounts.

The seller will update the estimated transaction price each reporting period to reflect the current circumstances at each reporting date.

The guidance on determining the transaction price applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Under paragraph 360-20-40-64, if the seller will participate in future profits from the property without risk of loss (such as participation in operating profits or residual values without further obligation), and the sale otherwise qualifies for recognition of profit by the full accrual method, the contingent future profits are recognized when realized. Accordingly, application of Topic 606 may result in earlier revenue (or gain) recognition for these provisions when the cumulative amount of revenue recognized is probable of not being subject to a risk of significant revenue reversal (i.e., because the constraint, in many cases, may not reduce the variable consideration associated with the future profits interest all the way to zero). When inclusion of those future amounts in the transaction price is not appropriate (because it is not probable that those future amounts would not result in a significant reversal of the cumulative revenue (or gain)) the resulting accounting under Topic 606 may be substantially equivalent to current accounting under Subtopic 360-20.

EXAMPLE 3.1: Sale of Property with Future Profits Interest

Description of the Arrangement

ABC Corp. sells a newly-constructed retail property with a cost of $1,200,000 to DEF Corp. for $2,000,000 in cash and a right to receive 5% of future operating profits from the property over a 10-year earn-out period. ABC has no ongoing performance obligation related to the operations of the property. Because the in-place leases generally have fixed lease payments for the first two years of the earn-out period, ABC concludes it is probable it will receive a payout of $50,000 in variable consideration relating to years one and two (based on the contractual fixed lease payments in those two years and its experience with similar properties and tenants) but is less certain about its expected payouts in years three through ten (because the lease payments the buyer of the property will receive in those years shift from fixed payments to entirely contingent payments based on the lessees' third party sales). Accordingly, ABC concludes it is probable a significant reversal of $2,050,000 (the contractual selling price plus $50,000 of the variable consideration related to years one and two of the earn-out period) will not occur. ABC is unable to support a higher *transaction price* because it believes the contingent rent provisions in the underlying leases taking effect in year three of the earn-out period result in a broad range of possible additional consideration amounts that are highly susceptible to outside factors (there is a lack of basis to reasonably estimate the property's operating profits based on the lessees' third party sales and therefore there is no higher amount of cumulative revenue/profit that would not be subject to a risk of significant reversal).

Evaluation

Profit of $850,000 ($2,000,000 contractual selling price + $50,000[3] in variable consideration – $1,200,000 cost) is recognized when control of the property transfers. The $50,000 of variable consideration is included in the *transaction price* because it is probable a significant reversal in revenue of $2,050,000 (the cumulative amount of revenue recognized) will not occur. Contingent future profit payments for years three through ten of the earn-out period are not recognized when control of the property initially transfers, but are recognized when it becomes probable that some or all of those amounts are no longer subject to a risk of significant revenue reversal.

If the leases instead were structured with some level of fixed base rent in years three through ten (in addition to the contingent rent provisions), ABC would have also included those base rent amounts in the *transaction price* if it concluded it was probable a significant reversal of the new cumulative amount of revenue recognized (i.e., the $2,000,000 contractual selling price plus the $50,000 of variable consideration for years one and two plus ABC's share of profits inclusive of the base rent for years three through ten) would not occur.

[3] Note the impact of the time value of money is not considered when consideration is variable and the timing of that consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or entity (see paragraph 606-10-32-17(b)).

Question 3.2: Is a change in estimate relative to the measure of progress towards satisfaction of the performance obligation on a construction contract subject to the revenue recognition constraint discussed in paragraphs 606-10-32-11 through 32-14?

Answer 3.2: The objective of the constraint on variable consideration is to recognize revenue only to the extent it is probable the cumulative amount of revenue recognized is not subject to a risk of significant revenue reversal due to variability in the transaction price. While a construction contractor may experience revenue reversals as a result of a change in its measure of progress toward complete satisfaction of a performance obligation, such reversals do not represent changes in the ultimate consideration to which the developer is entitled. Accordingly, the risk associated with a change in timing of total revenue is not evaluated under the constraint. However, significant changes in timing may (a) call into question the contractor's ability to reasonably estimate its progress as discussed in paragraphs 606-10-25-36 through 25-37, and (b) suggest the contractor should evaluate the need for a provision for anticipated losses on the contract within the scope of paragraphs 605-35-25-45 through 25-49 (which have largely been retained from previous guidance).

Question 3.3: What discount rate is used in accounting for the time value of money for a property management service contract prepaid in conjunction with an all-cash operating property sale (assuming the property sale and the property management service contract are two performance obligations)?

Answer 3.3: As discussed in paragraphs 606-10-32-15 and 32-20, because the objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price the customer would have paid if it had paid cash for the promised goods or services when or as they transfer, a seller determines the discount rate by identifying the rate that discounts the stand-alone selling price of the property management services to the allocated transaction price. The discount rate should be the rate that would exist in a separate financing transaction between the buyer and the seller at contract inception and would reflect the credit characteristics of the party receiving financing in the contract (in this case, the seller), as well as any collateral or security provided by the buyer or the seller (including assets transferred in the contract).

Note, however, that the transaction price is adjusted to reflect the time value of money only if the financing component is significant *to the contract*, not necessarily significant to one or more of the separate performance obligations. Accordingly, the financing component associated with the property management services is analyzed relative to the *transaction price* of the contract as a whole (i.e., the transaction price for the sale of the property and property management services combined). Further, if any factor in paragraph 606-10-32-17 exists (i.e., the customer makes an advance payment and the timing of the transfer of goods or services is at the customer's discretion, a substantial amount of the consideration is contingent on a future event outside the parties' control, or the difference between the promised consideration and the cash selling price arises for reasons other than financing), a contract does not have a significant financing component even if the timing of payments and the transfer of control of the goods or services differs significantly. As a practical expedient, a seller need not account for a financing component when the period between when it transfers a good or service and when the customer pays for such good or service will be one year or less.

The guidance on determining the transaction price applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-43(d) addresses the accounting when a seller agrees to manage the property for the buyer after the sale without compensation or at compensation less than prevailing rates. It requires that (a) the compensation for the services be imputed when the sale is recognized and be recognized in income as the services are performed over the term of the management contract, and (b) the remaining sales price (i.e., the residual) be attributed to the sale of the property. While the property management fee revenue continues to be recognized over the service period under Topic 606, (a) the imputed value (which represents the present value of the market rate of the services) likely will differ from the allocated transaction price (based on relative stand-alone selling prices under paragraph 606-10-32-29; see **Question 4.1** for further discussion), and (b) Topic 606 requires the seller to gross-up the revenue amount and recognize interest expense if the financing component associated with the prepayment of the management services is significant to the contract.

EXAMPLE 3.2: Sale of Property with Property Prepaid Management Services

Description of the Arrangement

ABC Corp. sells a hotel with a carrying amount of $1,500,000 to a customer and agrees to manage the hotel for three years. The buyer pays $2,000,000 in cash at the date of sale for both the sale of the hotel and the management services. Two performance obligations are identified and the *transaction price* allocated to the performance obligations is $1,714,286 for the sale of the hotel and $285,714 for the future property management services (see Example 4.1 for illustration) based on the stand-alone selling prices of $1,800,000 for the hotel without the services and $100,000 per year for the property management services. ABC determines that the financing component is significant to the contract[4] and the property management services will be delivered ratably over the three-year service period.

Evaluation

Because ABC has determined that the financing component is significant to the contract, it establishes an initial contract liability of $285,714 and accrues interest expense each period on the "principal" balance at the rate that discounts the cash selling price of the property management services ($300,000, or $100,000 per year for 3 years) to the promised consideration (i.e., $285,714). That rate (the rate implicit in the contract) is 3.19%. This rate (and the resulting interest expense amounts below) assume monthly "payments" on the contract liability equal to $8,333.33 ($300,000 over 36 months) to reflect the property management services being delivered over time.

One way to account for this would be as follows:

At inception:

Dr. Cash	285,714 (1)	
Cr. Contract liability		285,714
To reflect the cash received allocated to the property management services		
Dr. Cash	1,714,286 (2)	
Dr. Cost of sales	1,500,000	
Cr. Property and equipment		1,500,000
Cr. Revenue		1,714,286
To record revenue and cost of sales on the sale of the hotel		
(1) + (2) = $2,000,000 cash consideration received from buyer		

Year 1:

Dr. Interest expense	7,783	
Cr. Contract Liability		7,783
To accrue the aggregate annual interest expense on the contract liability		
Dr. Contract liability	100,000	
Cr. Revenue		100,000
To recognize the year one property management service revenue		

Year 2:

Dr. Interest expense	4,794	
Cr. Contract liability		4,794
To accrue the aggregate annual interest expense on the contract liability		
Dr. Contract liability	100,000	
Cr. Revenue		100,000
To recognize the year two property management service revenue		

Year 3:

Dr. Interest expense	1,709	
Cr. Contract liability		1,709
To accrue the aggregate annual interest expense on the contract liability		
Dr. Contract liability	100,000	
Cr. Revenue		100,000
To recognize the year three property management service revenue		

[4] The transaction price is adjusted for the time value of money only if the financing component is significant to the contract. This illustration also assumes the rate implicit in the contract is reasonable relative to what the seller's (ABC's) borrowing rate would be in a separate financing transaction.

STEP 4: ALLOCATE THE TRANSACTION PRICE

Question 4.1: How is the transaction price allocated in a contract that transfers control of a property and also requires a seller to provide ongoing property management services to a customer? What if the buyer is not a customer?

Answer 4.1: When the sale of the property and the property management services are separate performance obligations (see paragraph 606-10-25-15), the transaction price generally is allocated based on relative stand-alone selling prices (i.e., the price at which an entity would sell a promised good or service separately to a customer). This allocation process also will result in a proportionate allocation of any "discount" (i.e., the difference between the *transaction price* and the sum of the stand-alone selling prices) to each of the performance obligations (the sale of the property and the management services). However, an entity instead should allocate a discount entirely to one or more of the performance obligations if all of the following criteria are met (see paragraph 606-10-32-37):

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

b. The entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the good or services in each bundle; and

c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

As most real estate companies do not offer a wide range of bundled goods or services, we believe in most cases all of the above criteria generally will not be met and therefore allocation of any discount would be done on a relative stand-alone selling price basis. See Example 4.1.

We believe the guidance on allocating the transaction price for customer transactions also applies by analogy to noncustomer transactions even though Subtopic 610-20 does not address transactions with a noncustomer with more than one performance obligation.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-43(d) addresses the accounting when a seller agrees to manage the property for the buyer after the sale without compensation or at compensation less than prevailing rates. It requires that (a) the compensation for the services be imputed when the sale is recognized and be recognized in income as the services are performed over the term of the management contract, and (b) the remaining sales price (i.e., the residual) be attributed to the sale of the property. While the property management fee revenue continues to be recognized over the service period under Topic 606, (a) the imputed value (which represents the present value of the market rate of the services) likely will differ from the allocated transaction price (based on relative stand-alone selling prices under paragraph 606-10-32-29), and (b) Topic 606 requires the seller to gross-up the revenue amount and recognize interest expense if the financing component associated with the prepayment of the management services is significant to the contract (see **Question 3.3** for additional discussion).

EXAMPLE 4.1: Sale of Property with Property Ongoing Management Services

Description of the Arrangement

ABC Corp. sells a hotel with a carrying amount of $1,500,000 to a customer and agrees to manage the hotel for three years for total consideration of $2,000,000 payable in cash upon closing of the sale of the hotel. The estimated stand-alone selling price of the hotel and the management services are $1,800,000 and $100,000 per year, respectively. Assume (a) the customer makes no ongoing payments for the services, (b) the financing component is determined to be not significant to the contract[5], and (c) the criteria for allocating the overall discount entirely to one of the performance obligations are not met (see paragraph 606-10-32-37).

Evaluation

The total transaction price of $2,000,000 is allocated to the two separate performance obligations based on relative stand-alone selling prices:

Combined stand-alone selling price: $2,100,000 = $1,800,000 (property stand-alone selling price) + $300,000 (property management services stand-alone selling price at $100,000 each year for 3 years)

Property relative stand-alone selling price = $1,800,000 ÷ $2,100,000 × $2,000,000 = $1,714,286

Property management services relative stand-alone selling price = $300,000 ÷ $2,100,000 × $2,000,000 = $285,714

Profit of $214,286 is recognized when control of the property is transferred ($1,714,286 – $1,500,000) and $285,714 of property management service fee revenue is recognized over the three-year service period as the performance obligation is satisfied.

If the arrangement instead also provided for ongoing payments of $10,000 per year for the property management services, the process for allocating the total transaction price of $2,030,000 ($2,000,000 payable at closing + $30,000 in ongoing payments of $10,000 per year for three years) would follow the same approach as illustrated above (similarly assuming the financing component is not significant to the contract[5] and the discount is not allocated entirely to one of the performance obligations):

The total transaction price of $2,030,000 would be allocated to the two separate performance obligations based on relative stand-alone selling prices:

Combined stand-alone selling price: $2,100,000 = $1,800,000 (property stand-alone selling price) + $300,000 (property management services stand-alone selling price at $100,000 each year for 3 years)

Property relative stand-alone selling price = $1,800,000 ÷ $2,100,000 × $2,030,000 = $1,740,000

Property management services relative stand-alone selling price = $300,000 ÷ $2,100,000 × $2,030,000 = $290,000

Profit of $240,000 is recognized when control of the property is transferred ($1,740,000 – $1,500,000) and $290,000 of property management service fee revenue is recognized over the three-year service period as the performance obligation is satisfied.

[5] See Example 3.2 for an illustration of the accounting if the financing component is significant to the contract.

STEP 5: RECOGNIZE REVENUE

Question 5.1: At what point does control typically transfer in a real estate sale where the performance obligation is only the transfer of property?

Answer 5.1: Paragraph 606-10-25-23 states an entity recognizes revenue when it satisfies a performance obligation by transferring control of the good or service to the customer. An asset is considered "transferred" when or as the customer obtains control of the asset. Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Paragraph 606-10-25-24 requires an entity to determine at contract inception whether it satisfies the performance obligation over time or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A performance obligation to deliver a single asset (or group of assets) on a single settlement date is typically satisfied at a point in time because none of the paragraph 606-10-25-27 criteria are met and there is no progress to measure.

For performance obligations satisfied at a point in time, paragraph 606-10-25-30 provides the following indicators that control has 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

We believe in the context of property sales in the U.S., the guidance generally suggests that control transfers at closing, as the closing date is the point in time when most of the above factors typically are met. The Board reached a view consistent with this when it addressed the issue of control transfer in real estate transactions within the scope of ASU 2011-10, *Derecognition of In Substance Real-Estate:*

> BC10. Therefore, an entity would look to the definition and indicators of control in the proposed revenue recognition guidance to determine when the counterparty to the transaction obtains control of the asset (that is, real estate) and when to derecognize the real estate. Under the proposed revenue recognition guidance, indicators that the customer has obtained control of a good or service include, among others, the fact that the customer has legal title and physical possession.

While transfer of control often occurs at closing, the seller needs to consider the facts and circumstances of the particular transaction. **Question 5.5** addresses a situation where we believe control may transfer before closing.

The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-7 states:

> A sale shall not be considered consummated until all of the following conditions are met:
>
> a. The parties are bound by the terms of a contract.
>
> b. All consideration has been exchanged.
>
> c. Any permanent financing for which the seller is responsible has been arranged.
>
> d. All conditions precedent to closing have been performed. Paragraph 360-20-40-28 provides an exception to this requirement if the seller is constructing office buildings, condominiums, shopping centers, or similar structures.

Usually, those four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a pre-closing.

We believe the conditions required to support consummation of a sale under Subtopic 360-20 are similar to the indicators of the point in time when control transfers under Topic 606. However, Subtopic 360-20 prevents derecognition even when a sale is consummated in certain circumstances (e.g., when the initial and continuing investment requirements are not met or when certain types of continuing involvement are present suggesting that the risks and rewards of ownership have not transferred) whereas Topic 606 requires revenue recognition (and therefore derecognition) at the point in time control transfers (which is based on *indicators*, not *criteria*) as long as a contract exists. Consequently, derecognition under Topic 606 may occur at an earlier point than under Subtopic 360-20. See **Question 1.1** for additional discussion on how initial and continuing investments are considered in determining the timing of derecognition under Topic 606.

Note also that Topic 606 does not provide an exception for a seller constructing office buildings, condominiums, shopping centers, or similar structures (like paragraph 360-20-40-7(d) above). See **Question 5.4** for additional discussion of when control of a condominium unit (or similar structure) transfers under Topic 606.

Question 5.2: When does control typically transfer in a real estate construction contract (e.g., for the development of property improvements such as a building, infrastructure, or amenities on land owned by the customer) where the contract represents a single performance obligation for the construction services?

Answer 5.2: Paragraph 606-10-25-23 states an entity recognizes revenue when it satisfies a performance obligation by transferring control of the good or service to the customer. An asset or service is considered "transferred" when or as the customer obtains control of the asset. Paragraph 606-10-25-24 requires an entity to determine at contract inception whether it satisfies the performance obligation over time or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

Under paragraph 606-10-25-27, an entity transfers control of a good or service over time if at least one of the following criteria are met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

This criterion primarily is applicable to traditional service contracts (e.g., property management services) where the customer is benefitting on a periodic basis as the entity performs (e.g., as the property is being managed) as opposed to service contracts where an asset is being constructed or enhanced on the customer's behalf. When a customer's asset is being constructed or enhanced, further analysis is necessary under criterion (b) (and criterion (c) below if criterion (b) is not met).

b. 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; or

We believe this criterion generally will be met in a real estate construction contract when the customer owns the underlying land and takes control of the property improvements as construction progresses. In that case, the customer generally is able to direct the use of, and obtain substantially all of the remaining benefits from, those improvements during construction. In considering the benefits of an asset identified in paragraph 606-10-25-25, we note that generally during the construction period, the customer is able to use the property improvements to enhance the value of other assets (e.g., the land the customer owns on which the improvements are built), sell or exchange the property (including the partially completed improvements), and pledge the property (with the partially completed improvements) to secure a loan. This presumes the customer controls and holds legal title to the land on which the improvements are being constructed; however, a similar analysis may apply if the customer is leasing the underlying land but owns the property improvements. A developer will not meet this criterion, however, if it (as opposed to the customer) controls the property and/or the improvements until construction is complete. This may occur in constructing condominium units (or similar structures). See **Question 5.4** for additional discussion.

c. 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.

While only one criterion in paragraph 606-10-25-27 needs to be met in order to conclude a performance obligation is satisfied over time, we believe this criterion may also be met in a real estate construction contract provided the customer owns the underlying land and takes control of the property improvements as construction progresses because the developer's performance generally does not create an asset with alternative use to the developer. This is the case because the property improvements being constructed (e.g., building, infrastructure, or amenities) generally are controlled by the customer (and are affixed to land controlled by the customer) and therefore the developer generally is legally and practically prohibited from directing the improvements for any other use (as discussed in paragraph 606-10-25-28).

However, in order to meet this criterion, the developer also must have an enforceable right to payment for performance completed to date (which often is the case when a contract requires periodic payments as construction progresses).

If at least one of the criteria in paragraph 606-10-25-27 is met, revenue on the construction services performance obligation is recognized over time as satisfying the performance obligation progresses.

The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Contractors currently apply either the percentage-of-completion method or the completed-contract method under paragraph 605-35-25-1. Use of Subtopic 605-35's percentage-of-completion method depends on the ability to make reliable estimates of the extent of progress toward completion, contract revenues and contract costs and generally is considered the preferable method since contractors are expected to be able to reliably make such estimates (see paragraph 605-35-25-57).

The percentage-of-completion method recognizes income as work on a contract progresses. There are two different approaches for determining the amount of periodic revenue to recognize under paragraphs 605-35-25-82 through 25-84. One approach (Method A) is to multiply the total estimated contract revenue by the percentage of completion (based on an input or output measure; see paragraphs 605-35-25-70 through 25-81) and subtract from it the revenue recognized in prior periods. The other approach (Method B) is to add the periodic gross profit to the costs incurred during the period. The periodic gross profit under this method is computed by multiplying the total estimated gross profit by the percentage of completion and subtracting from it the gross profit recognized in prior periods. If an entity is using the cost-to-cost method for measuring progress (see paragraph 605-35-25-79 through 25-81), it generally will arrive at substantially the same periodic revenue recognition under either approach.

Topic 606 does not allow an entity to elect an accounting policy for its pattern of revenue recognition. Revenue for performance obligations meeting one of the criteria in paragraph 606-10-25-27 is recognized over time using the pattern that best depicts the entity's satisfaction of its performance obligation, so if a contractor had historically been accounting for those contracts under the completed-contract method, the change to Topic 606's over-time revenue recognition will be significant. If the contractor had been using the percentage-of-completion method, the effect of transitioning to Topic 606 on its pattern of revenue recognition will, in part, depend on whether it meets the over time criteria in Topic 606, how it measures its progress currently, and whether it currently uses Method A or Method B (which is not permissible under Topic 606). For example, a contractor using the cost-to-cost method to measure progress under Topic 606 may arrive at a similar revenue and gross profit recognition pattern for its contracts satisfied over time if it had historically used a cost-to-cost measure while a contractor using a measure other than cost-to-cost and historically using Method B above may not because Topics 606 and 340 de-link the accounting for contract revenue and contract costs (so there may not always be a constant profit margin).

Question 5.3: When does control typically transfer in a property sale with an accompanying construction contract (e.g., for the development of property improvements such as a building, infrastructure, amenities, etc.)?

Answer 5.3: As discussed in **Question 2.2**, a seller/developer first needs to determine whether the contract contains one or two performance obligations.

If the property sale and the construction services are two performance obligations, the transaction price is allocated based on relative stand-alone selling prices and each performance obligation is evaluated to determine whether revenue is recognized over time or at a point in time. As discussed in **Question 5.1**, control of property often transfers at a point in time and as discussed in **Question 5.2**, construction services (as a stand-alone performance obligation) are often, but not always, satisfied over time.

If the property sale and the construction contract comprise a single performance obligation, the entity will need to analyze whether the single performance obligation is satisfied at a point in time (e.g., upon delivery of the completed property, including improvements) or over time (as title to the land is transferred and construction progresses on the improvements affixed to the customer-owned land). If title to the land transfers to the customer before construction begins and the customer owns the improvements as they are being constructed, we believe the analysis of the over-time criteria relative to the single combined performance obligation may be similar to the analysis in **Question 5.2** (i.e., the contract will often meet the criterion in paragraph 606-10-25-27(b) because the seller/developer's performance creates or enhances an asset that the customer controls as the asset is created or enhanced). When there is just one performance obligation for both the land sale and the construction services, however, the total revenue recognized over time represents the total *transaction price* (including the contract consideration for both elements) and progress toward satisfaction of that single performance obligation is also measured relative to both elements (see Example 5.1).

When there is a single performance obligation and the customer does not hold title to the land or have legal ownership of the improvements affixed to the land as construction progresses (e.g., in some contracts to construct condominium units or similar structures), it may be difficult to conclude the performance obligation is satisfied over time. See additional discussion in **Question 5.4**.

The guidance on control transfer applies to both customer and noncustomer transactions.

EXAMPLE 5.1: Sale of Land with Construction Contract

Description of the Arrangement

ABC Corp. sells land with a carrying amount of $400,000 to DEF Corp. for $1,000,000. Additionally, ABC agrees to build an access road and fitness center for an additional $500,000 (estimated cost of $400,000). Assume the sale of the land and the construction of the access road and fitness center are a single performance obligation (see additional discussion in **Question 2.2**) and DEF obtains the title to the land at closing (before construction of the access road and fitness center begin).

Evaluation

Because the sale of the land and construction of the access road and fitness center are a single performance obligation and ABC's performance (i.e., delivery of title to the land to DEF and the ongoing construction of the improvements on DEF's land) creates and enhances an asset (i.e., the property) that DEF controls as it is created or enhanced, ABC concludes its performance obligation is satisfied over time. ABC uses an input method to recognize revenue on the basis of its efforts toward complete satisfaction of the performance obligation relative to the total expected effort to the satisfaction of that performance obligation.

Using costs incurred to measure its progress, ABC recognizes $750,000 of revenue ($1,500,000 x ($400,000 ÷ $800,000)) and $350,000 (50% × $700,000) of profit at the time of the land sale:

Measure of progress on a cost-to-cost basis: $400,000 (land cost at closing) ÷ $800,000 (total expected costs) = 50%

Total profit: $1,500,000 ($1,000,000 + $500,000) – $800,000 ($400,000 + $400,000 in total costs) = $700,000

The remaining revenue and profit of $750,000 and $350,000, respectively, will be recognized over time as ABC constructs the access road and fitness center.

Question 5.4: Can the seller/developer of a condominium unit (or similar structure) recognize revenue over time as construction of the unit progresses (e.g., on a percentage-of-completion basis) if title to the completed unit does not transfer until construction is completed (see Question 0.6 for discussion of the unit of account for such sales under Topic 606)?

Answer 5.4: In order to recognize revenue over time, at least one of the following criteria (see paragraph 606-10-25-27) must be met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

As discussed in **Question 5.2**, this criterion primarily is applicable to traditional service contracts (e.g., property management services) where the customer is benefitting on a periodic basis as the entity performs (e.g., as the property is being managed) as opposed to service contracts where an asset is being constructed or enhanced on the customer's behalf. When an asset is being constructed or enhanced on a customer's behalf, further analysis is necessary under criterion (b) (and criterion (c) below if criterion (b) is not met).

b. 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; or

In many cases, we believe the buyer of a condominium unit is unable to direct the use of, and obtain substantially all of the remaining benefits from, the unit during construction as title to the real estate typically does not transfer until construction of the unit is complete and the sale closes. When considering the benefits identified in paragraph 606-10-25-25, the buyer generally is unable to use the unit to produce goods or provide services, use the unit to enhance the value of other assets, use the unit to settle liabilities or reduce expenses, sell or exchange the unit, or pledge the unit to secure a loan because it does not hold title to the real estate until the sale closes. Further, the buyer generally does not direct the use of the unit during construction because it does not hold legal title or have physical possession.

c. 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.

Paragraphs 606-140-55-173 through 55-182 illustrate various scenarios where a seller/developer is constructing a unit in a multi-unit residential complex with differing customer payment structures.

The first example (paragraphs 606-10-55-174 through 55-175) presumes the buyer pays a deposit on entering into the contract and the remainder of the contract price is payable upon completion of construction when the buyer obtains physical possession of the unit. If the customer defaults on the contract before completion, the seller/developer only has a right to the deposit amount. In that case, the seller/developer does not have a right to payment for work completed to date so criterion (c) is not met.

The second example (paragraphs 606-10-55-176 through 55-180) presumes the buyer makes progress payments during construction, the contract has substantive terms that preclude the seller/developer from being able to direct the unit to another customer, the contract precludes the buyer from terminating the contract unless the seller/developer does not perform, and if the buyer defaults on its payments, the seller/developer has the right to all of the consideration promised in the contract if it completes the unit. In this fact pattern, the seller/developer concludes criterion (c) is met because (a) the unit does not have an alternative use (i.e., the contract precludes the seller/developer from transferring the unit to another customer – see additional discussion below), and (b) the seller/developer has an enforceable right to payment for performance completed to date (because the buyer must pay all of the consideration promised in the contract if the seller/developer completes the unit). However, paragraph 606-10-55-179 also indicates the legal practices in the particular jurisdiction are relevant in arriving at this conclusion. This is the case because if the contract terms provide for the right to payment for performance completed to date but the legal practices in the particular jurisdiction do not allow for enforcement of that right, criterion (c) would not be met.

The third example (paragraphs 606-10-55-181 through 55-182) presumes the same facts as the previous example except in the event of buyer default, the seller/developer can require the buyer to perform as required under the contract or it can cancel the contract in exchange for retention of the unit under construction and a penalty in proportion to the contract price. In this example, the seller/developer has the right to payment for performance completed to date because it could enforce its right to that payment. This is the case even though the seller/developer also could choose to accept the unit under construction and a penalty instead. That choice does not affect the assessment as long as the seller/developer's right to require the buyer to continue to perform under the contract is enforceable.

It is also important to note that while the examples primarily focus on the right to payment, even if a seller/developer does have the right to payment for performance completed to date (as discussed in examples two and three), a seller/developer still needs to conclude the unit cannot be directed to another buyer either contractually during construction or practically (i.e., without incurring significant economic loss; see paragraph 606-10-55-10) when it is completed (see paragraph 606-10-25-28). We believe in many cases, because buyers of condominium units typically cannot specify major structural changes to the design of the unit, the seller/developer often will be able to practically direct the unit to another buyer after completion. In that case, a substantive contractual restriction during construction would need to be in place to meet this requirement. All facts and circumstances should be considered.

If none of the criteria in paragraph 606-10-25-27 are met for satisfying a performance obligation over time, the performance obligation is satisfied at a point in time and the seller/developer would recognize revenue on the sale of a unit when control transfers to the buyer, generally at closing as discussed in **Question 5.1**. We believe that in the U.S., condominium sales contracts generally are structured similar to example one above, resulting in point in time revenue recognition when control of the completed unit transfers to the buyer at closing.

If the seller/developer has a further obligation to develop an amenity in connection with the sale of the unit (and presumably the undivided interest in the common area), the seller/developer would consider the guidance in **Questions 2.1** and **2.2** on determining whether the arrangement comprises one or two performance obligations and **Question 5.3** on the timing of revenue recognition.

Comparison to Legacy U.S. GAAP

If individual units in condominium projects or time-sharing interests are being sold separately, paragraph 360-20-40-50 requires profit to be recognized by the percentage-of-completion method on the sale of individual units or interests if construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest, sufficient units have already been sold to assure that the entire property will not revert to rental property, sales prices are collectible, and aggregate sales proceeds and costs can be reasonably estimated.

Topic 606 results in a change from Subtopic 360-20. Sellers/developers historically may have applied the percentage-of-completion method, measuring progress on a cost-to-cost basis relative to the project as a whole and applying that measure of progress to the estimated gross profit on an individual unit sold. The unit would be considered "sold" for this purpose if the criteria in paragraph 360-20-40-50 were met (which was typically before closing occurred). Under Topic 606, sellers/developers generally are required to separately account for each contract with an individual customer (unless the entity reasonably expects the effect on the financial statements of using a portfolio (or project) approach not to differ materially from applying the guidance to the individual contracts, which we believe would be difficult to demonstrate as discussed in **Question 0.6**) and will not recognize revenue/profit until (or as) control of the individual unit transfers (which often may not be until the buyer takes possession of the unit at closing).

EXAMPLE 5.2: Sale of a Condominium Unit

Description of the Arrangement

ABC Corp. is developing a condominium building and begins marketing individual units during construction. On January 1, 20X3, ABC enters into a sales contract with two customers to sell one unit to each. Each unit's sales price is $300,000 with an estimated cost of $180,000. Each buyer provides a 5% down-payment. Construction on the building is 50% complete. The buyers are expected to take possession of the units (and settle all remaining consideration) one year later on January 1, 20X4; however, during construction ABC retains control of the building and the improvements. In the event the buyers cancel the contracts, ABC has a right only to the deposit amount.

Evaluation

Because the arrangement does not meet any of the criteria for satisfying a performance obligation over time, ABC recognizes revenue at the point in time control transfers to the buyers, generally when the buyers take possession of the units on January 1, 20X4.

Question 5.5: When does control transfer in a standstill arrangement where the owner of an in substance real estate entity that defaults on nonrecourse debt loses its controlling financial interest in the entity, but the lender chooses to maintain the legal relationship until a buyer can be identified?

Answer 5.5: Paragraph 810-10-40-3B requires an owner/borrower to apply Subtopic 610-20 in evaluating derecognition on the loss of a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is an in substance nonfinancial asset (e.g., in substance real estate) because of a default by the subsidiary on its nonrecourse debt. The deconsolidation guidance in Subtopic 810-10 does not apply to those transactions.

The owner/borrower looks to the indicators of control in Topic 606 to determine when the lender obtains "control" (i.e., the ability to direct the use and obtain substantially all of the remaining benefits) of the real estate. As the over-time criteria generally would not be met, an entity would need to determine the point in time the customer (the lender in this situation) obtains control of the asset. Paragraph 606-10-25-30 provides the following indicators to determine the point in time that control has transferred to the customer:

- 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

Although the lender is the only party with the legal right to benefit from changes in the fair value of the property because it often has right to the ongoing cash flow of the property to service the debt (suggesting it has the significant risks and rewards of ownership which is one of the indicators that control has transferred), and the power to direct the activities that most significantly affect the property's economic performance, the owner/borrower retains legal title and physical possession. While the transfer of legal title and physical possession generally are key indicators of control in the context of real estate sale transactions (see **Question 5.1**), we believe further analysis is necessary under these circumstances. Paragraph 606-10-25-30(c) states that physical possession may not coincide with control of an asset, for example, in some repurchase or consignment arrangements (where the customer has physical possession but the seller has control) and in some bill-and-hold transactions (where the seller has physical possession but the customer controls). Specifically, paragraph 606-10-55-83 states that for a customer (or lender in this situation) to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria should be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

We believe in many standstill arrangements, all of the above criteria will be met, resulting in the conclusion that the lender would be deemed to have control even though the borrower maintains physical possession. In consideration of the last criterion, while the borrower continues to operate the property during the standstill period (and therefore arguably "uses" it), the lender may have the right to receive as debt service payments substantially all of the cash flows arising from the property's operations. In addition, the borrower generally does not have the ability to sell the property to another party, or otherwise have the power to direct the activities that most significantly affect the property's economic performance (as determined by the application of Subtopic 810-10).

We believe the control analysis during the standstill period also is similar to the analysis performed when there is a repurchase option in place as discussed in paragraphs 606-10-55-66 through 55-71. That guidance indicates that the holder of an option to acquire the asset (the lender in this situation) may presently control the asset even though the other party has physical possession.

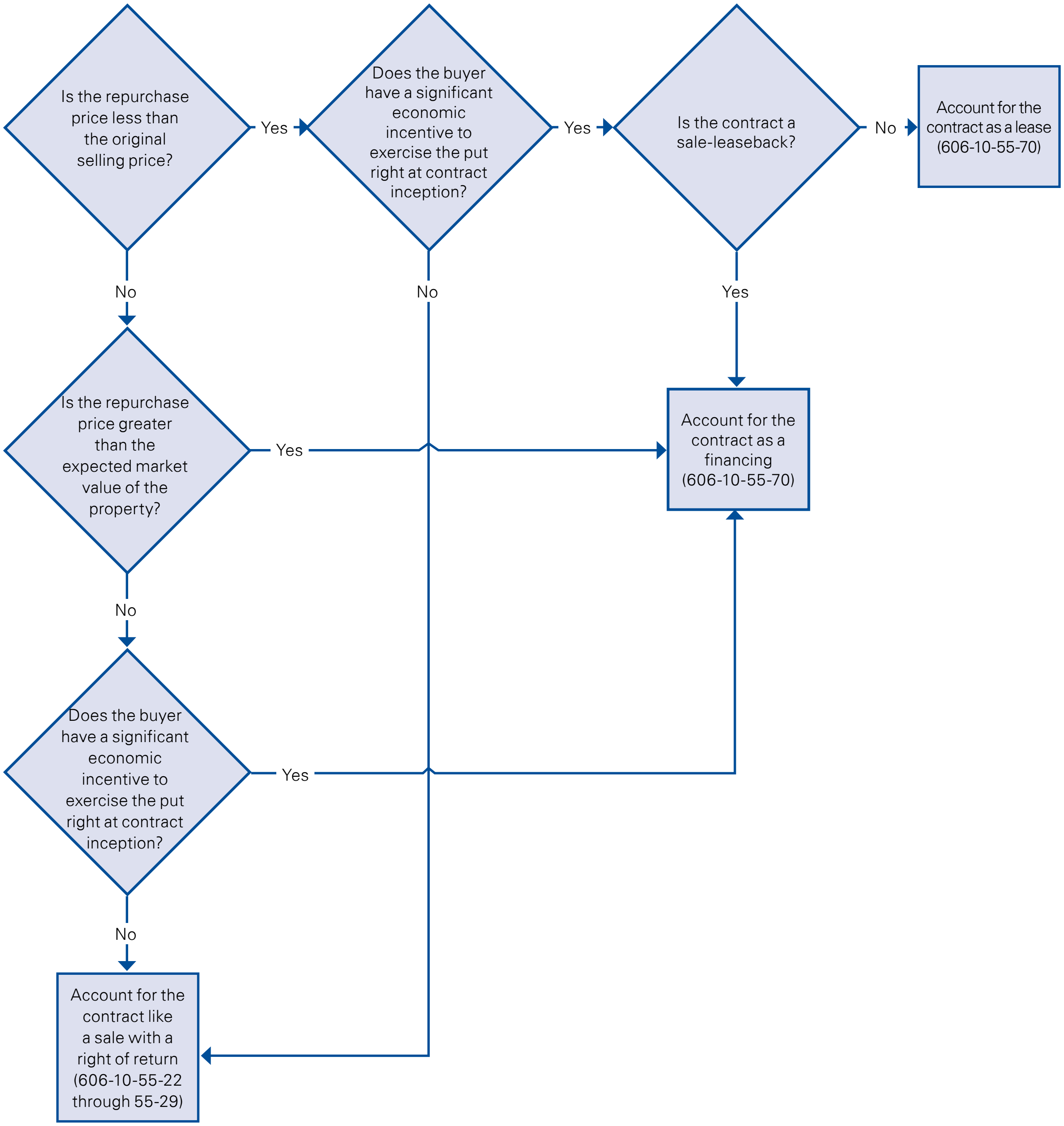
Comparison to Legacy U.S. GAAP

Paragraph 360-20-15-3(f) indicates the loss of a controlling financial interest in a subsidiary that is in substance real estate because of a default by the subsidiary on its nonrecourse debt is evaluated using the guidance applicable to the derecognition of real estate as opposed to the deconsolidation guidance under Subtopic 810-10. This scope-out from Subtopic 810-10 has been retained in the amendments made to paragraph 810-10-40-3B for subsidiaries that are in substance real estate and additionally has been broadened to all such transactions that involve nonfinancial assets and in substance nonfinancial assets. However, rather than those transactions being subject to Subtopic 360-20, they now are subject to Subtopic 610-20.

While these transactions remain subject to the derecognition guidance applicable to transfers of nonfinancial assets/in substance nonfinancial assets, the application of the new guidance differs from the existing guidance in Subtopic 360-20. Derecognition of the asset occurs under Subtopics 610-20/606-10 when *control* of the asset transfers, which may occur before derecognition under Subtopic 360-20.

Question 5.6: Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller provides the buyer with an option to put the property back to the seller?

Answer 5.6: Paragraphs 606-10-55-72 through 55-78 provide guidance on accounting for a seller's obligation to repurchase a property at the buyer's request (a put option). The accounting for these transactions generally depends on the relationships between the repurchase price, the original selling price and the market value of the property. The analysis is as follows:



To determine whether the buyer has a significant economic incentive to exercise its put right, the seller considers the facts and circumstances including the relationship of the repurchase price to the expected market value of the property at the date of the repurchase (including consideration of the time value of money) and the amount of time until the right expires. If the repurchase price is expected to significantly exceed the market value of the property, this may indicate the customer has a significant economic incentive to exercise the put option.

If the seller accounts for the contract as a financing arrangement under paragraph 606-10-55-70, it continues to recognize the property and also recognizes a financial liability initially equal to the consideration received from the buyer. The seller recognizes amounts paid to the buyer over that amount as interest expense (see paragraphs 606-10-55-70 and 55-71). If the option lapses unexercised, the seller derecognizes the property and the liability and recognizes revenue (or gain) at that time.

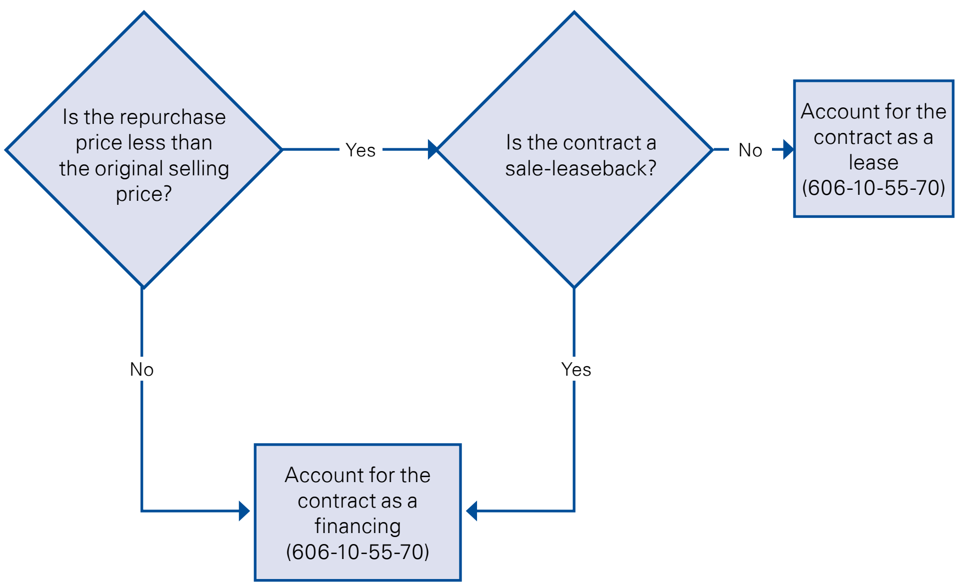
The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-38 requires a sale of real estate to be accounted for as a financing, leasing, or profit-sharing arrangement any time the seller has an obligation to repurchase the property. Topic 606 results in a change for transactions with a put option when either (a) the repurchase price is lower than the original selling price of the property and the buyer does not have a significant economic incentive to exercise its option, or (b) the repurchase price is greater than or equal to the original selling price of the property but less than or equal to the expected market value of the property, and the buyer does not have a significant economic incentive to exercise its option. In these two circumstances, Topic 606 requires the seller to account for the put option as a right of return, which does not affect revenue recognition unless the property is expected to be returned. In other circumstances, while Subtopic 360-20 and Topic 606 both may result in lease or financing accounting, there is no option under Topic 606 to apply a profit-sharing model.

Question 5.7: Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller obtains the right to repurchase the property?

Answer 5.7: Paragraphs 606-10-55-68 through 55-71 provide guidance on accounting for a seller's right to repurchase a property (a call option). A seller's right under a call option (or obligation under a forward agreement) to repurchase the property precludes transfer of control to the buyer because the buyer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the property even though it may have physical possession of the property. Whether the contract is accounted for as a lease or a financing depends on the relationship between the repurchase price and the original selling price. The analysis is as follows:



While an option to repurchase the property at fair value arguably allows the buyer to obtain substantially all of the remaining benefits from the property, it limits the buyer's ability to direct the use of the asset. Accordingly, we believe sales subject to a seller's call option exercisable at fair value are accounted for as a leasing or financing arrangement depending on the expectation of the property's fair value over the option period relative to the original selling price. We expect these transactions generally will be accounted for as financing arrangements.

This guidance applies to both conditional and unconditional rights and does not permit or require an assessment of the probability that a conditional right will become unconditional. However, we believe if the condition that makes the right exercisable is controlled by the buyer (e.g., in an anti-speculation clause whereby the seller is provided the right to repurchase the property if the buyer fails to comply with certain provisions of the sales contract), then a seller generally considers whether the customer has the economic incentive to trigger the seller's right to repurchase (similar to the analysis described in paragraphs 606-10-55-72 through 55-78 on evaluating customer put options). As discussed in **Question 5.6**, if the buyer has an economic incentive not to comply with the contract (and therefore trigger the seller's right to repurchase the asset), or there is greater than a remote likelihood the buyer will not comply for other reasons notwithstanding its ability to comply with the contract, the contract is accounted for as a lease or a financing arrangement depending on the relationship between the repurchase price and the original selling price as previously discussed. If the buyer does not have a significant economic incentive to trigger the seller's right to repurchase the asset and it is remote that the buyer would trigger the seller's repurchase right for other reasons, the seller follows the guidance on sales with a right of return under paragraphs 606-10-55-22 through 55-29 (revenue is not recognized if the property is expected to be returned).

Comparison to Legacy U.S. GAAP

Because paragraph 360-20-40-38 requires a sale of real estate to be accounted for as a financing, leasing, or profit-sharing arrangement if the seller has a right to repurchase the property (except for anti-speculation clauses, see below), Topic 606 does not substantially change the accounting for these transactions, except there is no option under Topic 606 to apply a profit-sharing model.

Specifically with respect to anti-speculation clauses, paragraph 360-20-40-39 states:

> Land sale agreements sometimes contain anti-speculation clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Anti-speculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of the sales contract, the seller has the right, but not the obligation, to reacquire the property. The seller's contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. A number of factors might lead one to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. A probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

Accordingly, we believe Topic 606 does not substantially change the accounting for transactions with anti-speculation clauses, provided the buyer does not have a significant economic incentive to trigger the seller's repurchase right and it is remote the buyer will trigger the seller's repurchase right for other reasons.

Question 5.8: Is a right of first refusal (or a right of first offer) considered an obligation or right to repurchase the property?

Answer 5.8: We do not believe a right of first refusal based on a bona fide offer by a third party constitutes an obligation or right to repurchase the property because the buyer can act in its best interest and is not economically or contractually compelled to accept the offer from a seller (and therefore has the ability to direct the use of and obtain substantially all of the remaining benefits from the property).

We believe a similar conclusion applies to a right of first offer (which allows the seller to make an offer to the buyer before the buyer solicits or receives offers from third parties) as long as the buyer can act in its best interest and is not economically or contractually compelled to accept the offer and the seller is not economically compelled to make an offer.

The guidance applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-38 (and paragraph 840-40-25-13 in the context of sale-leaseback transactions) indicates a right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. Accordingly, we do not believe there will be any change to the accounting for rights of first refusal or rights of first offer in real estate sale contracts under Topic 606.

Question 5.9: How should a seller evaluate transfer of control in the context of a partial sale; for example, on the sale of less than 100% of the seller's ownership interest in an entity considered an in substance nonfinancial asset (see Question 0.2 for discussion of which sales of ownership interests in real estate entities are within the scope of Subtopics 610-20/606-10 versus Subtopic 810-10)?

Answer 5.9: Partial sales of real estate typically occur in the following ways:

a. A seller contributes a wholly-owned property (or an interest in a real estate entity considered an in substance real estate/in substance nonfinancial asset) to a newly formed venture and simultaneously receives cash from a third party to buy a partial ownership interest in that newly formed venture. The cash may come directly from the third party to the seller or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a *controlling* interest in the venture post-sale and no interest in the third party.

b. Same facts as (a) except the seller retains only a *noncontrolling* interest in the venture post-sale and no interest in the third party.

c. A seller contributes a wholly-owned property (or an interest in a real estate entity considered an in substance real estate/in substance nonfinancial asset) to a newly formed, wholly-owned venture. Sometime later, it sells a partial ownership interest in the venture to a third party for cash. The cash may come directly from the third party to the seller or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a *controlling* interest in the venture post-sale and no interest in the third party.

d. Same facts as (c) except the seller retains only a *noncontrolling* interest in the venture post-sale and no interest in the third party.

Paragraph 970-323-30-3 states an investor contributing real estate to a venture must record its investment in the venture at the cost of the contributed real estate (with no profit recognition) regardless of what other investors may contribute to the same venture because this transaction is a contribution of capital. However, the guidance also states that sometimes these equity contributions are in substance sales because the seller withdraws the other investors' contributed cash from the venture (to compensate it for the sale of the partial interest) and it has no commitment to reinvest that cash. In those cases, the seller should look to the revenue recognition guidance to determine if revenue/profit recognition is appropriate (Topic 606 for customer transactions or Subtopic 610-20 (via 360-10-40-3A through 40-3C) for noncustomer transactions). Paragraph 970-323-30-3 includes an example of an in substance sale where the seller receives cash for a 50% interest in the venture and accounts for transaction as a sale of 50% of its interest to the third party.

Currently, there are alternative views on how to apply the revenue recognition guidance in these circumstances. While the seller is selling a partial ownership interest in the venture (and may be transferring control of that equity interest, as control is defined in Topic 606), it may or may not be giving up control of the underlying property (because it may continue to consolidate the venture under Subtopic 810-10, and therefore continue to recognize the property in its consolidated financial statements post-sale).

One view (View A) is the control transfer provisions of Topic 606 apply to the partial ownership interest sold without regard to whether the seller retains a controlling financial interest in the venture. Proponents of View A cite (a) paragraph 970-323-40-1, which indicates a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and should be evaluated under the same guidance applicable to any other sale of real estate, and (2) paragraph 970-323-30-3, which includes the example that presumes partial profit recognition without specific consideration of whether the venture continues to be consolidated by the seller.

Under View A, all the scenarios described above ((a) through (d)) are accounted for similarly. The initial contribution of the real estate (or in substance real estate) results in no immediate profit recognition, but when the partial ownership interest is sold for cash (either simultaneously or sometime later), the seller applies Topic 606's control transfer principles relative to the partial ownership interest without regard to whether it retains a controlling financial interest in the venture. When (or as) control of the partial ownership interest is transferred, the seller recognizes profit equal to the *transaction price* received from the third party (i.e., the buyer of the partial ownership interest) minus the carrying amount of the partial interest sold. Opponents of View A believe the seller's unit of account when considering the application of Topic 606 (or Subtopic 610-20) to a sale of real estate is the asset that the seller controls before the transaction. If the seller controls the entire underlying property, opponents of View A believe the buyer must obtain control of the entire underlying property for the seller to recognize a sale. If the seller has a noncontrolling interest in an entity that holds the underlying property, opponents of View A believe the buyer must obtain control of the seller's entire noncontrolling interest for the seller to recognize a sale.

A second view (View B) is that the control transfer provisions of Topic 606 apply to the partial ownership interest sold, but only if the seller no longer retains a controlling financial interest in the venture. Proponents of View B cite paragraph 970-323-35-15, which states that a sale of property in which the seller holds or acquires an equity interest in the buyer results in recognizing only the part of the profit proportionate to the outside interest in the buyer and *no profit is recognized if the seller controls the buyer until it is realized from transactions with outside parties through sale or operations of the property* (emphasis added). Proponents of View B interpret this paragraph's reference to the "buyer" to be the venture so no immediate profit can be recognized when the seller retains a controlling financial interest in the venture (i.e., in scenarios (a) and (c) above, profit would be deferred until realized through sale or operations of the underlying real estate). Proponents of View B also observe its consistency with the guidance in paragraph 805-30-30-8, which precludes profit recognition on the transfer of a nonfinancial asset in exchange for a controlling financial interest in the transferee in a business combination (on the basis that the transferor/acquirer has control of the transferred asset before and after transfer/acquisition). Opponents of View B believe paragraph 970-323-35-15's reference to the "buyer" means the buyer of the partial interest (i.e., the third party) because the guidance in paragraphs 970-323-40-1 and 30-3 imply the partial interest is the asset being sold, not the underlying real estate.

A third view (View C) is that the seller must relinquish its controlling financial interest in the venture under Subtopic 810-10 in order to recognize profit. Unlike View B though, upon loss of the controlling financial interest in the venture, the seller treats the fair value of its retained interest like consideration received and recognizes 100% profit at the sale date and the retained interest at fair value (versus only partial profit for the portion sold under View B). Alternatively, if the seller retains control (sells a noncontrolling interest), no profit is recognized and the difference between the consideration received and the amount by which the noncontrolling interest needs to be adjusted is recorded in additional paid-in capital (versus a deferred profit on the partial interest sold under View B). Opponents of both Views B and C argue (a) these transactions are specifically outside the scope of Subtopic 810-10 and therefore continued consolidation of the venture is not relevant, and (b) prohibiting immediate profit recognition because the seller has not relinquished its controlling financial interest in the venture conflicts with the partial profit recognition language in paragraphs 970-323-30-3 and 35-15.

A fourth view (View D) is that the control transfer provisions of Topic 606 apply to the underlying real estate (or in substance real estate). Under View D, the seller recognizes no profit unless/until the third party can direct the use and obtain substantially all of the remaining benefits of the underlying property. While the total amount of profit under this view may the same as the amount recognized under View C, that profit recognition may be delayed even beyond deconsolidation of the venture because the seller could lose its controlling financial interest in the venture (as described in Subtopic 810-10) before the third party can *direct* the use and obtain *substantially all* of the remaining benefits of the property under Topic 606. Opponents believe View D conflicts with the partial profit recognition language in paragraphs 970-323-30-3 and 35-15.

The following table summarizes the results of applying each of the views above assuming the seller owns 100% of the real estate venture before the transaction and 60% after (sale of 40%), the *transaction price* (equal to the fair value of the 40% interest) is $120, and the carrying amount of the seller's 100% interest at the time of sale is $100. The seller continues to consolidate the venture post-transaction.

View	Profit at Sale Date	Notes
A	**$80** = $120 – ($100 × 40%)	Immediate profit recognition on the partial interest sold
B	**$0**	No immediate profit recognition because the seller retains a controlling financial interest; gain of $80 is deferred until realized through third-party sale of the property or operations
C	**$0**	No immediate profit recognition because the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of $80
D	**$0**	No immediate profit recognition because the buyer does not have *control* (i.e., *substantially all* of the remaining benefits) of the underlying property and the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of $80

The following table summarizes the results of applying each of the views above assuming the seller owns 100% of the real estate venture before the transaction and 40% after (sale of 60%), the *transaction price* (equal to the fair value of the 60% interest) is $180, and the carrying amount of the seller's 100% interest at the time of sale is $100. The seller holds only a noncontrolling interest post-transaction.

View	Profit at Sale Date	Notes
A	**$120** = $180 – ($100 × 60%)	Immediate profit recognition on the partial interest sold; retained interest accounted for under the equity method
B	**$120** = $180 – ($100 × 60%)	Immediate profit recognition on the partial interest sold because seller no longer holds a controlling financial interest; retained interest accounted for under the equity method
C	**$200** = ($180 ÷ 60%)[3] – $100	Immediate profit recognition based on a sale of the entire 100% interest with the fair value of the 40% retained interest treated as consideration received; retained interest accounted for under the equity method
D	**$0**	No immediate profit recognition because the buyer does not have *control* (i.e., *substantially all* of the remaining benefits) of the underlying property; seller continues to recognize the property and recognizes a liability for any cash or other assets received.

[3] This calculation results in the implied fair value of a 100% interest. If the fair value of a 60% interest is $180, the implied fair value of the 100% interest is $180 ÷ 60%, or $300.

This issue is expected to be addressed in the FASB's project on clarifying the definition of a business. That project is intended to clarify the definition of a business with the objective of addressing whether transactions involving in substance nonfinancial assets (held directly or in a subsidiary) should be accounted for as acquisitions (or disposals) of nonfinancial assets or as acquisitions (or disposals) of businesses. The project will include clarifying the guidance for partial sales or transfers and the corresponding acquisition of partial interests in a nonfinancial asset or assets. Until the Board reaches conclusions on this project, there may be diversity in practice on this issue.

We believe the accounting for these transactions would be the same regardless of whether the third party is a customer or a noncustomer.

Question 5.10: Does the guidance on partial sales discussed in Question 5.9 apply when the venture owns operating real estate that meets the definition of a *business*?

Answer 5.10: Generally yes, because an ownership interest in a venture owning operating real estate often is an in substance nonfinancial asset even if it also meets the definition of a *business*. As discussed in **Question 0.2**, land plus property improvements and integral equipment collectively are considered "in substance real estate," so sales of those assets are accounted for under Subtopic 610-20 (or Topic 606 if the sale is to a customer, via the guidance in Section 360-10-40) even if all (or part) of the operations of the property otherwise meet the definition of a business for which derecognition would normally be accounted for under Subtopic 810-10 (paragraphs 810-10-40-3A and 810-10-45-21A exclude the transfer of in substance nonfinancial assets from Subtopic 810-10's guidance on accounting for the deconsolidation, and decrease in ownership, of a subsidiary/business).

If the interest in the venture is **not** considered an in substance nonfinancial asset and the venture is a business (after considering the guidance in **Question 0.2**), partial sales are accounted for under Subtopic 810-10 (illustrated as View C in **Question 5.9**), resulting in 100% profit recognition when the seller no longer consolidates post-transaction and $0 profit recognition when the seller continues to consolidate post-transaction.

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-46 through 40-49 define a sale as a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. Profit equal to the difference between the sales value and the proportionate cost of the partial interest sold is recognized if the buyer is independent of the seller, collection of the sales price is reasonably assured and the seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest. If these conditions are not met and:

- Collection of the sales price is not reasonably assured, the seller applies the cost recovery or installment method of recognizing profit.
- The buyer is not independent of the seller (for example, if the seller holds or acquires an equity interest in the buyer), the seller recognizes the part of the profit proportionate to the outside interests in the buyer at the date of sale.
- The seller controls the buyer, no profit on the sale is recognized until it is realized from transactions with outside parties through sale or operations of the property.
- The seller is required to support the operations of the property after the sale, the accounting is based on the nature of the support obligation.

Paragraphs 970-323-30-3, 35-15 and 40-1 also illustrate/address partial sales where (a) the buyer is not independent of the seller because it holds or acquires an equity interest in the buyer, and (b) the seller controls the buyer.

While the scope of Subtopic 360-20 (as amended by the new standard) has been limited to sale-leasebacks of real estate (and therefore paragraphs 360-20-40-46 through 40-49 no longer apply to partial sales of real estate that do not involve leasebacks), few substantive amendments were made to paragraphs 970-323-30-3, 35-15 and 40-1. As discussed above, one potential interpretation of this is that similar to current U.S. GAAP, Topic 606 (or Subtopic 610-20) requires profit recognition on at least some partial sale transactions when/as the seller transfers control of the partial interest itself (with the profit equal to the difference between the transaction price and the carrying amount of the partial interest sold). However, it is unclear whether all partial sales will be accounted for similarly.

Currently there is some diversity in practice in the accounting for the sale of a noncontrolling interest in a real estate venture when the seller retains a controlling interest in the venture. Many sellers do not recognize a sale or immediate profit in such transactions, but some sellers recognize those transactions as partial sales with partial profit recognition. Under the new guidance, diversity is likely to increase as the interaction between the revenue standard and the deconsolidation guidance in Subtopic 810-10 is less clear. Potential views are described in **Question 5.9**. We understand the FASB is considering these issues, among others, in its project on clarifying the definition of a business; however, the timing of completion of that project is unclear.

Question 5.11: Is a "buy-sell" clause allowing either of the investors to make an offer to acquire the other investor's interest in an entity that holds real estate considered an obligation or right to repurchase the property from the perspective of the investor that sold the real estate to the entity?

Answer 5.11: Frequently, in order to facilitate a partial sale transaction, a seller will contribute property to a newly-formed entity and a third-party will contribute cash so that the seller can take a simultaneous cash distribution for the sale to that third party of an ownership interest in the entity. A contractual buy-sell clause may be included in the terms of the sale that enables both investors in the jointly-owned entity to offer to buy the other investor's interest. In some cases, a buy-sell clause may be executed at any time; in other cases, only at a specified future date or if specified circumstances arise. When an offer is made under the buy-sell clause, the recipient of the offer can elect to sell its interest for the offered amount or buy the offeror's interest at the offered amount. Generally, once an offer is made, the offeror is contractually required to buy the other investor's interest or sell its interest at the offered amount, depending on the other investor's election. A buy-sell clause can specify that the offer be at fair value, at a contractually specified amount, or at an amount determined by the offeror.

We do not believe a buy-sell clause, in and of itself, precludes the buyer from obtaining control unless it gives the buyer an in substance option to put its interest back to the seller or gives the seller an in substance option to acquire the buyer's interest in the property. If the buy-sell clause is an in substance put or call option, the guidance in **Questions 5.6** and **5.7** is applied.

A buy-sell clause may be considered an in substance option in circumstances where the buyer cannot act independently from the seller or the seller is economically compelled to reacquire the other investor's interest in the jointly owned entity (thereby reacquiring the property) as those circumstances suggest that the buyer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the property are limited. We believe the following indicators (which are not meant to be all-inclusive) may suggest the buyer has not obtained control:

a. The price specified in the buy-sell agreement indicates that the parties have already negotiated for the seller to acquire the buyer's interest (e.g., the fixed-price specified in the buy-sell clause relative to the fair value of the buyer's interest economically compels the seller to acquire the buyer's interest or economically compels the buyer to sell its interest to the seller).

b. The seller has a strategic necessity or an investment strategy that indicates that it cannot relinquish its ownership rights to the buyer and therefore the seller is compelled to reacquire full ownership of the real estate.

c. The seller has arrangements with the jointly owned entity, such as management or third-party leasing arrangements, that may economically compel the seller to reacquire the real estate to retain the economic benefits (e.g., leasing commissions from lessees) or escape the negative economic consequences (e.g., a below-market contract with the entity) of such arrangements.

d. Tax implications economically compel the seller to acquire the buyer's interest in the entity (thereby reacquiring the real estate).

e. Tax implications economically compel the buyer to sell its interest in the entity to the seller.

f. The buyer is financially unable to acquire the seller's interest. A requirement for an appraisal or for the offer price to be at fair value may provide protection to the buyer in these circumstances and provide evidence that the buyer is financially unable to acquire the seller's interest. However, a requirement for an appraisal may not be evidence of compulsion in other situations.

g. The buy-sell clause stipulates a specified rate of return to the buyer (or seller), indicating that the buyer may not fully participate in the rewards of ownership from the real estate.

h. The buyer has a strategic necessity or an investment strategy that requires it to sell its interest to the seller.

i. The buyer is legally restricted from acquiring the seller's interest.

j. The real estate is integrated into the seller's business, so that the buyer does not have alternative means available, such as sale to an independent third party, to realize its economic interest.

We believe this guidance applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

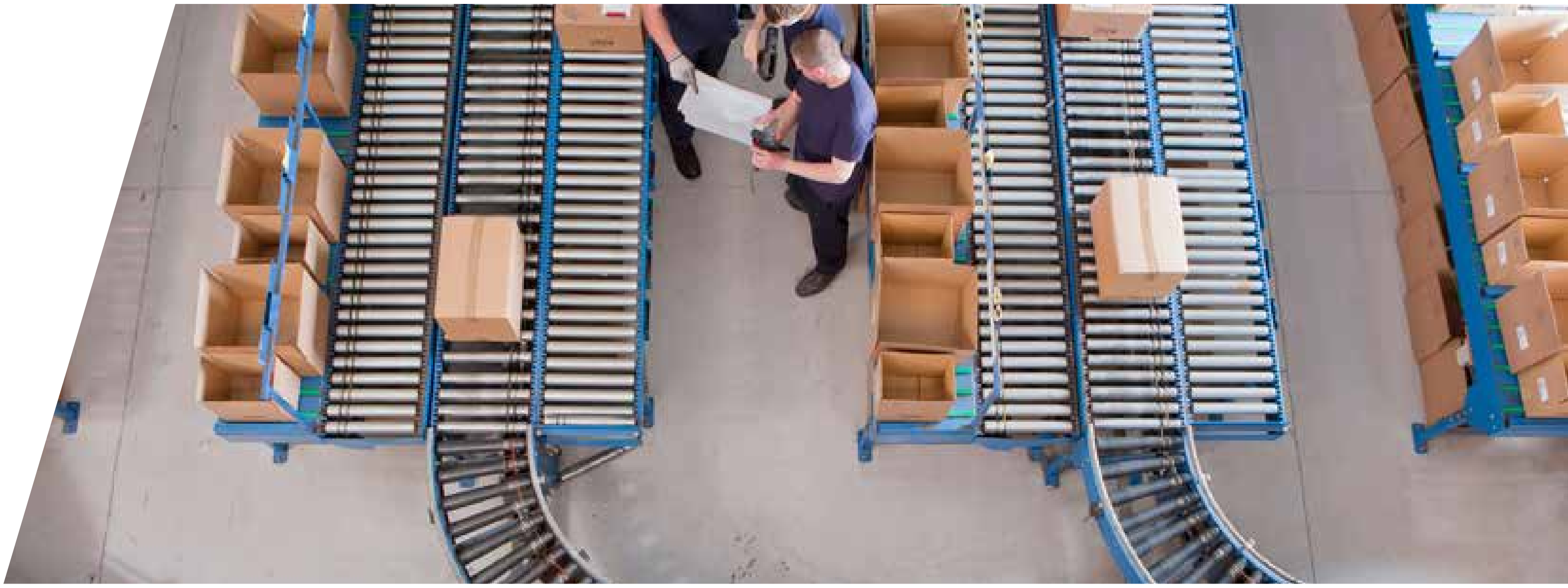
Paragraphs 360-20-40-38 and 55-21A indicate a buy-sell clause, in and of itself, does not constitute a prohibited form of continuing involvement that would preclude profit recognition on the sale of the partial interest, but would need to be evaluated in light of all the relevant facts and circumstances to determine whether its terms indicate that the seller has transferred the usual risks and rewards of ownership and does not have substantial continuing involvement. That is, a buy-sell clause must be evaluated to determine whether it gives the buyer an in substance option to put its interest back to the seller or gives the seller an in substance option to acquire the buyer's interest in the real estate. Accordingly, we believe the analysis of whether a buy-sell clause is an in substance put or call option under Subtopic 360-20 is similar to the analysis under Topic 606, although the resulting accounting may differ depending on the facts and circumstances as discussed in **Questions 5.6** and **5.7**.

Question 5.12: What is the accounting consequence when a general partner in a limited partnership sells a property to the partnership for cash (contributed by the limited partners) and a significant receivable (i.e., a sale of a partial ownership interest in an entity that is considered in substance real estate)?

Answer 5.12: Under Topic 606, the seller first determines if a contract exists given the significance of the receivable (see **Questions 1.1** and **1.2** for discussion of the evaluating whether a contract exists and the resulting accounting if it does not). Next, it determines if, and when, control transfers, which may depend on the facts and circumstances of the transaction and the ultimate interpretation of the guidance on partial sales (see **Question 5.9**).

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-40 requires a seller who (a) retains a general partnership interest in the entity that purchases its property, and (b) holds a receivable from the limited partnership for a significant part of the sales price (defined as a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property) to account for the transaction as a financing, leasing or profit-sharing arrangement. Topic 606 may result in a change because revenue/profit recognition may be appropriate if a contract exists and control has transferred (i.e., the mere existence of the general partner interest and significant receivable does not preclude revenue/profit recognition under Topic 606 as it does under Subtopic 360-20).



For more information or guidance on these issues, please contact any member of our national real estate leadership team or our real estate revenue recognition network.

National Real Estate Leadership Team

Tom Gerth
Midatlantic
T: 703-286-6566
E: tgerth@kpmg.com

Todd Refnes
Pacific Southwest
T: 213-593-6326
E: trefnes@kpmg.com

Tony Circolone
Midwest
T: 312-665-2210
E: acircolone@kpmg.com

Rob Labenski
Southeast
T: 904-350-1211
E: rlabenski@kpmg.com

Phil Marra
Northeast
T: 212-954-7864
E: pmarra@kpmg.com

Chris Turner
Southeast
T: 404-222-3334
E: clturner@kpmg.com

Roger Power
Pacific Northwest
T: 415-963-5410
E: rjpower@kpmg.com

Troy Butts
Southwest
T: 214-840-2107
E: tbutts@kpmg.com

John Davis
Pacific Southwest
T: 213-955-8730
E: jdavis@kpmg.com

Real Estate Revenue Recognition Network Members

Sam Kerlin
Atlanta
T: 404-222-3516
E: skerlin@kpmg.com

Lionel Deschamps
San Diego
T: 858-750-7240
E: lrdeschamps@kpmg.com

Raymond Anderson
Chicago
T: 312-665-2712
E: randerson@kpmg.com

Jared Byers
Tysons Corner
T: 703-286-6587
E: jbyers@kpmg.com

Jamie Weisman
Chicago
T: 312-665-4913
E: jsmith2@kpmg.com

Stuart Logan
Tysons Corner
T: 703-286-8308
E: slogan@kpmg.omc

Erik Lange
New York
T: 212-872-6654
E: elange@kpmg.com

Pramit Patel
Tysons Corner
T: 703-286-8225
E: pramitpatel@kpmg.com

Landon Westerlund
New York
T: 212-909-5553
E: lbwesterlund@kpmg.com

Julia Ryan
Tysons Corner
T: 703-286-8413
E: jjryan@kpmg.com

Greg Williams
National Sector Leader
Building, Construction, & Real Estate
T: 214-840-2425
E: gregorylwilliams@kpmg.com

Andy Corsini
Audit Lead
Building, Construction, & Real Estate
T: 312-665-3264
E: acorsini@kpmg.com

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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.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

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

REIT Valuation
The NAV-based Pricing Model

Green Street Advisors

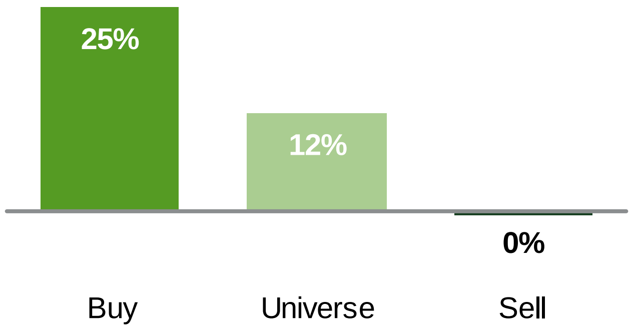
It's All Relative

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.

An Impressive Track Record

20+Yr Annualized Total Return of Green Street's Stock Recommendations*



* Past performance (as of 5/30/14) can not be used to predict future performance. Please see recommendation track record disclosure on page 20

660 Newport Center Drive, Suite 800, Newport Beach, CA 92660, USA
+1 949 640 8780

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Table of Contents

Sections

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

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

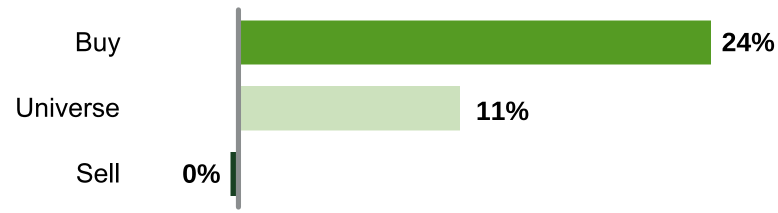
NAV-Based Pricing Model

NAV
<u>+ Warranted Premium to NAV</u>
= Warranted Share Price

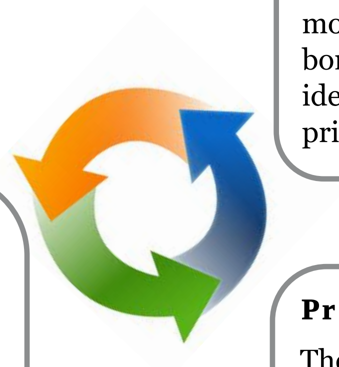
Stock Recomendations

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

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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

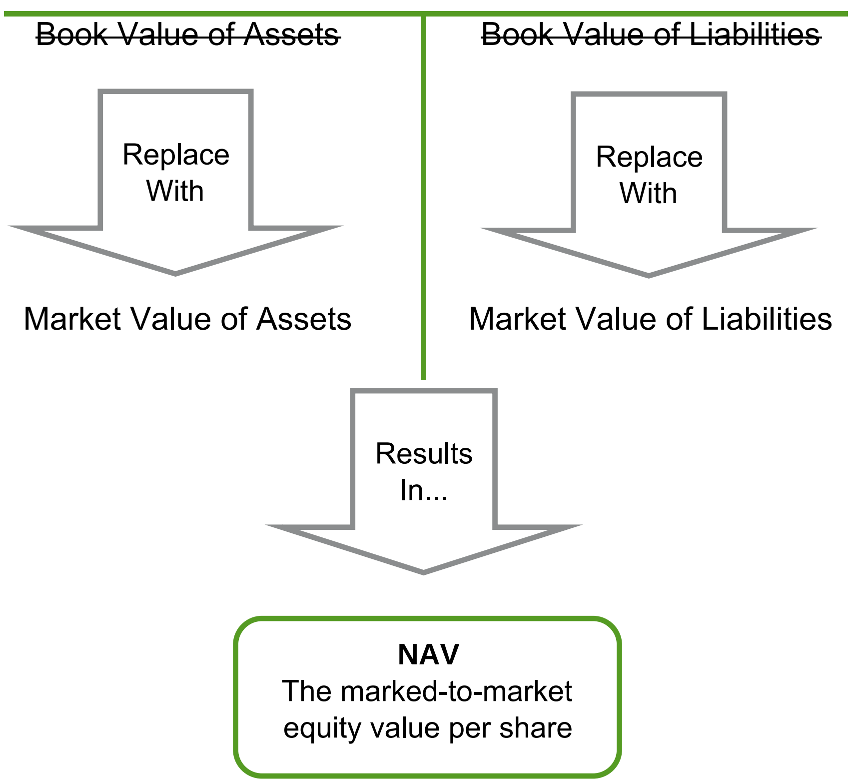
Used to compare valuations *relative* to those of other REITs. It's fair to call it "relative intrinsic value."

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Overview: What is NAV?

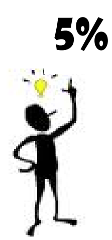
Mark It to Market: An NAV-based valuation methodology is only as good as the underlying estimate of NAV. High-quality estimates of marked-to-market asset value require a great deal of effort and resources, but the estimate can be reasonably precise when done properly. It is also important to mark-to-market 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.

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
Equity in Unconsolidated JVs	$1,000,000	D	$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.

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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

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.

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

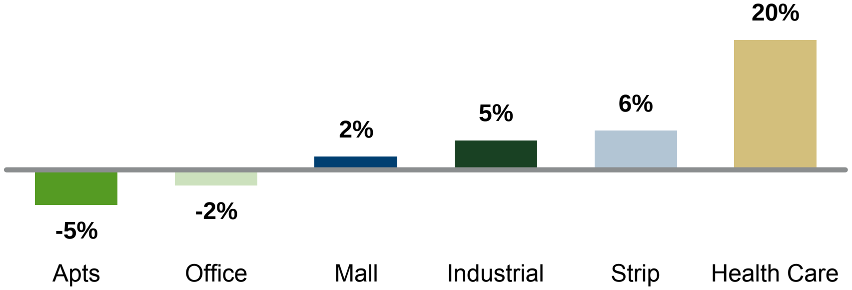
This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Overview: The Influence of Property Sectors

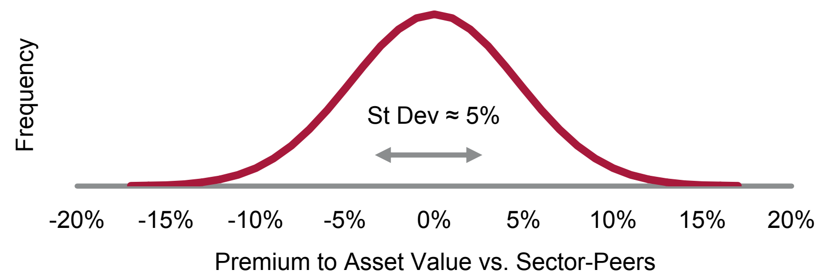
A Normal World: The starting point in calculating the warranted premium for any REIT is the sector-average premium ascribed by the market at current share prices. An assumption is made that the dispersion of observed premiums for the entirety of our coverage universe serves as a good indicator of how 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

Observed Average Premium to Asset Value

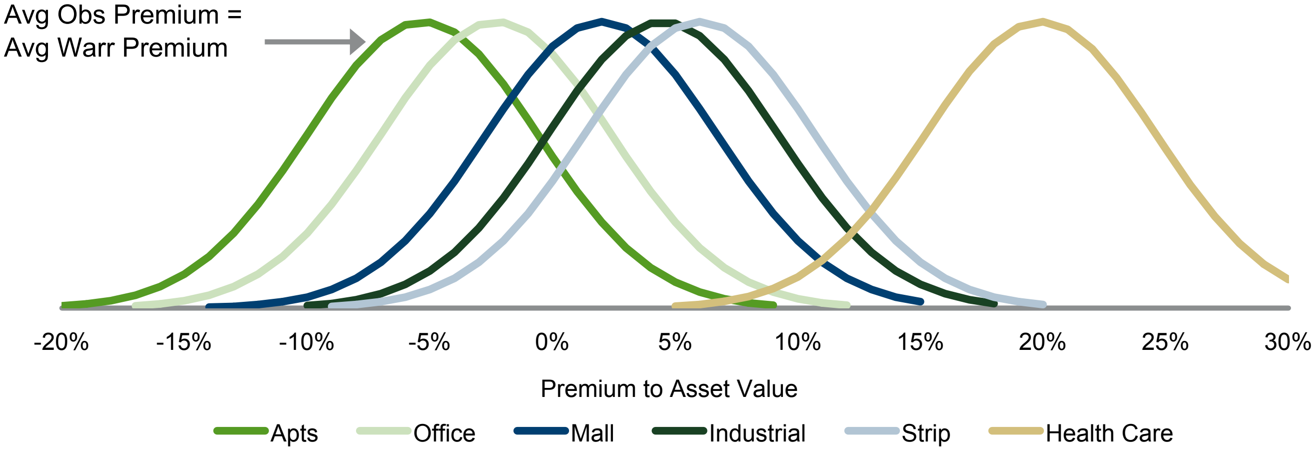


Dispersion of Observed Premiums - All REITs



Relative Model:
Avg Obs Premium =
Avg Warr Premium

Dispersion of Warranted Premiums Across Sectors



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.

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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.

Exhibit I

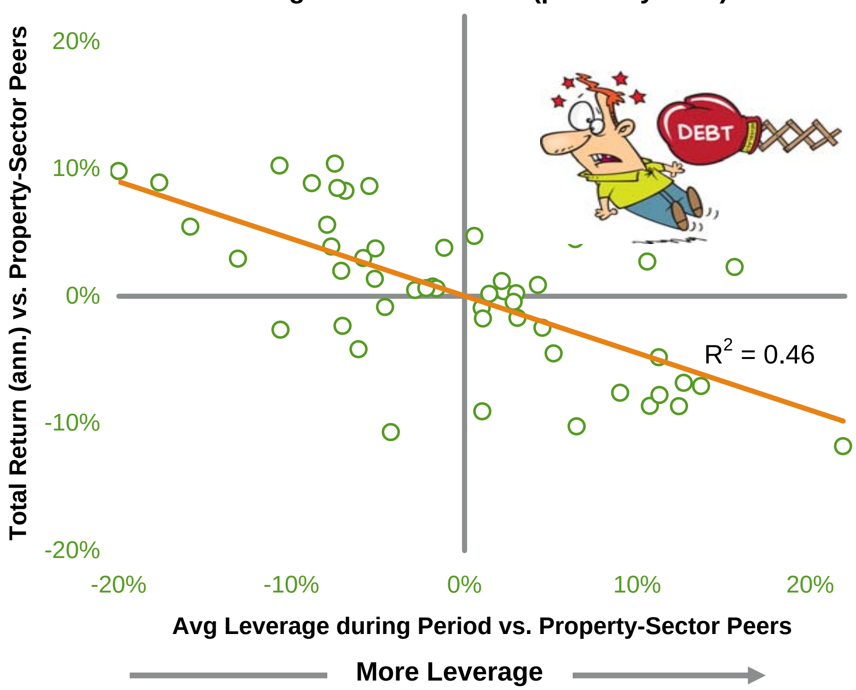
Balance Sheet Risk: Balance Sheets Matter

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!

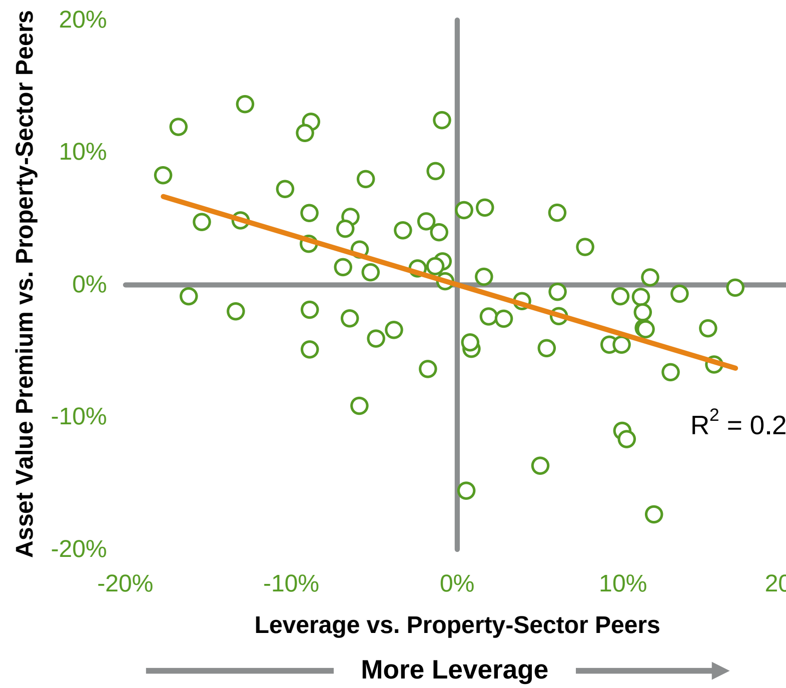
Leverage & Total Returns (past 10 years*)



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.

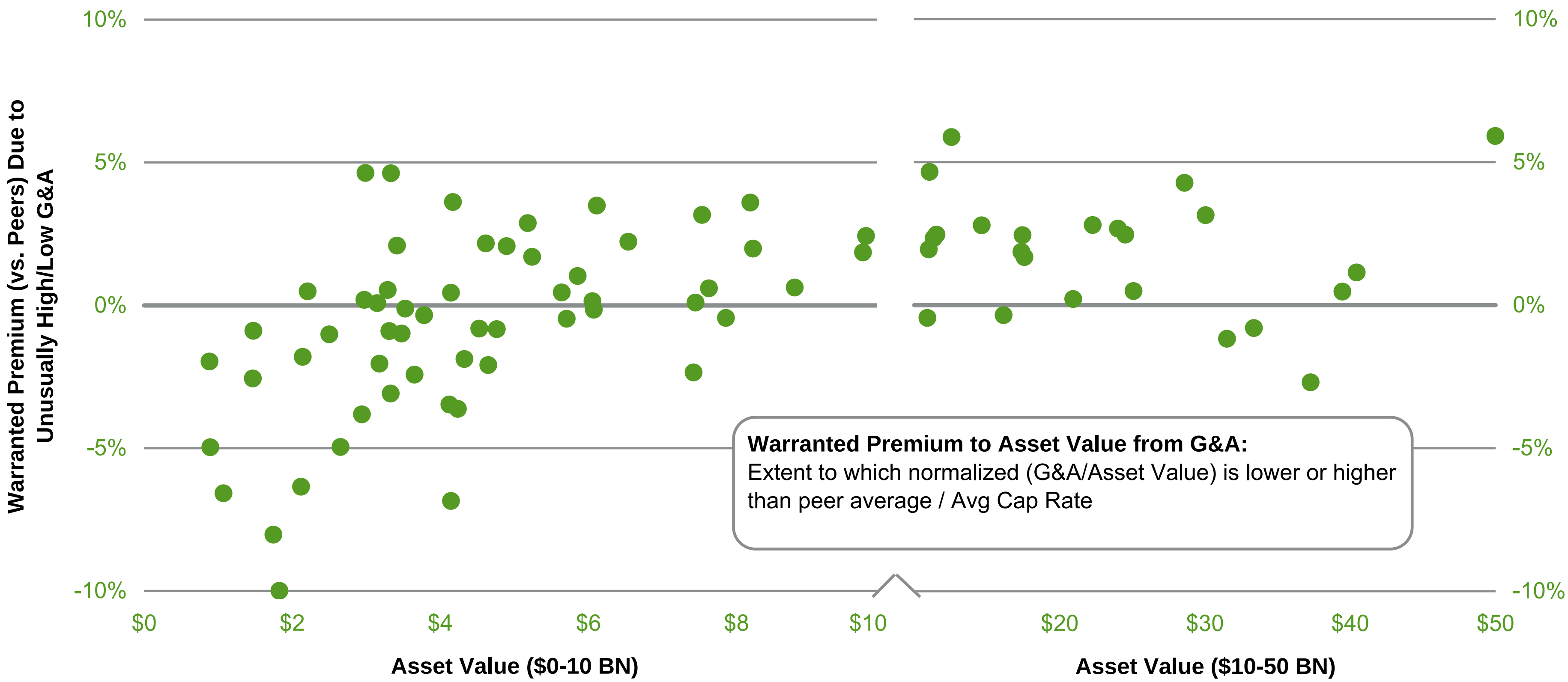
Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders 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.

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

To View the Full Report…
Please contact a member of our Sales team at
(949) 640-8780 or e-mail
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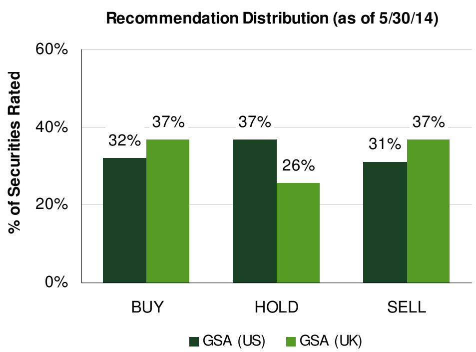
- The research recommendation contained in this report was first released for distribution on the date identified on the cover of this report.
- Green Street will furnish upon request available investment information supporting the recommendation(s) contained in this report.

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

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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.

Exhibit II

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%

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					Total Square Footage at Economic Ownership %				
	Bulk Distribution	Suburban Office	Medical Office	Retail	Total	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

	Square Feet (1)							
Primary Market	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%			

	Occupancy %				
Primary Market	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.

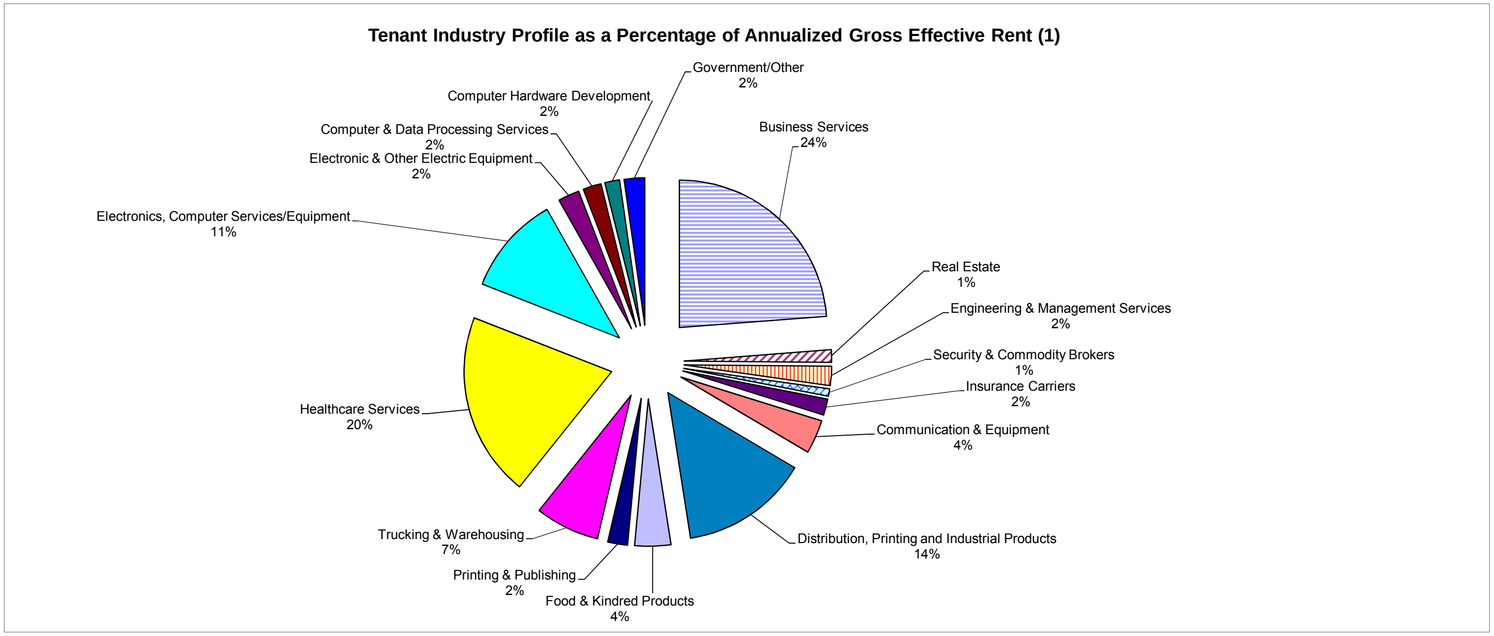
(2) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating 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



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)

	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)
Wholly Owned Portfolio:											
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

Product Type	Leases up for Renewal Number	Leases up for Renewal Square Feet	Leases Renewed Number	Leases Renewed Square Feet	Percent Renewed (1)	Average Term in Years	Average Net Effective Rent	Average Capital Expenditures Per Sq. Ft.	Average Capital Expenditures 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

REALpac
Real Property Association of Canada | Association des biens immobiliers du Canada

One University Avenue
Suite 1410
Toronto, ON M5J 2P1
Canada

tel : 416.642.2700
fax : 416.642.2727
toll free : 1.855.REALpac
(732.5722)

www.realpac.ca

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 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:

REALpac Real Property Association of Canada Association des biens immobiliers du Canada

"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

REALpac
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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

Nancy Anderson
VP Financial Reporting & CFO
REALpac

Exhibit IV

Building a better working world

Ernst & Young Global Limited
Becket House
1 Lambeth Palace Road
London
SE1 7EU

Tel: +44 [0]20 7980 0000
Fax: +44 [0]20 7980 0275
ey.com

INVESTOR IN PEOPLE

International Financial Reporting Standards
Interpretations Committee
30 Cannon Street
London
EC4M 6XH

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).

Building a better working world

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
401 Merritt 7
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

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

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,

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T Drula

Christopher T. Drula
Vice President, Financial Standards

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NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS

SFO Alert (February 27, 2015)

February 27, 2015

FASB PROVIDES LESSORS WITH TRANSITION RELIEF FOR INITIAL DIRECT LEASING COSTS

On Feb. 25, NAREIT observed a meeting of the Financial Accounting Standards Board (FASB or Board) in Norwalk, CT on the Leases Project. Among the topics discussed was transition for the new Leases standard (the New Standard). The Board typically favors comparability of financial reporting before and after the effective date of new financial standards, thereby requiring companies to retroactively restate comparative periods presented in the financial statements. However, at the meeting, the Board decided to require a modified retrospective transition method (with specified reliefs) for existing operating leases. Of particular interest to NAREIT member companies operating as equity REITs was the relief that the Board afforded with respect to initial direct leasing costs. Previously, the Board decided that initial direct leasing costs would be expensed as incurred, which would represent a significant change in current practice. However, in order to alleviate the burden for companies that currently capitalize these costs, the Board decided that lessors would not be required to reassess initial direct leasing costs for any existing leases. Thus, companies would be able to continue to amortize any initial direct leasing costs that were previously capitalized and amortized prior to the effective date of the New Standard. This transition relief avoids writing off the remaining unamortized balance of leasing costs previously deferred upon adoption.

At the current time, Board has not established an effective date for the New Standard. The Board plans to discuss the effective date at a future meeting.

FASB ISSUES FINAL STANDARD TO AMEND EXISTING CONSOLIDATION GUIDANCE

On Feb. 18, the Financial Accounting Standards Board (FASB or Board) issued Accounting Standards Update *Consolidations (Topic 810): Amendments to Consolidations Guidance* (the Final Standard). The Final Standard amends the consolidation guidance for variable interest entities (VIEs) and voting interest entities. In so doing, the FASB mandates the application of consolidation guidance to investment companies, which had previously been indefinitely deferred. The Final Standard impacts the consolidation analysis and documentation that NAREIT member companies perform surrounding limited partnerships and securitization vehicles (*e.g.*, collateralized debt obligations and collateralized loan obligations). Regardless of whether companies arrive at a different decision with respect to consolidation, companies will need to revise internal control processes and procedures to reflect the evaluation performed pursuant to the new guidance in the Final Standard.

Among other items, the Final Standard:

- Eliminates the presumption that a general partner should consolidate a limited partnership and removes the consolidation model that previously applied to limited partnerships;
- Clarifies when fees paid to a decision maker (e.g., asset manager) should be a factor to include in the consolidation analysis for VIEs, thereby placing a greater emphasis on the risk of loss when evaluating consolidation risk; and,
- Amends the guidance for how to assess related party relationships that affect the consolidation evaluation for VIEs.

For public companies, the Final Standard is effective for periods beginning after Dec. 15, 2015. For private companies, the Final Standard is effective for annual periods beginning after Dec. 15, 2016, and for interim periods beginning after Dec. 15, 2017.

Early adoption is permitted, including adoption in an interim period.

CONTACT

For further information, please contact George Yungmann, NAREIT's SVP, Financial Standards, at gyungmann@nareit.com or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com.

Government Relations Committee Meeting

Tuesday, March 31st
3pm – 4:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts

Panelists:
Andrea Hoffenson, Branch Chief-FI&P, IRS
Julanne Allen, Assistant to Branch Chief, IRS
Michael Novey, Associate Tax Legislative Counsel, Office of Tax Policy, US Treasury Department
Rohn Grazer, Managing Director-Tax, Prologis, Inc.
Dara Bernstein, Sr. Tax Counsel, NAREIT
Tony Edwards, EVP & General Counsel, NAREIT
Brian Wood, SVP & Chief Tax Officer, Ventas, Inc.

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GOVERNMENT RELATIONS COMMITTEE MEETING
(Open to all REITWise® Registrants)
JW Marriott Desert Ridge Resort & Spa
Grand Sonoran G-K
Phoenix, AZ
Tuesday March 31, 2015
3:00 p.m. – 4:30 p.m.

Co-Chairs:

Jeffrey Clark, SVP-Tax & JV Accounting, Host Hotels & Resorts, Inc.
Rohn Grazer, Managing Director-Tax, Prologis, Inc.
Brian Wood, SVP & Chief Tax Officer, Ventas Inc.

Panelists:

Julanne Allen, Assistant to the Branch Chief, FI&P, IRS
Andrea Hoffenson, Branch Chief, FI&P, IRS
Michael Novey, Associate Tax Legislative Counsel, Department of the Treasury

NAREIT Staff Liaisons:

Tony Edwards, Executive Vice President & General Counsel
Dara Bernstein, Senior Tax Counsel

I. IRS and Treasury Department perspective

II. Tax reform developments

III. OECD's Base Erosion and Profit Shifting (BEPS) applicability to U.S. REITs' cross border investments

IV. FIRPTA reform update

V. U.S. REIT compliance with the EU's Alternative Investment Fund Managers Directive

VI. Main Street Fairness changes ahead?

VII. More fun items if there's time

Note: This meeting may qualify for 1.25 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

Bill in 2/11/15 SFC Mark-up to Amend FIRPTA to Encourage Equity Investment in U.S. Commercial Real Estate

Background on FIRPTA

In general, developed nations around the world do not impose an income tax on the sale of capital assets by foreign investors, including interests held by foreign investors in real estate corporations, so long as such investors are not conducting a trade or business. However, in the United States, since the 1980s the Foreign Investment in Real Property Act (FIRPTA) has imposed a significant withholding tax on foreigners in conjunction with the sale of U.S. real estate equity. Notably, the U.S. imposes no U.S. tax on most interest payments on most debt paid to debt holders who own less than 10% of the issuer (the "portfolio interest" exception), whether or not the debt is real estate related. As a result of this difference in tax treatment, foreign investment in U.S. real estate is often structured as debt rather than as equity.

This unduly harsh treatment of non-U.S. real estate equity investment arose in the 1980s when Congress enacted FIRPTA after a wave of foreign investment engendered concern that farmland and other U.S. real estate would come under foreign control. (The primary FIRPTA sponsor in the Senate unsuccessfully attempted to repeal the entire law a few years after it went into effect). This tax burden is further increased when the "branch profits tax" is imposed on foreign institutions investing in U.S. real estate.

FIRPTA treats any gain from a non-U.S. person's sale of U.S. real property as if the non-U.S. person was doing business in the United States, and therefore subjects it to full U.S. income tax. To enforce the FIRPTA regime, the tax code requires U.S. persons who acquire real property from non-U.S. investors to withhold a significant tax (usually 10% of the gross proceeds, or 35% of in the case of REIT capital gain distributions) and remit it to the IRS. The FIRPTA rules do not apply to sales of debt secured by real estate such as mortgages.

FIRPTA taxation applies both to sales of direct interests in U.S. real estate as well as to sales of shares of corporations the assets of which primarily consist of U.S. real estate (United States Real Property Holding Corporations, or USRPHCs). However, recognizing that "portfolio" investors of listed real estate companies, such as REITs, are more akin to securities owners than to direct real estate investors, FIRPTA has always exempted sales of stock in a USRPHC that is regularly traded on an established securities market (so long as the seller owns 5% or less of that company).

Finally, REIT capital gains distributions are subject to a 35% FIRPTA withholding tax unless they are paid to 5% or less shareholders of a listed REIT, in which case the distributions are subject to the same withholding rates as ordinary dividends (30% or a lower tax treaty rate -- often 15% or 0% in certain limited cases, such as for a foreign pension fund).

Proposed Change

Portfolio Investors. The 5% "portfolio" investor limit in FIRPTA has become badly outdated. In addition to the 10% ceiling used for portfolio interest mentioned above, the Model U.S. Tax

Convention in use by the Treasury Department for negotiation with foreign governments utilizes a 10% ceiling (rather than 5%) for applying a lower tax rate for individual investors generally as well as for the lower tax rate employed for U.S. REIT dividends paid to foreign "portfolio" investors. So, while most of our U.S. tax treaties with our leading trading partners encourage foreign ownership up to 10%, FIRPTA effectively caps a foreigner's ownership at 5%.

To encourage further foreign equity investment in U.S. REITs (which generates substantial U.S. taxes because of the high dividend payments required under the REIT rules), the bill before the Senate Finance Committee on February 11, 2015 would modify the 5% FIRPTA "portfolio" investor ceiling to conform to the modern 10% treaty standard both for the FIRPTA sales rule and the REIT capital gains rule modified in 2004 while also applying that rule to certain widely-held publicly-traded "qualified collective investment vehicles", which are entities that qualify under a comprehensive income tax treaty with the United States and meet certain detailed reporting requirements.

Revenue Raisers. The budgetary impact of these FIRPTA reforms is offset by five revenue raiser proposals. Most of these proposals generally do not impose any new tax but instead merely collect unpaid FIRPTA taxes. First, the required rate of FIRPTA withholding imposed on the disposition or distribution of a U.S. real property interest would be increased from 10% to 15%, to ensure that FIRPTA withholding collects a sufficient share of amounts owed. Second, USRPHCs would be required to make their FIRPTA status readily accessible to shareholders and the IRS through disclosures in their annual returns. Third, brokers whose clients sell more than 5% of a publicly-traded U.S. real property holding corporation (10% for publicly-traded, foreign controlled REITs upon passage of the bill) would be required to withhold 15% of the proceeds of a disposition of their client's interests in such corporation. Again, each of these provisions imposes no new taxes, but rather collects taxes that are current going unpaid in many cases.

Fourth, the FIRPTA "cleansing rule" exception would no longer apply when a REIT or RIC disposes U.S. real property and claims a dividends paid deduction on the subsequent distribution to shareholders. Finally, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80% owned domestic corporation) are eligible for a dividends received deduction under Section 245 of the Code, dividends from REITs and RICs would no longer be treated as dividends from domestic corporations. The fourth and fifth revenue raisers were included in H.R. 1 in the last Congress.

General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals

Department of the Treasury
February 2015

MODIFY LIKE-KIND EXCHANGE RULES FOR REAL PROPERTY AND COLLECTIBLES

Current Law

When capital assets are sold or exchanged, capital gain or loss is generally recognized. Under section 1031, however, no gain or loss is recognized when business or investment property is exchanged for "like-kind" business or investment property. As a result, the tax on capital gain is deferred until a later realization event, provided that certain requirements are met. The "like-kind" standard under section 1031, which focuses on the legal character of the property, allows for deferral of tax on the exchange of improved and unimproved real estate. Certain properties, including stocks, bonds, notes or other securities or evidences of indebtedness are excluded from nonrecognition treatment under section 1031. Exchanges of art and collectibles for investment are eligible for deferral of gain under section 1031.

Reasons for Change

There is little justification for allowing deferral of the capital gain on the exchange of real property or art and collectibles. Historically, section 1031 deferral has been justified on the basis that valuing exchanged property is difficult. However, for the exchange of one property for another of equal value to occur, taxpayers must be able to value the properties. In addition, many, if not most, exchanges affected by this proposal are facilitated by qualified intermediaries who help satisfy the exchange requirement by selling the exchanged property and acquiring the replacement property. These complex three-party exchanges were not contemplated when the provision was enacted. They highlight the fact that valuation of exchanged property is not the hurdle it was when the provision was originally enacted. Further, the ability to exchange unimproved real estate for improved real estate encourages "permanent deferral" by allowing taxpayers to continue the cycle of tax deferred exchanges.

Proposal

The proposal would limit the amount of capital gain deferred under section 1031 from the exchange of real property to $1 million (indexed for inflation) per taxpayer per taxable year. The proposal limits the amount of real estate gain that qualifies for deferral while preserving the ability of small businesses to generally continue current practices and maintain their investment in capital. In addition, art and collectibles would no longer be eligible for like-kind exchanges. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The provision would be effective for like-kind exchanges completed after December 31, 2015.

REPEAL PREFERENTIAL DIVIDEND RULE FOR PUBLICLY TRADED AND PUBLICLY OFFERED REAL ESTATE INVESTMENT TRUSTS (REITS)

Current Law

REITs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a "preferential dividend." For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. Previously, a similar rule had applied to all regulated investment companies (RICs). Section 307 of the Regulated Investment Company Modernization Act of 2010 repealed application of that rule for publicly offered RICs.

Reasons for Change

The original purpose of the preferential dividend rule in 1936 was to prevent tax avoidance by closely held personal holding companies. The inflexibility of the rule can produce harsh results for inadvertent deviations in the timing or amount of distributions to some shareholders. Because an attempt to compensate for a preference in one distribution produces a preference in a second offsetting distribution, it is almost impossible to undo the impact of a prior error. As applied to publicly traded REITs and publicly offered REITs, the rule has ceased to serve a necessary function either in preventing tax avoidance or in ensuring fairness among shareholders. Today, for these shareholders, corporate and securities laws bar preferences and ensure fair treatment.

Proposal

The proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

1. As of the record date of the distribution, the REIT was publicly traded; or

2. As of the record date of the distribution:
    a. The REIT was required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Act of 1934;
    b. Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318); and
    c. Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period.

The Secretary would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders.

The proposal would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.

EPRA

Memo

TO	*Jacques Sasseville, OECD Paris*
FROM	*EPRA (Fraser Hughes / Jean Edouard Carbonnelle / Ronald Wijs, GiuseppeAndrea Giannantonio)*
CC.	*Philip Charls, CEO EPRA*
DATE	*Tony Edwards, NAREIT*
	March 05, 2015
REFERENCE	*18100727*
RE	**BEPS Action 6 – REITs and Treaty Abuse**

Introduction

1 During our meeting of Friday January 30 last, we discussed the above subject and the position of REITs. Reference is also made to our previous submissions, a copy of which is attached for your convenience.

2 We discussed the absence of a reference to the position of REITs in the OECD's publications on Action 6 and the OECD 2007 REITs report[1]. We have observed with great interest the discussions that you had with NAREIT and we welcome the fact that the OECD recognises that more attention should be given to the specific position of REITs (not being CIVs or non-CIVs) as residents of tax treaties.

3 We promised you to provide you with a brief and 'to-the-point' outline of our views on the position of REITs under the proposed LOB rule and the PPT. Below, we will outline why we think REITs are *inherently* not in the game of "tax treaty shopping" and we make a brief proposal for including an example to the proposed amendment to the Commentary to the Model Convention, as well as a proposal for a simplification of the LOB rule.

Why REITS are inherently not Abusive

4 Part of the OECD definition of REITs is that these are widely held (often on the basis of a stock listing). In the vast majority of cases REITs are 'self-managed' (unlike CIVs) and have adequate and transparent governance systems in place. REITs benefit from a 'flow through' regime: the point of taxation is moved from the company to the shareholders (on the basis of an obligation to distribute the annual profit or earnings). All REIT regimes in OECD countries contain detailed and specific anti-abuse provisions in order to avoid that the REIT residence country would lose its taxing rights in respect of the REIT income.

Also the OECD REIT model tax treaty provisions (2007) take into account that the REIT residence country will always levy withholding tax (Commentary to article 10, paragraphs 67.1 to 67.7).

[1] "Tax treaty issues related to REITs in Model Tax Convention on income (OECD 2007).

The domestic REIT laws, together with the OECD model tax treaty provisions on REITs, already enforce sufficient anti-abuse rules to avoid the undesired use of tax treaties by REITs. Therefore, REITs can be seen as a solid and robust concept to prevent the proliferation of offshore property schemes and aggressive international tax structures, being exactly the type of structures that the BEPS Action 6 work is looking to clamp down on.

REITs and LOB Rule

5 We explained to you that REITs working cross border may face serious problems with the proposed LOB rule, in particular in situations where a REIT of Country A, has subsidiaries in Country B (**REIT Subsidiaries**) that will invest in Country C. REIT Subsidiaries may often not qualify for the LOB rule mainly due to the structure of the current "derivative benefits test". Introduction of the LOB rule in its current form would discourage REITs to grow internationally, hamper essential cross-border investment and make the international capital markets less transparent.

6 Therefore, EPRA would like to make the suggestion to delete the requirement that "each intermediate owner is itself an equivalent beneficiary" (delete "provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary" in the proposed article X, paragraph 4, subparagraph a). EPRA is of the view that treaty entitlement should be available if at least 95 per cent of the aggregate voting power and value of the shares of the company claiming the treaty benefits is owned, directly or indirectly, by seven or fewer persons that are classified as equivalent beneficiaries. According to our understanding, this would be in line with the derivative benefits test, included in various US tax treaties.

REITs and PPT

7 Under the proposed Principal Purpose Tests, treaty benefits can be denied if one of the principal purposes of an arrangement is obtaining that benefit. In the current version of the proposed Commentary on article X, paragraph 7, nothing is said about the position of REITs under the PPT (while ample attention is given to CIVs, including an example in the proposed Commentary on CIVs and the PPT[2]).

8 We believe that the specific features of a REIT, the importance of REITs for international capital flows and the elaborate 2007 OECD work on REITs advocate for including special attention to REITS in the proposed commentary on the PPT. This could be done by taking up the following example in the draft Commentary.

Example [..]: RCo, is a resident of State R, RCo is a self-managed "real estate investment trust" (REIT) under the tax laws of State R. RCo holds the shares of SCo, a company resident in State S that owns a portfolio of real estate properties. The shareholders of the REIT are resident in various states. Pursuant to the applicable REIT regime, RCo is

[2] Page 72, 2014 Deliverable: Preventing the granting of treaty benefits in inappropriate circumstances, OECD Base Erosion and Profit Shifting Project, OECD Publishing.

obliged to distribute annually almost all of its profits to its shareholders. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 25 per cent to 5 per cent and REITs are considered to be "residents" for purposes of the said tax convention. RCo's investment decisions take into account the existence of tax benefits provided under State R's extensive tax convention network. A number of investors in RCo are residents of States with which State S does not have a tax convention.

In accordance with the 2007 OECD definition of REITs, RCo's shares are widely held, RCo derives its income primarily from long-term investment in real estate, RCo is under the obligation to distribute most of that income annually, and RCo does not pay income tax on income related to real property that is so distributed. Consistent with the 2007 OECD REIT report, the fact that RCo does not pay tax on its real property income is the result of tax rules in State R that provide for a single level of taxation in the hands of the investors in RCo (with corresponding withholding tax obligations imposed on RCo with respect to its distributions to investors resident in countries other than State R).

State R's domestic REIT legislation contains specific provisions aimed at ensuring that profits cannot be shifted free of tax to foreign investors. RCo's annual mandatory distribution obligation means that taxes are being paid in State R on RCo's profits each year. That is, taxation of investors in RCo is safeguarded and also the recommended tax treatment for REIT dividends under the OECD Model Tax Treaty provisions (see Commentary on article 10, paragraph 67) is included in the tax conventions that State R has concluded. This enables State R to impose – under all circumstances - withholding tax on distributions by resident REITs, like RCo, to foreign shareholders. Given these circumstances, including the taxation of investors in REITs, RCo is not a vehicle of a type that typically would be used for any tax avoidance purpose.

Investors' decisions to invest in RCo are not driven by any particular investment made by RCo, and RCo's investment strategy is not driven by the tax position of its investors. The intent of tax treaties is to provide benefits to encourage cross-border investment. The Commentary on article 10 on "Distributions by Real Estate Investment Trusts" (paragraph 67.2) acknowledges the importance and globalization of investments through REITs. Given the specific context in which RCo (being a REIT) is making the investment in State S, unless RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefits of the convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCo.

European Public Real Estate Association
Square de Meeus, 23
1000 Brussels, Belgium

T: +32 (0) 2739 1010 **F**: +32 (0) 2739 1020 **W**. www.epra.com

Issued in Kansas City, Missouri on May 7, 2014.

Timothy Smyth,

Acting Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 2014–11072 Filed 5–13–14; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–150760–13]

RIN 1545–BM05

Definition of Real Estate Investment Trust Real Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that clarify the definition of real property for purposes of the real estate investment trust provisions of the Internal Revenue Code (Code). These proposed regulations provide guidance to real estate investment trusts and their shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 12, 2014. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for September 18, 2014 must be received by August 12, 2014.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–150760–13), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–150760–13), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–150760–13). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Andrea Hoffenson, (202) 317–6842, or Julanne Allen, (202) 317–6945; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to real estate investment trusts (REITs). Section 856 of the Code defines a REIT by setting forth various requirements. One of the requirements for a taxpayer to qualify as a REIT is that at the close of each quarter of the taxable year at least 75 percent of the value of its total assets is represented by real estate assets, cash and cash items (including receivables), and government securities. See section 856(c)(4). Section 856(c)(5)(B) defines *real estate assets* to include real property and interests in real property. Section 856(c)(5)(C) indicates that *real property* means "land or improvements thereon." Section 1.856–3(d) of the Income Tax Regulations, promulgated in 1962, defines real property for purposes of the regulations under sections 856 through 859 as—

> land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

Section 1.856–3(d).

The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings describe assets such as railroad properties,[1] mobile home units permanently installed in a planned community,[2] air rights over real property,[3] interests in mortgage loans secured by total energy systems,[4] and mortgage loans secured by microwave transmission property,[5] and the rulings address whether the assets qualify as either real property or interests in real property under section 856. Since these published rulings were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the published rulings, and have asked for and received letter rulings from the IRS addressing certain of these assets. Because letter rulings are limited to their particular facts and may not be relied upon by taxpayers other than the taxpayer that received the ruling, see section 6110(k)(3), letter rulings are not a substitute for published guidance. The IRS and the Treasury Department recognize the need to provide additional published guidance on the definition of real property under sections 856 through 859. This document proposes regulations that define real property for purposes of sections 856 through 859 by providing a framework to analyze the types of assets in which REITs seek to invest. These proposed regulations provide neither explicit nor implicit guidance regarding whether various types of income are described in section 856(c)(3).[6]

Explanation of Provisions

Consistent with section 856, the existing regulations, and published guidance interpreting those regulations, these proposed regulations define *real property* to include land, inherently permanent structures, and structural components. In determining whether an item is land, an inherently permanent structure, or a structural component, these proposed regulations first test whether the item is a *distinct asset,* which is the unit of property to which the definitions in these proposed regulations apply.

In addition, these proposed regulations identify certain types of intangible assets that are real property or interests in real property for purposes of sections 856 through 859. These proposed regulations include examples to illustrate the application of the

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[1] Rev. Rul. 69–94 (1969–1 CB 189), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[2] Rev. Rul. 71–220 (1971–1 CB 210), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[3] Rev. Rul. 71–286 (1971–2 CB 263), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[4] Rev. Rul. 73–425 (1973–2 CB 222), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[5] Rev. Rul. 75–424 (1975–2 CB 269), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

[6] One of the requirements for qualifying as a REIT is that a sufficiently large fraction of an entity's gross income be derived from certain specified types of income (which include "rents from real property" and "interest on obligations secured by mortgages on real property or on interests in real property"). Section 856(c)(3).

principles of these proposed regulations to determine whether certain distinct assets are real property for purposes of sections 856 through 859.

Distinct Asset

These proposed regulations provide that each distinct asset is tested individually to determine whether the distinct asset is real or personal property. Items that are specifically listed in these proposed regulations as types of buildings and other inherently permanent structures are distinct assets. Assets and systems specifically listed in these proposed regulations as types of structural components also are treated as distinct assets. Other distinct assets are identified using the factors provided by these proposed regulations. All listed factors must be considered, and no one factor is determinative.

Land

These proposed regulations define land to include not only a parcel of ground, but the air and water space directly above the parcel. Therefore, water space directly above the seabed is land, even though the water itself flows over the seabed and does not remain in place. Land includes crops and other natural products of land until the crops or other natural products are detached or removed from the land.

Inherently Permanent Structures

Inherently permanent structures and their structural components are real property for purposes of sections 856 through 859. These proposed regulations clarify that inherently permanent structures are structures, including buildings, that have a passive function. Therefore, if a distinct asset has an active function, such as producing goods, the distinct asset is not an inherently permanent structure under these proposed regulations. In addition to serving a passive function, a distinct asset must be inherently permanent to be an inherently permanent structure. For this purpose, permanence may be established not only by the method by which the structure is affixed but also by the weight of the structure alone.

These proposed regulations supplement the definition of inherently permanent structure by providing a safe harbor list of distinct assets that are buildings, as well as a list of distinct assets that are other inherently permanent structures. If a distinct asset is on one of these lists, either as a building or as an inherently permanent structure, the distinct asset is real property for purposes of sections 856 through 859, and a facts and circumstances analysis is not necessary. If a distinct asset is not listed as either a building or an inherently permanent structure, these proposed regulations provide facts and circumstances that must be considered in determining whether the distinct asset is either a building or other inherently permanent structure. All listed factors must be considered, and no one factor is determinative.

One distinct asset that these proposed regulations list as an inherently permanent structure is an outdoor advertising display subject to an election to be treated as real property under section 1033(g)(3). Section 1033(g)(3) provides taxpayers with an election to treat certain outdoor advertising displays [7] as real property for purposes of Chapter 1 of the Code.

Structural Components

These proposed regulations define a structural component as a distinct asset that is a constituent part of and integrated into an inherently permanent structure that serves the inherently permanent structure in its passive function and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. An entire system is analyzed as a single distinct asset and, therefore, as a single structural component, if the components of the system work together to serve the inherently permanent structure with a utility-like function, such as systems that provide a building with electricity, heat, or water.[8] For a structural component to be real property under sections 856 through 859, the taxpayer's interest in the structural component must be held by the taxpayer together with the taxpayer's interest in the inherently permanent structure to which the structural component is functionally related. Additionally, if a distinct asset that is a structural component is customized in connection with the provision of rentable space in an inherently permanent structure, the customization of that distinct asset does not cause it to fail to be a structural component.

Under these proposed regulations, an asset or system that is treated as a distinct asset is a structural component, and thus real property for purposes of sections 856 through 859, if the asset or system is included on the safe harbor list of assets that are structural components. If an asset or system that is treated as a distinct asset is not specifically listed as a structural component, these proposed regulations provide a list of facts and circumstances that must be considered in determining whether the distinct asset or system qualifies as a structural component. No one factor is determinative.

These proposed regulations do not retain the phrase "assets accessory to the operation of a business," which the existing regulations use to describe an asset with an active function that is not real property for purposes of the regulations under sections 856 through 859. The IRS and the Treasury Department believe that the phrase "assets accessory to the operation of a business" has created uncertainty because the existing regulations are unclear whether certain assets that are permanent structures or components thereof nevertheless fail to be real property because they are used in the operation of a business. Instead, these proposed regulations adopt an approach that considers whether the distinct asset in question either serves a passive function common to real property or serves the inherently permanent structure to which it is constituent in that structure's passive function. On the other hand, if an asset has an active function, such as a distinct asset that produces, manufactures, or creates a product, then the asset is not real property unless the asset is a structural component that serves a utility-like function with respect to the inherently permanent structure of which it is a constituent part. Similarly, if an asset produces or contributes to the production of income other than consideration for the use or occupancy of space, then that asset is not real property. Thus, items that were assets accessory to the operation of a business under the existing regulations will continue to be excluded from the definition of real property for purposes of sections 856 through 859 either because they are not inherently permanent or because they serve an active function. These distinct assets include, for example, machinery; office, off-shore drilling, testing, and other equipment; transportation equipment

[7] Section 1.1033(g)–1(b)(3) defines *outdoor advertising display* for purposes of the section 1033 election as "a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently attached to a building or other inherently permanent structure."

[8] See Rev. Rul. 73–425 (1973–2 CB 222), (see § 601.601(d)(2)(ii)(*b*) of this chapter) (holding that a total energy system that provides a building with electricity, steam or hot water, and refrigeration may be a structural component of that building). The IRS and the Treasury Department are considering guidance to address the treatment of any income earned when a system that provides energy to an inherently permanent structure held by the REIT also transfers excess energy to a utility company.

that is not a structural component of a building; printing presses; refrigerators; individual air-conditioning units; grocery counters; furnishings of a motel, hotel, or office building; antennae; waveguides; transmitting, receiving, and multiplex equipment; prewired modular racks; display racks and shelves; gas pumps; and hydraulic car lifts.

Intangible Assets That Are Real Property

These proposed regulations also provide that certain intangible assets are real property for purposes of sections 856 through 859. To be real property, the intangible asset must derive its value from tangible real property and be inseparable from the tangible real property from which the value is derived. Under § 1.856–2(d)(3) the assets of a REIT are its gross assets determined in accordance with generally accepted accounting principles (GAAP). Intangibles established under GAAP when a taxpayer acquires tangible real property may meet the definition of real property intangibles. A license or permit solely for the use, occupancy, or enjoyment of tangible real property may also be an interest in real property because it is in the nature of an interest in real property (similar to a lease or easement). If an intangible asset produces, or contributes to the production of, income other than consideration for the use or occupancy of space, then the asset is not real property or an interest in real property. Thus, for example, a permit allowing a taxpayer to engage in or operate a particular business is not an interest in real property.

Other Definitions of Real Property

The terms real property and personal property appear in numerous Code provisions that have diverse contexts and varying legislative purposes. In some cases, certain types of assets are specifically designated as real property or as personal property by statute, while in other cases the statute is silent as to the meaning of those terms. Ordinarily, under basic principles of statutory construction, the use of the same term in multiple Code provisions would imply (absent specific statutory modifications) that Congress intended the same meaning to apply to that term for each of the provisions in which it appears. In the case of the terms real property and personal property, however, both the regulatory process and decades of litigation have led to different definitions of these terms, in part because taxpayers have advocated for broader or narrower definitions in different contexts.

For example, in the depreciation and (prior) investment tax credit contexts, a broad definition of personal property (and a narrow definition of real property) is ordinarily more favorable to taxpayers. A tangible asset may generally be depreciated faster if it is personal property than if it is considered real property, see section 168(c) and (g)(2)(C), and (prior) section 38 property primarily included tangible personal property and excluded a building and its structural components, see § 1.48–1(c) and (d). During decades of controversy, taxpayers sought to broaden the meaning of tangible personal property and to narrow the meanings of building and structural component in efforts to qualify for the investment tax credit or for faster depreciation. That litigation resulted in courts adopting a relatively broad definition of tangible personal property (and correspondingly narrow definition of real property) for depreciation and investment tax credit purposes.

Similarly, in the context of the Foreign Investment in Real Property Tax Act (FIRPTA), codified at section 897 of the Code, a narrower definition of real property is generally more favorable to taxpayers. Enacted in 1980, FIRPTA is intended to subject foreign investors to the same U.S. tax treatment on gains from the disposition of interests in U.S. real property that applies to U.S. investors. Accordingly, foreign investors can more easily avoid U.S. tax to the extent that the definition of real property is narrow for FIRPTA purposes. As in the depreciation and investment credit contexts, this situation has led to vigorous debate over the appropriate characterization of certain types of assets (such as intangible assets) that may have characteristics associated with real property but do not fall within the traditional categories of buildings and structural components. See, for example, Advance Notice of Proposed Rulemaking, Infrastructure Improvements Under Section 897, published in the **Federal Register** (REG–130342–08, 73 FR 64901) on October 31, 2008 (noting that taxpayers may be taking the position that a governmental permit to operate a toll bridge or toll road is not a United States real property interest for purposes of section 897 and stating that the IRS and the Treasury Department are of the view that such a permit may properly be characterized as a United States real property interest in certain circumstances). In the case of FIRPTA, however, Congress modified the definition of real property to include items of personal property that are associated with the use of real property. See section 897(c)(6)(B) (including as real property movable walls, furnishings, and other personal property associated with the use of the real property). Consequently, it is explicitly contemplated in section 897 that an item of property may be treated as a United States real property interest for FIRPTA purposes, notwithstanding that it is characterized as personal property for other purposes of the Code.

In the REIT context, taxpayers ordinarily benefit from a relatively broad definition of real property. Consequently, taxpayers have generally advocated in the REIT context for a more expansive definition of real property than applies in the depreciation, (prior) investment tax credit, and FIRPTA contexts. In drafting these regulations, the Treasury Department and the IRS have sought to balance the general principle that common terms used in different provisions should have common meanings with the particular policies underlying the REIT provisions. These proposed regulations define real property only for purposes of sections 856 through 859. The IRS and the Treasury Department request comments, however, on the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled, whether through modifications to these proposed regulations or through modifications to the regulations under other Code provisions.

Proposed Effective Date

The IRS and the Treasury Department view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property. As such, these proposed regulations are proposed to be effective for calendar quarters beginning after these proposed regulations are published as final regulations in the **Federal Register**. The IRS and the Treasury Department solicit comments regarding the proposed effective date.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13653. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on all aspects of these proposed rules. All comments will be available for public inspection and copying at *http://www.regulations.gov*, or upon request.

A public hearing has been scheduled for September 18, 2014, at 10:00 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 12, 2014. A period of ten minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Andrea M. Hoffenson and Julanne Allen, Office of Associate Chief Council (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** In § 1.856–3, paragraph (d) is revised to read as follows:

§ 1.856–3 Definitions.

* * * * *

(d) *Real property.* See § 1.856–10 for the definition of *real property.*

* * * * *

■ **Par. 3.** Section 1.856–10 is added to read as follows:

§ 1.856–10 Definition of real property.

(a) *In general.* This section provides definitions for purposes of part II, subchapter M, chapter 1 of the Internal Revenue Code (Code). Paragraph (b) of this section defines real property, which includes land as defined under paragraph (c) of this section, and improvements to land as defined under paragraph (d) of this section. Improvements to land include inherently permanent structures as defined under paragraph (d)(2) of this section, and structural components of inherently permanent structures as defined under paragraph (d)(3) of this section. Paragraph (e) of this section provides rules for determining whether an item is a distinct asset for purposes of applying the definitions in paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section identifies intangible assets that are real property or interests in real property. Paragraph (g) of this section provides examples illustrating the rules of paragraphs (b) through (f) of this section.

(b) *Real property.* The term *real property* means land and improvements to land. Local law definitions are not controlling for purposes of determining the meaning of the term real property.

(c) *Land.* Land includes water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as crops, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land. The storage of severed or extracted natural products or deposits, such as crops, water, ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property.

(d) *Improvements to land*—(1) *In general.* The term *improvements to land* means inherently permanent structures and their structural components.

(2) *Inherently permanent structure*—(i) *In general.* The term *inherently permanent structure* means any permanently affixed building or other structure. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent. A distinct asset that serves an active function, such as an item of machinery or equipment, is not a building or other inherently permanent structure.

(ii) *Building*—(A) *In general.* A building encloses a space within its walls and is covered by a roof.

(B) *Types of buildings.* Buildings include the following permanently affixed distinct assets: houses; apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

(iii) *Other inherently permanent structures*—(A) *In general.* Other inherently permanent structures serve a passive function, such as to contain, support, shelter, cover, or protect, and do not serve an active function such as to manufacture, create, produce, convert, or transport.

(B) *Types of other inherently permanent structures.* Other inherently permanent structures include the following permanently affixed distinct assets: microwave transmission, cell, broadcast, and electrical transmission towers; telephone poles; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; stationary wharves and docks; and outdoor advertising displays for which an election has been properly made under section 1033(g)(3).

(iv) *Facts and circumstances determination.* If a distinct asset (within the meaning of paragraph (e) of this section) does not serve an active function as described in paragraph (d)(2)(iii)(A) of this section, and is not otherwise listed in paragraph (d)(2)(ii)(B) or (d)(2)(iii)(B) of this section or in guidance published in the Internal Revenue Bulletin (see

§ 601.601(d)(2)(ii) of this chapter), the determination of whether that asset is an inherently permanent structure is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner in which the distinct asset is affixed to real property;

(B) Whether the distinct asset is designed to be removed or to remain in place indefinitely;

(C) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(D) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease); and

(E) The time and expense required to move the distinct asset.

(3) *Structural components*—(i) *In general.* The term *structural component* means any distinct asset (within the meaning of paragraph (e) of this section) that is a constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. If interconnected assets work together to serve an inherently permanent structure with a utility-like function (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. Structural components are real property only if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related. If a distinct asset is customized in connection with the rental of space in or on an inherently permanent structure to which the asset relates, the customization does not affect whether the distinct asset is a structural component.

(ii) *Types of structural components.* Structural components include the following distinct assets and systems: Wiring; plumbing systems; central heating and air conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems.

(iii) *Facts and circumstances determination.* If a distinct asset (within the meaning of paragraph (e) of this section) is not otherwise listed in paragraph (d)(3)(ii) of this section or in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter), the determination of whether the asset is a structural component is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner, time, and expense of installing and removing the distinct asset;

(B) Whether the distinct asset is designed to be moved;

(C) The damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed;

(D) Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;

(E) Whether the distinct asset serves the inherently permanent structure in its passive function;

(F) Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;

(G) Whether the distinct asset is installed during construction of the inherently permanent structure;

(H) Whether the distinct asset will remain if the tenant vacates the premises; and

(I) Whether the owner of the real property is also the legal owner of the distinct asset.

(e) *Distinct asset*—(1) *In general.* A distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.

(2) *Facts and circumstances.* The determination of whether a particular separately identifiable item of property is a distinct asset is based on all of the facts and circumstances. In particular, the following factors must be taken into account:

(i) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

(ii) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;

(iii) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

(iv) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

(f) *Intangible assets*—(1) *In general.* If an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, then the intangible asset is real property or an interest in real property.

(2) *Licenses and permits.* A license, permit, or other similar right solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real property. A license or permit to engage in or operate a business generally is not real property or an interest in real property because it produces or contributes to the production of income other than consideration for the use or occupancy of space.

(g) *Examples.* The following examples demonstrate the rules of this section. *Examples 1* and *2* illustrate the definition of land as provided in paragraph (c) of this section. *Examples 3* through *10* illustrate the definition of improvements to land as provided in paragraph (d) of this section. Finally, *Examples 11* through *13* illustrate whether certain intangible assets are real property or interests in real property as provided in paragraph (f) of this section.

Example 1. Natural products of land. A is a real estate investment trust (REIT). REIT A owns land with perennial fruit-bearing plants. REIT A leases the fruit-bearing plants to a tenant on a long-term triple net lease basis and grants the tenant an easement on the land. The unsevered plants are natural products of the land and qualify as land within the meaning of paragraph (c) of this section. Fruit from the plants is harvested annually. Upon severance from the land, the harvested fruit ceases to qualify as land. Storage of the harvested fruit upon or within real property does not cause the harvested fruit to qualify as real property.

Example 2. Water space superjacent to land. REIT B leases a marina from a governmental entity. The marina is comprised of U-shaped boat slips and end ties. The U-shaped boat slips are spaces on the water that are surrounded by a dock on three sides. The end ties are spaces on the water at the end of a slip or on a long, straight dock. REIT B rents the boat slips and end ties to boat owners. The boat slips and end ties are water space superjacent to land that qualify as land within the meaning of paragraph (c) of this section and, therefore, qualify as real property.

Example 3. Indoor sculpture. (i) REIT C owns an office building and a large sculpture in the atrium of the building. The sculpture measures 30 feet tall by 18 feet wide and weighs five tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. The sculpture was constructed within the building. Removal would be costly and time consuming and would destroy the sculpture. The sculpture is reasonably expected to remain in the building indefinitely. The sculpture does not manufacture, create, produce, convert, transport, or serve any similar active function.

(ii) When analyzed to determine whether it is an inherently permanent structure using the factors provided in paragraph (d)(2)(iv) of this section, the sculpture—

(A) Is permanently affixed to the building by supports embedded in the building's foundation;

(B) Is not designed to be removed and is designed to remain in place indefinitely;

(C) Would be damaged if removed and would damage the building to which it is affixed;

(D) Will remain affixed to the building after any tenant vacates the premises and will remain affixed to the building indefinitely; and

(E) Would require significant time and expense to move.

(iii) The factors described in this paragraph (g) *Example 3* (ii)(A) through (ii)(E) all support the conclusion that the sculpture is an inherently permanent structure within the meaning of paragraph (d)(2) of this section and, therefore, is real property.

Example 4. Bus shelters. (i) REIT D owns 400 bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides. REIT D enters into a long-term lease with a local transit authority for use of the bus shelters. Each bus shelter is prefabricated from steel and is bolted to the sidewalk. Bus shelters are disassembled and moved when bus routes change. Moving a bus shelter takes less than a day and does not significantly damage either the bus shelter or the real property to which it was affixed.

(ii) The bus shelters are not enclosed transportation stations or terminals and do not otherwise meet the definition of a building in paragraph (d)(2)(ii) of this section nor are they listed as types of other inherently permanent structures in paragraph (d)(2)(iii)(B) of this section.

(iii) When analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section, the bus shelters—

(A) Are not permanently affixed to the land or an inherently permanent structure;

(B) Are designed to be removed and are not designed to remain in place indefinitely;

(C) Would not be damaged if removed and would not damage the sidewalks to which they are affixed;

(D) Will not remain affixed after the local transit authority vacates the site and will not remain affixed indefinitely; and

(E) Would not require significant time and expense to move.

(iv) The factors described in this paragraph (g) *Example 4* (iii)(A) through (iii)(E) all support the conclusion that the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section. Although the bus shelters serve a passive function of sheltering, the bus shelters are not permanently affixed, which means the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property.

Example 5. Cold storage warehouse. (i) REIT E owns a refrigerated warehouse (Cold Storage Warehouse). REIT E enters into long-term triple net leases with tenants. The tenants use the Cold Storage Warehouse to store perishable products. Certain components and utility systems within the Cold Storage Warehouse have been customized to accommodate the tenants' need for refrigerated storage space. For example, the Cold Storage Warehouse has customized freezer walls and a central refrigeration system. Freezer walls within the Cold Storage Warehouse are specifically designed to maintain the desired temperature within the warehouse. The freezer walls and central refrigeration system are each comprised of a series of interconnected assets that work together to serve a utility-like function within the Cold Storage Warehouse, were installed during construction of the building, and will remain in place when a tenant vacates the premises. The freezer walls and central refrigeration system were each designed to remain permanently in place.

(ii) Walls and central refrigeration systems are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of the freezer walls does not affect their qualification as structural components. Therefore, the freezer walls and central refrigeration system are structural components of REIT E's Cold Storage Warehouse.

Example 6. Data center. (i) REIT F owns a building that it leases to a tenant under a long-term triple net lease. Certain interior components and utility systems within the building have been customized to accommodate the particular requirements for housing computer servers. For example, to accommodate the computer servers, REIT F's building has been customized to provide a higher level of electrical power, central air conditioning, telecommunications access, and redundancies built into the systems that provide these utilities than is generally available to tenants of a conventional office building. In addition, the space for computer servers in REIT F's building is constructed on raised flooring, which is necessary to accommodate the electrical, telecommunications, and HVAC infrastructure required for the servers. The following systems of REIT F's building have been customized to permit the building to house the servers: central heating and air conditioning system, integrated security system, fire suppression system, humidity control system, electrical distribution and redundancy system (Electrical System), and telecommunication infrastructure system (each, a System). Each of these Systems is comprised of a series of interconnected assets that work together to serve a utility-like function within the building. The Systems were installed during construction of the building and will remain in place when the tenant vacates the premises. Each of the Systems was designed to remain permanently in place and was customized by enhancing the capacity of the System in connection with the rental of space within the building.

(ii) The central heating and air conditioning system, integrated security system, fire suppression system, and humidity control system are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of these Systems does not affect the qualification of these Systems as structural components of REIT F's building within the meaning of paragraph (d)(3) of this section.

(iii) In addition to wiring, which is listed as a structural component in paragraph (d)(3)(ii) of this section and, therefore, is real property, the Electrical System and telecommunication infrastructure system include equipment used to ensure that the tenant is provided with uninterruptable, stable power and telecommunication services. When analyzed to determine whether they are structural components using the factors in paragraph (d)(3)(iii) of this section, the Electrical System and telecommunication infrastructure system—

(A) Are embedded within the walls and floors of the building and would be costly to remove;

(B) Are not designed to be moved, are designed specifically for the particular building of which they are a part, and are intended to remain permanently in place;

(C) Would not be significantly damaged upon removal and although they would damage the walls and floors in which they are embedded, they would not significantly damage the building if they were removed;

(D) Serve a utility-like function with respect to the building;

(E) Serve the building in its passive function of containing, sheltering and protecting computer servers;

(F) Produce income as consideration for the use or occupancy of space within the building;

(G) Were installed during construction of the building;

(H) Will remain in place when the tenant vacates the premises; and

(I) Are owned by REIT F, which also owns the building.

(iv) The factors described in this paragraph (g) *Example 6* (iii)(A), (iii)(B), and (iii)(D) through (iii)(I) all support the conclusion that the Electrical System and telecommunication infrastructure system are structural components of REIT F's building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) *Example 6* (iii)(C) would support a conclusion that the

Electrical System and telecommunication infrastructure system are not structural components. However this factor does not outweigh the factors supporting the conclusion that the Electric System and telecommunication infrastructure system are structural components.

Example 7. Partitions. (i) REIT G owns an office building that it leases to tenants under long-term triple net leases. Partitions are used to delineate space between tenants and within each tenant's space. The office building has two types of interior, non-load-bearing drywall partition systems: a conventional drywall partition system (Conventional Partition System) and a modular drywall partition system (Modular Partition System). Neither the Conventional Partition System nor the Modular Partition System was installed during construction of the office building. Conventional Partition Systems are comprised of fully integrated gypsum board partitions, studs, joint tape, and covering joint compound. Modular Partition Systems are comprised of assembled panels, studs, tracks, and exposed joints. Both the Conventional Partition System and the Modular Partition System reach from the floor to the ceiling.

(ii) Depending on the needs of a new tenant, the Conventional Partition System may remain in place when a tenant vacates the premises. The Conventional Partition System is designed and constructed to remain in areas not subject to reconfiguration or expansion. The Conventional Partition System can be removed only by demolition, and, once removed, neither the Conventional Partition System nor its components can be reused. Removal of the Conventional Partition System causes substantial damage to the Conventional Partition System itself but does not cause substantial damage to the building.

(iii) Modular Partition Systems are typically removed when a tenant vacates the premises. Modular Partition Systems are not designed or constructed to remain permanently in place. Modular Partition Systems are designed and constructed to be movable. Each Modular Partition System can be readily removed, remains in substantially the same condition as before, and can be reused. Removal of a Modular Partition System does not cause any substantial damage to the Modular Partition System itself or to the building. The Modular Partition System may be moved to accommodate the reconfigurations of the interior space within the office building for various tenants that occupy the building.

(iv) The Conventional Partition System is a wall, and walls are listed as structural components in paragraph (d)(3)(ii) of this section. The Conventional Partition System, therefore, is real property.

(v) When analyzed to determine whether it is a structural component using the factors provided in paragraph (d)(3)(iii) of this section, the Modular Partition System—

(A) Is installed and removed quickly and with little expense;

(B) Is not designed specifically for the particular building of which it is a part and is not intended to remain permanently in place;

(C) Is not damaged, and the building is not damaged, upon its removal;

(D) Does not serve a utility-like function with respect to the building;

(E) Serves the building in its passive function of containing and protecting the tenants' assets;

(F) Produces income only as consideration for the use or occupancy of space within the building;

(G) Was not installed during construction of the building;

(H) Will not remain in place when a tenant vacates the premises; and

(I) Is owned by REIT G.

(vi) The factors described in this paragraph (g) *Example 7* (v)(A) through (v)(D), (v)(G), and (v)(H) all support the conclusion that the Modular Partition System is not a structural component of REIT G's building within the meaning of paragraph (d)(3) of this section and, therefore, is not real property. The factors described in this paragraph (g) *Example 7* (v)(E), (v)(F), and (v)(I) would support a conclusion that the Modular Partition System is a structural component. These factors, however, do not outweigh the factors supporting the conclusion that the Modular Partition System is not a structural component.

Example 8. Solar energy site. (i) REIT H owns a solar energy site, among the components of which are land, photovoltaic modules (PV Modules), mounts, and an exit wire. REIT H enters into a long-term triple net lease with a tenant for the solar energy site. The mounts (that is, the foundations and racks) support the PV Modules. The racks are affixed to the land through foundations made from poured concrete. The mounts will remain in place when the tenant vacates the solar energy site. The PV Modules convert solar photons into electric energy (electricity). The exit wire is buried underground, is connected to equipment that is in turn connected to the PV Modules, and transmits the electricity produced by the PV Modules to an electrical power grid, through which the electricity is distributed for sale to third parties.

(ii) REIT H's PV Modules, mounts, and exit wire are each separately identifiable items. Separation from a mount does not affect the ability of a PV Module to convert photons to electricity. Separation from the equipment to which it is attached does not affect the ability of the exit wire to transmit electricity to the electrical power grid. The types of PV Modules and exit wire that REIT H owns are each customarily sold or acquired as single units. Removal of the PV Modules from the mounts to which they relate does not damage the function of the mounts as support structures and removal is not costly. The PV Modules are commonly viewed as serving the useful function of converting photons to electricity, independent of the mounts. Disconnecting the exit wire from the equipment to which it is attached does not damage the function of that equipment, and the disconnection is not costly. The PV Modules, mounts, and exit wire are each distinct assets within the meaning of paragraph (e) of this section.

(iii) The land is real property as defined in paragraph (c) of this section.

(iv) The mounts are designed and constructed to remain permanently in place, and they have a passive function of supporting the PV Modules. When analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section, the mounts—

(A) Are permanently affixed to the land through the concrete foundations or molded concrete anchors (which are part of the mounts);

(B) Are not designed to be removed and are designed to remain in place indefinitely;

(C) Would be damaged if removed;

(D) Will remain affixed to the land after the tenant vacates the premises and will remain affixed to the land indefinitely; and

(E) Would require significant time and expense to move.

(v) The factors described in this paragraph (g) *Example 8* (iv)(A) through (iv)(E) all support the conclusion that the mounts are inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are real property.

(vi) The PV Modules convert solar photons into electricity that is transmitted through an electrical power grid for sale to third parties. The conversion is an active function. The PV Modules are items of machinery or equipment and are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property. The PV Modules do not serve the mounts in their passive function of providing support; instead, the PV Modules produce electricity for sale to third parties, which is income other than consideration for the use or occupancy of space. The PV Modules are not structural components of REIT H's mounts within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

(vii) The exit wire is buried under the ground and transmits the electricity produced by the PV Modules to the electrical power grid. The exit wire was installed during construction of the solar energy site and is designed to remain permanently in place. The exit wire is inherently permanent and is a transmission line, which is listed as an inherently permanent structure in paragraph (d)(2)(iii)(B) of this section. Therefore, the exit wire is real property.

Example 9. Solar-powered building. (i) REIT I owns a solar energy site similar to that described in *Example 8,* except that REIT I's solar energy site assets (Solar Energy Site Assets) are mounted on land adjacent to an office building owned by REIT I. REIT I leases the office building and the solar energy site to a single tenant. Although the tenant occasionally transfers excess electricity produced by the Solar Energy Site Assets to a utility company, the Solar Energy Site Assets are designed and intended to produce electricity only to serve the office building. The Solar Energy Site Assets were designed and constructed specifically for the office building and are intended to remain permanently in place but were not installed during construction of the office building. The Solar Energy Site Assets will not be removed if the tenant vacates the premises.

(ii) With the exception of the occasional transfers of excess electricity to a utility company, the Solar Energy Site Assets serve the office building to which they are constituent, and, therefore, the Solar Energy Site Assets are analyzed to determine whether they are a structural component using the factors provided in paragraph (d)(3)(iii) of this section. The Solar Energy Site Assets—

(A) Are expensive and time consuming to install and remove;

(B) Are designed specifically for the particular office building for which they are a part and are intended to remain permanently in place;

(C) Will not cause damage to the office building if removed (but the mounts would be damaged upon removal);

(D) Serve a utility-like function with respect to the office building;

(E) Serve the office building in its passive function of containing and protecting the tenants' assets;

(F) Produce income from consideration for the use or occupancy of space within the office building;

(G) Were installed after construction of the office building;

(H) Will remain in place when the tenant vacates the premises; and

(I) Are owned by REIT I (which is also the owner of the office building).

(iii) The factors described in this paragraph (g) *Example 9* (ii)(A), (ii)(B), (ii)(C) (in part), (ii)(D) through (ii)(F), (ii)(H), and (ii)(I) all support the conclusion that the Solar Energy Site Assets are a structural component of REIT I's office building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factors described in this paragraph (g) *Example 9* (ii)(C) (in part) and (ii)(G) would support a conclusion that the Solar Energy Site Assets are not a structural component, but these factors do not outweigh factors supporting the conclusion that the Solar Energy Site Assets are a structural component.

(iv) The result in this *Example 9* would not change if, instead of the Solar Energy Site Assets, solar shingles were used as the roof of REIT I's office building. Solar shingles are roofing shingles like those commonly used for residential housing, except that they contain built-in PV modules. The solar shingle installation was specifically designed and constructed to serve only the needs of REIT I's office building, and the solar shingles were installed as a structural component to provide solar energy to REIT I's office building (although REIT I's tenant occasionally transfers excess electricity produced by the solar shingles to a utility company). The analysis of the application of the factors provided in paragraph (d)(3)(ii) of this section would be similar to the analysis of the application of the factors to the Solar Energy Site Assets in this paragraph (g) *Example 9* (ii) and (iii).

Example 10. Pipeline transmission system. (i) REIT J owns an oil pipeline transmission system that contains and transports oil from producers and distributors of the oil to other distributors and end users. REIT J enters into a long-term, triple net lease with a tenant for the pipeline transmission system. The pipeline transmission system is comprised of underground pipelines, storage tanks, valves, vents, meters, and compressors. Although the pipeline transmission system serves an active function, transporting oil, a distinct asset within the system may nevertheless be an inherently permanent structure that does not itself perform an active function. Each of these distinct assets was installed during construction of the pipeline transmission system and will remain in place when a tenant vacates the pipeline transmission system. Each of these assets was designed to remain permanently in place.

(ii) The pipelines and storage tanks are inherently permanent and are listed as inherently permanent structures in paragraph (d)(2)(iii)(B) of this section. Therefore, the pipelines and storage tanks are real property.

(ii) Valves are placed at regular intervals along the pipeline to control oil flow and isolate sections of the pipeline in case there is need for a shut-down or maintenance of the pipeline. Vents equipped with vent valves are also installed in tanks and at regular intervals along the pipeline to relieve pressure in the tanks and pipeline. When analyzed to determine whether they are structural components using the factors set forth in paragraph (d)(3)(iii) of this section, the valves and vents—

(A) Are time consuming and expensive to install and remove from the tanks or pipeline;

(B) Are designed specifically for the particular tanks or pipeline for which they are a part and are intended to remain permanently in place;

(C) Will sustain damage and will damage the tanks or pipeline if removed;

(D) Do not serve a utility-like function with respect to the tanks or pipeline;

(E) Serve the tanks and pipeline in their passive function of containing tenants' oil;

(F) Produce income only from consideration for the use or occupancy of space within the tanks or pipeline;

(G) Were installed during construction of the tanks or pipeline;

(H) Will remain in place when a tenant vacates the premises; and

(I) Are owned by REIT J.

(iii) The factors described in this paragraph (g) *Example 10* (ii)(A) through (ii)(C) and (ii)(E) through (ii)(I) support the conclusion that the vents and valves are structural components of REIT J's tanks or pipeline within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) *Example 10* (ii)(D) would support a conclusion that the vents and valves are not structural components, but this factor does not outweigh the factors that support the conclusion that the vents and valves are structural components.

(iv) Meters are used to measure the oil passing into or out of the pipeline transmission system for purposes of determining the end users' consumption. Over long distances, pressure is lost due to friction in the pipeline transmission system. Compressors are required to add pressure to transport oil through the entirety of the pipeline. The meters and compressors do not serve the tanks or pipeline in their passive function of containing the tenants' oil, and are used in connection with the production of income from the sale and transportation of oil, rather than as consideration for the use or occupancy of space within the tanks or pipeline. The meters and compressors are not structural components within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

Example 11. Goodwill. REIT K acquires all of the stock of Corporation A, whose sole asset is an established hotel in a major metropolitan area. The hotel building is strategically located and is an historic structure viewed as a landmark. The hotel is well run by an independent contractor but the manner in which the hotel is operated does not differ significantly from the manner in which other city hotels are operated. Under GAAP, the amount allocated to Corporation A's hotel is limited to its depreciated replacement cost, and the difference between the amount paid for the stock of Corporation A and the depreciated replacement cost of the hotel is treated as goodwill attributable to the acquired hotel. This goodwill derives its value and is inseparable from Corporation A's hotel. If REIT K's acquisition of Corporation A had been a taxable asset acquisition rather than a stock acquisition, the goodwill would have been included in the tax basis of the hotel for Federal income tax purposes, and would not have been separately amortizable. The goodwill is real property to REIT K when it acquires the stock of Corporation A.

Example 12. Land use permit. REIT L receives a special use permit from the government to place a cell tower on federal government land that abuts a federal highway. Governmental regulations provide that the permit is not a lease of the land, but is a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate REIT L if the site is needed for a higher public purpose. REIT L leases space on the tower to various cell service providers. Each cell service provider installs its equipment on a designated space on REIT L's cell tower. The permit does not produce, or contribute to the production of, any income other than REIT L's receipt of payments from the cell service providers in consideration for their being allowed to use space on the tower. The permit is in the nature of a leasehold that allows REIT L to place a cell tower in a specific location on government land. Therefore, the permit is an interest in real property.

Example 13. License to operate a business. REIT M owns a building and receives a license from State to operate a casino in the building. The license applies only to REIT M's building and cannot be transferred to another location. REIT M's building is an inherently permanent structure under paragraph (d)(2)(i) of this section and, therefore, is real property. However, REIT M's license to operate a casino is not a right for the use, enjoyment, or occupation of REIT M's building, but is rather a license to engage in the business of operating a casino in the building. Therefore, the casino license is not real property.

(h) *Effective/applicability date.* The rules of this section apply for calendar quarters beginning on or before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2014–11115 Filed 5–9–14; 4:15 pm]

BILLING CODE 4830–01–P

DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 243

[Docket ID: DOD–2013–OS–0130]

RIN 0790–AJ08

Ratemaking Procedures for Civil Reserve Air Fleet Contracts

AGENCY: USTRANSCOM, DoD.

ACTION: Proposed rule.

SUMMARY: Section 366 of the National Defense Authorization Act for Fiscal Year 2012 directs the Secretary of Defense to determine a fair and reasonable rate of payment for airlift services provided to the Department of Defense by air carriers who are participants in the Civil Reserve Air Fleet Program. The Department of Defense (the Department or DoD) proposes to promulgate regulations to establish ratemaking procedures for civil reserve air fleet contracts as required by Section 366(a) in order to determine a fair and reasonable rate of payment.

DATES: Comments must be received no later than July 14, 2014.

ADDRESSES: You may submit comments, identified by docket number and or Regulatory Information Number and title, by any of the following methods;

• *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.

• *Mail:* Federal Docket Management System Office, 4800 Mark Center Drive, 2nd Floor, East Tower, Suite 02G09, Alexandria, VA 22350–3100.

Instructions: All submissions received must include the agency name and docket number or RIN for this **Federal Register** document. The general policy for comments and other submissions from members of the public is to make these submissions available for public viewing on the Internet at *http://www.regulations.gov* as they are received without change, including any personal identifiers or contact information.

FOR FURTHER INFORMATION CONTACT: Mr. Dwight Moore, Chief, Fiscal and Civil Law, USTRANSCOM/TCJA, (618) 220–3982 or Mr. Jeff Beyer, Chief, Business Support and Policy Division, USTRANSCOM/TCAQ, (618) 220–7021.

SUPPLEMENTARY INFORMATION:

Background

The Civil Reserve Air Fleet (CRAF) is a wartime readiness program, based on the Defense Production Act of 1950, as amended, (50 U.S.C. App. 2601 et seq.), and Executive Order 13603 (National Defense Resource Preparedness), March 16, 2012, to ensure quantifiable, accessible, and reliable commercial airlift capability to augment DoD airlift and to assure a mobilization base of aircraft available to the Department of Defense for use in the event of any level of national emergency or defense-orientated situations. As a readiness program, CRAF quantifies the number of passenger and cargo commercial assets required to support various levels of wartime requirements and thus allows DoD to account for their use when developing and executing contingency operations and war plans. In addition, the CRAF program identifies how DoD gains access to these commercial assets for operations by defining the authorities and procedures for CRAF activation. Finally, the program helps ensure that the DoD has reliable lines of communication and a common understanding of procedures with the carriers.

The United States Transportation Command (USTRANSCOM) negotiates and structures award of aircraft service contracts with certificated civilian air carriers willing to participate in the CRAF program in order to ensure that a mobilization base of aircraft is capable of responding to any level of defense-orientated situations.

The ability to set rates maintains the CRAF program's great flexibility to have any air carrier in the program able to provide aircraft within 24 hours of activation to fly personnel and cargo to any location in the world at a set rate per passenger or ton mile, regardless of where the air carrier normally operates. It also provides the Secretary of Defense the ability to respond rapidly to assist in emergencies and approved humanitarian operations, both in the United States and overseas where delay could result in more than monetary losses. The Government-set rate allows contracts to any location, sometimes awarded within less than an hour, and provides substantial commercial capability on short notice.

During the initial CRAF program years (between 1955 and 1962), ratemaking to price DoD airlift service relied upon price competition to meet its commercial airlift needs. This procurement method resulted in predatory pricing issues and failed to provide service meeting safety and performance requirements. Congressional Subcommittee hearings held at the time determined price competition to be non-compensatory and destructive to the industry. As a result, the ratemaking process was implemented under the regulatory authority of the Civil Aeronautics Board (CAB). Ratemaking continued under the CAB until deregulation in 1980. At that time, civil air carriers and DoD's contracting agency for long-term international airlift, the Military Airlift Command (MAC), agreed by a memorandum of understanding (MOU) that CAB methodologies by which rates for DoD airlift were established produced fair and reasonable rates and furthered the objectives of the CRAF program; and therefore, the parties agreed to continue to use CAB methodologies for establishing MAC uniform negotiated rates under an MOU renewed every five years. MAC became Air Mobility Command (AMC) on June 1, 1992. Ratemaking continued under AMC until January 1, 2007, when DoD's contracting authority for long-term international airlift was transferred from AMC to USTRANSCOM. On December 31, 2011, the National Defense Authorization Act for Fiscal Year 2012 (FY12 NDAA) was signed into law. Section 366 of the FY12 NDAA, codified at 10 U.S.C. § 9511a, authorized and directed the Secretary of Defense to determine a fair and reasonable rate of payment made to participants in the CRAF program. This proposed rulemaking effectuates Section 366.

This proposed rulemaking broadly tracks the longstanding ratemaking procedures for CRAF contracts in all substantial elements and the ratemaking methodologies supporting the pricing of airlift services as described in previous and current MOUs between certificated civilian air carriers willing to participate in the CRAF program and USTRANSCOM and USTRANSCOM predecessor entities.

In addition to compliance with this rule, CRAF participants, consistent with past practice, will be expected to enter into a MOU with USTRANSCOM where they will be expected to furnish USTRANSCOM, as a condition of its continued participation in the CRAF program, with the financial and operational information required by USTRANSCOM to adequately make a determination of fairness and reasonableness of price. This rulemaking will have no impact on air operators or certificated air carriers not

GOODWIN PROCTER

REIT ALERT

November 19, 2014

REITs and the Alternative Investment Fund Managers Directive

SPEED READ

The implementation of the Alternative Investment Fund Managers Directive throughout the European Union may have implications for REITs in the United States if they are determined to be alternative investment funds or “AIFs”. While the AIFMD rules are evolving, U.S. REITs should be prepared to differentiate themselves from AIFs. This alert examines some areas that should be explored when preparing to make such a distinction.

Introduction

The Alternative Investment Fund Managers Directive, or AIFMD, has now been implemented throughout the European Union. These rules generally impose various registration and reporting requirements on the managers of “alternative investment funds,” or AIFs. These requirements apply even to non-EU managers of non-EU AIFs if the AIF is raising equity capital in the EU.

In our October 29, 2014 Client Alert, “The Alternative Investment Fund Managers Directive One Year On–A Guide for Non-EU Managers”, we discuss the current state of the AIFMD, its requirements and staged implementation across the EU. In this REIT Alert, we focus on how the AIFMD might impact REITs in the United States and examine the status of REITs as possible AIFs under the new rules.

Capital raising is increasingly global. Even for strictly U.S. domestic REITs, underwriters and placement agents routinely seek to add a European tranche to U.S. offerings. This is true whether the transaction is an underwritten public offering, bought deal and/or private placement. Moreover, for REITs that have acquired, or are considering acquiring, assets in Europe, access to the European real estate investor base may be a key strategic goal or advantage.

The ability to raise equity capital in Europe on an equal footing with all other U.S. public companies is becoming increasingly important to U.S. REITs, of whatever variety or sector. As such, determining whether and how the AIFMD may affect capital raising activities by U.S. REITs in Europe is becoming a gating question when considering capital raising strategies.

As discussed below, the EU rules defining an AIF are broadly written and may implicate business entities and enterprises that would not otherwise have considered themselves “alternative investment funds”. Many U.S. REITs whose equity securities are listed for trading on major exchanges would have no reason to consider themselves AIFs any more than operating companies in any industry other than real estate. Unfortunately, the AIFMD provides no blanket exemption for REITs and, to date, among REITs formed in EU jurisdictions, some have concluded that they are AIFs and their managers have registered under the AIFMD. As more fully addressed below, we believe that the structure and operations most publicly-traded U.S. equity REITs will enable them to sufficiently differentiate themselves from the type of investment entity intended to be covered by the AIFMD to conclude that they are not AIFs.

AIFs Under the AIFMD

The primary targets of the directive are unregulated alternative investment funds and their managers. “Alternative investment funds” are defined in the directive as:

*“… **collective investment undertakings**, including investment compartments thereof, which:*

(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(ii) [are not EU regulated retail UCITS schemes];”[1]

The European Securities and Markets Authority (“ESMA” – the college of EU regulators whose task it is to create unity of interpretation throughout the EU) has given guidance on the term “collective investment undertaking”. It believes that an AIF does <u>not</u> include a vehicle that has a general commercial or industrial purpose, meaning:

“the purpose of pursuing a business strategy which includes characteristics such as running predominantly:

(i) a commercial activity, involving the purchase, sale, and/or exchange of goods or commodities and/or the supply of non-financial services, or

(ii) an industrial activity, involving the production of goods or construction of properties, or

(iii) a combination thereof.”[2]

How to distinguish between an investment undertaking and a commercial entity is often not easy. In a series of submissions to EU regulators during the course of the AIFMD drafting and implementation process, the National Association of Real Estate Investment Trusts urged regulators and other participants in the process to clarify generally the scope of the AIFMD and particularly with respect to its application to REITs.[3] In addition, the nature of the AIMFD as an EU directive, rather than an EU regulation, means that it needs to be transposed into law on a country-by-country basis. This has resulted in some differing national interpretations on, among other things, the precise characterization of an AIF.

Is a REIT an AIF?

To decide whether any particular REIT is an AIF, all relevant <u>operational</u> facts and circumstances must be considered. Note that, while counter-intuitive, none of the following non-operational factors is really relevant in making this assessment:

- an entity is a public REIT traded on a national securities exchange;
- REITs are treated as commercial enterprises in the United States and included as such in major equity indices such as the S&P 500; or
- a REIT's income may be treated as operating income rather than investment income for tax purposes.

These may be all true but do not, in and of themselves, automatically mean that a REIT is not an AIF for purposes of the AIFMD. Instead, the focus must be on the operational and commercial characteristics of the company. In the table below, we have summarized general operational and commercial characteristics of typical U.S. publicly traded equity REITs versus those of an AIF. The two criteria we believe to be most significant to the analysis are highlighted in italics, but no single criterion on its own is determinative.

TYPICAL U.S. REIT	AIF
A business which acquires, constructs, refurbishes, develops and provides services related to land and buildings	*An entity that merely holds property to take advantage of changing market prices or (rental) income streams*
Corporation having perpetual existence and one or more classes of permanent equity capital	Fund with a pre-defined finite life, often contingent on the investment goals or status of individual investors
Substantial number of employees from junior personnel to executive board directors to operate the business. Executive directors are paid at the level of executive directors generally	*A largely skeleton staff or no staff at all, with mainly non-executive directors*
Frequent board meetings at which major business is decided	Infrequent board meetings
Little outsourcing of major functions, with appropriate personnel in house to supervise any outsourced activities	Activities frequently outsourced to third parties, including third-party managers and with little ability to supervise outsourced activities
Investment policies that may be changed at the board's discretion	Changes to investment policies normally require some form of investor consent
Typically raises capital for itself by itself to fund its development activities, commercial business strategy and commitments	Typically raises capital through a "sponsor" that plans (itself or through a group member) to make a profit out of the management of the capital raised from third party/external sources
Issues debt in the public and private markets that is subject to ratings agencies review	Typically does not widely issue debt securities to the market and does not have rated debt securities

Whether or not an issuer is an AIF is up to each individual issuer to determine in consultation with its advisors. The criteria listed above are not exhaustive; in any given circumstance there are likely to be additional factors unique to the specific company that may have the effect of making it more or less like an AIF.[4]

European REITs

In this regard, it may be helpful for U.S. REITs to note the views taken by their EU counterparts to date. Property vehicles in the EU generally fall into three distinct categories (although working out which category is relevant for a particular REIT is not necessarily so easy):

- ***True-Commercial Property Vehicles.*** Companies that undertake property construction or development-for-sale businesses are clearly not AIFs. Given the relevant tax rules, though, they are also not likely to be REITs either. Examples in the EU include Persimmon plc and Quintain Estates and Development plc, or Barratt Homes, the house builder.
- ***Property Investment Vehicles.*** Various EU REITs have classified themselves as AIFs under the AIFMD, including, for example, *Standard Life Investments Property Income Trust Limited, Picton Property Income Limited, Tritax Big Box REIT plc* and *Green REIT plc*. In very general terms, the purpose of all four vehicles is to produce income and capital growth by investing in a portfolio of commercial properties; day-to-day activities are often outsourced to an investment manager and administrator (although Green REIT plc is self-managed) and changes to the investment policy may be made only with shareholder approval. Importantly, none of these entities has other than a token number of employees.
- ***"Mixed activity" REITs.*** The classification of these vehicles is more difficult since they undertake a mixture of development and investment activities. Two UK entities are helpful examples, *British Land plc* and *Great Portland Estates plc* — neither has classified itself as an AIF. In both cases, they have a significant number of employees (more than one hundred in each case), with a board of directors that meets frequently to take business decisions. Directors are paid as fully active executives.

Conclusion: Next Steps for U.S. REITs

As noted above, whether or not a U.S. REIT is an AIF is up to the individual company to determine in consultation with its advisors. While the notion of a REIT as a commercial operating company is uniformly accepted in the United States, U.S. REITs will need to affirmatively determine their status under the AIFMD in advance of any equity capital raising activities in the EU.

To be sure, the AIFMD rules are new and regulatory practice is still evolving. Moreover, as noted above, not all EU jurisdictions are necessarily taking exactly the same approach to interpretation or enforcement. Nevertheless, at this point U.S. REITs should at least have a plan. We believe that based on the factors discussed above and in consultation with appropriate advisors, many U.S. equity REITs will be able to sufficiently differentiate themselves from AIFs, taking into account both the general and unique operational characteristics of each individual company.

* * * * *

Please contact any of the attorneys below if you have questions about the issues raised in this REIT Alert.

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[1] Article 4(1)(a).

[2] See page 29 of the Final Report here.

[3] See the documents available at http://www.reit.com/nareit/policy-issues/cross-border-issues/eus-alternative-investment-fund-managers-directive-0.

[4] See, e.g., letter dated January 31, 2013 from the National Association of Real Estate Investment Trusts to ESMA, highlighting other possible differentiating factors between operating businesses and funds, including applicable regulatory regime and valuation metrics.

Authors: Glynn Barwick, Yoel Kranz, Ettore A. Santucci

GET IN TOUCH

For more information about the contents of this alert, please contact:

Glynn Barwick
Counsel
+44 (0) 20 7447 4226
gbarwick@goodwinprocter.com

Yoel Kranz
Partner
212.813.8831
ykranz@goodwinprocter.com

Ettore Santucci
Partner
617.570.1531
esantucci@goodwinprocter.com

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REITs

Hogan Lovells Alert
January 2015

See note below about Hogan Lovells

Marketing U.S. REITs to European Investors: Are you subject to the Alternative Investment Fund Managers Directive?

Introduction
This guide is aimed at U.S.-domiciled real estate investment trusts (REITs) and their advisers who wish to market in the EU[1] following the implementation of the Alternative Investment Fund Managers Directive (the Directive).

For clarity, this guide focuses on the position under the current law and guidance in the United Kingdom, which may differ from that in other EU member states. REITs should note that it is critical to confer with local counsel in each EU member state before marketing in that EU member state.

This note is written as a general introductory guide only. It should not be relied upon as a substitute for specific legal advice.

Overview
The Directive is part of a suite of complex rules that has a material impact on all funds (wherever domiciled) managed in the EU or marketed in the EU or to any person domiciled or with a registered office in the EU (EU investors).[2]

The Directive applies to "alternative investment funds" (AIFs). This is a broad concept that captures private equity, venture capital, real estate, hedge and infrastructure funds and investment companies. It also captures many investment entities that do not traditionally regard themselves as funds. A REIT that is an AIF must comply with onerous additional obligations in order to market to EU investors.

Despite extensive industry lobbying, there is no "safe harbor" for REITs, some of which may be AIFs. Each REIT will need to carefully consider whether it is an AIF prior to conducting any fundraising[3] activities with EU investors.[4]

This guide provides an overview of the elements of the definition of an AIF that REITs will need to consider in determining whether the Directive applies to them.

Contacts

Michael McTiernan
Partner, Capital Markets, Washington, D.C.
michael.mctiernan@hoganlovells.com
+1 202 637 5684

Nicholas Holman
Partner, Investment Funds, London
nicholas.holman@hoganlovells.com
+44 207 296 5180

Nigel Read
Partner, Corporate, London
nigel.read@hoganlovells.com
+44 207 296 5121

Jeremy Pickles
Senior Associate, Investment Funds, London
jeremy.pickles@hoganlovells.com
+44 207 296 5796

Visit us at
www.hoganlovells.com

Penalties for failure to comply can be severe but vary from EU member state to EU member state – for example, in the United Kingdom "unlawful marketing" may amount to a criminal offense and investors may reclaim their invested money as well as compensation for any losses sustained - so it is critical that REITs understand and adhere to these new rules if they apply.

In the United Kingdom, penalties for "unlawful marketing" apply to the REIT (or any external manager) as well as any underwriter marketing on behalf of the REIT (or any external manager).

What is an AIF?
An AIF is defined as:

- a collective investment undertaking
- that raises capital from a number of investors
- with a view to investing that capital in accordance with a defined investment policy for the benefit of those investors.[5]

There are only a very limited number of exemptions, meaning that a wide range of vehicles could be caught by this definition, including certain REITs. The lack of exemptions in the legislation is deliberate.

That being said, the Directive focuses on investment undertakings, and "ordinary companies"[6] are expressly outside its scope. A typical equity REIT may be able to contend that it is not within the Directive’s scope on this basis. However, in order to do so, it will be necessary to carry out an analysis of a particular REIT's characteristics in light of the regulatory guidance available on this issue.

Given its relevance to equity REITs, the remainder of this guide focuses solely on this "ordinary company" issue. If a REIT is an "ordinary company," it will not be considered an AIF; however, if a REIT is not an "ordinary company" or the analysis is not conclusive, then it may be an AIF, and further analysis will be necessary to reach a conclusion.

"Ordinary Companies": A UK perspective
The guidance issued by United Kingdom's Financial Conduct Authority (the FCA), one of the more "business-friendly" of the EU regulators, discusses the concept of an "ordinary company" in detail. It sets out a number of factors that are indicative (but not conclusive) of a business either being an "ordinary company" or an AIF.[7]

Although this guide does not propose to set out these factors in full, and any analysis should consider all applicable facts and circumstances, we believe that when the following factors are present in an equity REIT, this strongly supports the conclusion that the REIT is an "ordinary company" and not an AIF:

- The REIT, like most equity REITs, does not simply hold real estate to take account of changing market prices or income streams, but carries out commercial activities, such as the development or redevelopment of properties.
- The REIT is an operating business with a substantial number of employees over and above the number necessary to simply ensure that investment values of properties are maintained, including employees performing commercial activities such as on-site property management activities and development and redevelopment activities.
- The REIT does not outsource its core operations.
- The REIT's board includes executive officers with executive compensation packages, and the REIT’s board or its committees meet more frequently than just quarterly.
- The REIT does not have a defined mechanism for the return of capital to investors, such as a targeted liquidation date.
- The REIT is not marketed as an investment fund.

What do REITs need to do?
Prior to undertaking any fundraising in the EU or with EU investors, it is essential for REITs and their advisers to identify whether the REIT in question is an AIF or not. **We recommend that REITs, with the assistance of their advisers, perform this analysis now rather than at the time of an actual securities offering, when there may be significant time constraints.**

If it is an AIF, the REIT will need to comply with certain parts of the Directive as well as the national private placement regimes of each EU member state in which they wish to market, some of which impose onerous and time-consuming requirements. For example, a REIT that is an AIF wishing to market to German investors will need to, among other things, appoint a depositary to provide certain custody and oversight services and seek approval from the German regulator, a process that can take several months, in each case prior to any marketing.

If the REIT is not an AIF, any promotional activities will need to be carried out in compliance with local securities laws, but the additional burden of the Directive will not apply.

How can Hogan Lovells help?
Hogan Lovells, with its market-leading REIT practice and highly-regarded global investment funds practice with practitioners throughout the EU and the U.S., is uniquely qualified to assist REITs with this analysis.

- Our transactional lawyers, in collaboration with our regulatory practitioners, have already advised many REITs, real estate managers, and real estate trade bodies on their position under the Directive. We have a practical understanding of the regulation and the regulatory environment and extensive experience in the industry.
- We have also advised numerous AIFs and their managers on the impact of the Directive on the operation, management, and marketing of such AIFs. This enhanced insight into the Directive allows us to provide clear guidance about what U.S. REITs need to do to be compliant.

Further information
If you would like further information on the subject matter discussed in this note, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the right hand side of this alert.

1. For ease of reference, the term "EU" as used in this memorandum includes Norway, Iceland, and Liechtenstein, which together with the 28 member states of the European Union form the European Economic Area.
2. EU Directives do not apply directly across the EU, rather they have to be implemented into the national law of each EU member state, and it is the national law that has effect. Although the legislative intention is that the Directive apply harmoniously across the EU, the national level implementation has resulted in the law being applied inconsistently across the EU. REITs and their advisers therefore cannot rely on the interpretation in one EU member state as applying in another. To minimize this, the European Securities and Markets Authority (ESMA) has published guidelines to aid EU member states in their interpretation and implementation of the Directive, which it can update from time to time.
3. Fundraising by way of an issue of conventional debt securities should not be restricted by the Directive, whether a REIT is an AIF or not.
4. "Marketing" under the Directive has been interpreted in different ways. Certain EU member states require formal registration under the Directive prior to any contact being made with prospective investors; others permit test marketing without compliance, only requiring notification and compliance prior to shares being made available to acquire.
5. We understand that some equity REITs have focused their analyses on the need for a defined investment policy, arguing that a broad investment policy that can be changed without investor approval does not qualify as being "defined". While this argument is persuasive, particularly when compared to a typical real estate fund where a detailed, enforceable, and fixed investment policy is a key component, because the Directive was clearly intended to cover certain hedge funds with similarly broad policies that can be changed without reference to the investors, and because certain regulators have determined these policies to be sufficiently "defined," the position is not certain, and equity REITs should not rely solely on this argument.
6. The term "ordinary company" was replaced in later guidance issued by ESMA by the concept of an undertaking having "a general commercial or industrial purpose". Ordinary company is used in this note for simplicity.
7. The FCA guidance only applies in the United Kingdom. Although the intention is that the Directive is applied in a consistent manner across the EU, it is very possible that some other EU member states will interpret the provisions differently. A REIT proposing to raise funds on a pan-European basis should therefore consider whether to seek advice in respect of each EU member state in which it intends to market.

Atlantic House, Holborn Viaduct, London EC1A 2FG, United Kingdom
Columbia Square, 555 Thirteenth Street, NW, Washington, D.C. 20004, United States of America

II

114TH CONGRESS
1ST SESSION

H. R. 636

IN THE SENATE OF THE UNITED STATES

FEBRUARY 23, 2015

Received

AN ACT

To amend the Internal Revenue Code of 1986 to permanently extend increased expensing limitations, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "America's Small Business Tax Relief Act of 2015".

SEC. 2. EXPENSING CERTAIN DEPRECIABLE BUSINESS ASSETS FOR SMALL BUSINESS.

(a) IN GENERAL.—

(1) DOLLAR LIMITATION.—Section 179(b)(1) of the Internal Revenue Code of 1986 is amended by striking "shall not exceed—" and all that follows and inserting "shall not exceed $500,000.".

(2) REDUCTION IN LIMITATION.—Section 179(b)(2) of such Code is amended by striking "exceeds—" and all that follows and inserting "exceeds $2,000,000.".

(b) COMPUTER SOFTWARE.—Section 179(d)(1)(A)(ii) of such Code is amended by striking ", to which section 167 applies, and which is placed in service in a taxable year beginning after 2002 and before 2015" and inserting "and to which section 167 applies".

(c) ELECTION.—Section 179(c)(2) of such Code is amended—

(1) by striking "may not be revoked" and all that follows through "and before 2015"; and

(2) by striking "IRREVOCABLE" in the heading thereof.

(d) AIR CONDITIONING AND HEATING UNITS.—Section 179(d)(1) of such Code is amended by striking ''and shall not include air conditioning or heating units''.

(e) QUALIFIED REAL PROPERTY.—Section 179(f) of such Code is amended—

(1) by striking ''beginning after 2009 and before 2015'' in paragraph (1); and

(2) by striking paragraphs (3) and (4).

(f) INFLATION ADJUSTMENT.—Section 179(b) of such Code is amended by adding at the end the following new paragraph:

''(6) INFLATION ADJUSTMENT.—

''(A) IN GENERAL.—In the case of any taxable year beginning after 2015, the dollar amounts in paragraphs (1) and (2) shall each be increased by an amount equal to—

''(i) such dollar amount, multiplied by

''(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2014' for 'calendar year 1992' in subparagraph (B) thereof.

"(B) ROUNDING.—The amount of any increase under subparagraph (A) shall be rounded to the nearest multiple of $10,000.".

(g) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2014.

SEC. 3. REDUCED RECOGNITION PERIOD FOR BUILT-IN GAINS OF S CORPORATIONS MADE PERMANENT.

(a) IN GENERAL.—Paragraph (7) of section 1374(d) of the Internal Revenue Code of 1986 is amended to read as follows:

"(7) RECOGNITION PERIOD.—

"(A) IN GENERAL.—The term 'recognition period' means the 5-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.

"(B) INSTALLMENT SALES.—If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.''.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2014.

SEC. 4. PERMANENT RULE REGARDING BASIS ADJUSTMENT TO STOCK OF S CORPORATIONS MAKING CHARITABLE CONTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Section 1367(a)(2) of the Internal Revenue Code of 1986 is amended by striking the last sentence.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to contributions made in taxable years beginning after December 31, 2014.

SEC. 5. BUDGETARY EFFECTS.

The budgetary effects of this Act shall not be entered on either PAYGO scorecard maintained pursuant to section 4(d) of the Statutory Pay-As-You-Go Act of 2010.

Passed the House of Representatives February 13, 2015.

Attest: KAREN L. HAAS,

Clerk.

JOINT COMMITTEE ON TAXATION
February 10, 2015
JCX-37-15

DESCRIPTION OF THE CHAIRMAN'S MODIFCATIONS TO THE CHAIRMAN'S MARK PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS (REITS), REGULATED INVESTMENT COMPANIES (RICS), AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)

(a) Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status

The modification clarifies that the required disclosures of USRPHC status on an income tax return and on forms 1099 shall be made in such form and manner as the Secretary may prescribe, including electronic filing. The modification also makes clear that in addition to notification to the Internal Revenue Service, and to shareholders through 1099's, the company must provide notice to the public. Notice to the public shall require disclosure in the company's annual reports available on its website, or such other media as the Secretary determines are appropriate in the interests of tax administration.

The modification provides that the penalty amount may be adjusted for inflation.

(b) Require FIRPTA withholding by brokers

The modification clarifies that the proposal requiring withholding by a broker in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)) shall apply only to the broker of the seller, not the purchaser.

(c) Cleansing rule

The modification clarifies that the proposal applies to dispositions on or after the date of enactment.

(d) Estimated revenue effects of the chairman's mark proposals as modified

Fiscal Years
[Millions of Dollars]

2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2015-20	2015-25
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

NOTE: Details do not add to totals due to rounding.
[1] Gain of less than $500,000.
[2] Loss of less than $500,000.

DESCRIPTION OF H.R. 629, A BILL TO MAKE PERMANENT THE REDUCED RECOGNITION PERIOD FOR BUILT-IN GAINS OF S CORPORATIONS

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 4, 2015

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 3, 2015
JCX-14-15

CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 629, a bill to make permanent the reduced recognition period for built-in gains of S corporations on February 4, 2015. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 629, A Bill to Make Permanent the Reduced Recognition Period for Built-in Gains of S Corporations* (JCX-14-15), February 3, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Reduced Recognition Period for Built-in Gains of S Corporations Made Permanent (sec. 1374 of the Code)

Present Law

In general

S corporations

A small business corporation[2] may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[3]

A corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain[4] that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, (*i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect).[5] If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no built-in gain tax is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.[6] Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method [7] during or after the recognition period, that income is subject to the built-in gain tax.[8]

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or

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[2] This term is defined in section 1361(b).

[3] Sec. 1366.

[4] Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

[5] Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d).

[6] Sec. 1374(d)(2).

[7] Sec. 453.

[8] Treas. Reg. sec. 1.1374-4(h).

other property) in the hands of the C corporation.[9] In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[10]

The amount of the built-in gains tax is treated as a loss by each of the S corporation shareholders in computing its own income tax.[11]

For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.[12] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the fifth year in the corporation's recognition period preceded such taxable year.[13] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the S corporation election was in effect for five years preceding the taxable year beginning in 2011.

For taxable years beginning in 2012, 2013, and 2014, the term "recognition period" in section 1374, for purposes of determining the net recognized built-in gain, is applied by substituting a five-year period[14] for the otherwise applicable 10-year period. Thus, for such taxable years, the recognition period is the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation apply). If an S corporation with assets subject to section 1374 disposes of such assets in a taxable year beginning in 2012, 2013, or 2014 and the disposition occurs more than five years after the first day of the relevant recognition period, gain or loss on the disposition will not be taken into account in determining the net recognized built-in gain.

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[9] Sec. 1374(d)(8).

[10] Sec. 1374(d)(8)(B).

[11] Sec. 1366(f)(2). Shareholders continue to take into account all items of gain and loss under section 1366.

[12] Sec. 1374(d)(7)(B).

[13] Sec. 1374(d)(7)(C).

[14] The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

If an S corporation subject to section 1374 sells a built-in gain asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received will be governed by the provisions of section 1374(d)(7) applicable to the taxable year in which the sale was made.

Application to real estate investment trusts and regulated investment corporations

Under Treasury regulations, a regulated investment company ("RIC") or a real estate investment trust ("REIT") that was formerly a C corporation not taxed as a REIT or RIC (or that acquired assets from such a C corporation) generally is subject to the built-in gain tax rules as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment, requiring recognition of all C corporation built-in gain and loss at the time of the conversion or asset acquisition.[15] Deemed sale treatment is not permitted if its application would result in the recognition of a net loss.[16] For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.[17]

Description of Proposal

The proposal makes permanent the five-year recognition period for built-in gains of S corporations. Under current Treasury regulations, this five-year recognition period also would apply to real estate investment trusts and regulated investment companies that do not elect "deemed sale" treatment.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

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[15] Treas. Reg. secs. 1.337(d)-7(a) and 1.337(d)-7(b).

[16] Treas. Reg. sec. 1.337(d)-7(c)(1).

[17] Treas. Reg. sec. 1.337(d)-7(c)(1).

B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2015-20**	**2015-25**
-70	-218	-283	-222	-147	-103	-84	-81	-86	-92	-99	-1,043	-1,485

DESCRIPTION OF THE CHAIRMAN'S MARK OF PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS (REITs), REGULATED INVESTMENT COMPANIES (RICs) AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on February 11, 2015

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 9, 2015
JCX-30-15

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INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on February 11, 2015, of proposals relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA). This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the proposals.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of Proposals Relating to the Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA)* (JCX-30-15), February 9, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Proposals Relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and the Foreign Investment in Real Property Tax Act (FIRPTA)

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or of other capital assets.[2]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[3] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[4] In the case of a foreign corporation, the gain from the disposition or distribution of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payer of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment. Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on

[2] Secs. 871(b), 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

[4] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

any sale of stock that is regularly traded on an established securities market),[5] and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation during the applicable testing period.[6] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USPRI from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[7] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

U.S. real property holding corporations and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a domestic U.S. real property holding corporation ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during a "testing period," which is the shorter of the duration of the taxpayer's ownership of the stock since June 18, 1980, or the five-year period ending on the date of disposition of the stock.[8]

Under an exception, even if a corporation were a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the seller shareholder held (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.[9] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[10] The attribution rules also attribute

[5] Sec. 1445(b). Other excepted circumstances include the sale of a personal residence where the amount realized does not exceed $300,000.

[6] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See Sec. 1445(e)(4) and 1445(e)(5).

[7] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

[8] Secs. 897(c)(1)(A)(ii) and 897(c)(2).

[9] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[10] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. (Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C)). Also, if five percent or more in value of the stock in a

stock ownership between spouses and between children, grandchildren, parents, and grandparents.

"Cleansing rule" exception where corporate gain recognized

An interest in a corporation is not a USRPI if, as of the date of disposition of such interest, such corporation did not hold any USRPIs and all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations.[11]

FIRPTA rules for foreign investment through REITS and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity", which includes any real estate investment trust ("REIT"). Prior to January 1, 2015, the term also included certain regulated investment companies ("RICs") that invest largely in U.S. real property interests (including stock of one or more REITs). On and after that date, such RICs are treated as qualified investment entities under FIRPTA only for the purpose of applying FIRPTA to certain distributions the RIC receives or makes that are attributable to its interest in a REIT.[12]

REITs and RICs must satisfy a number of requirements, and are generally taxable as U.S. domestic corporations, but are subject to a modified corporate tax regime that permits the corporation to deduct amounts distributed to shareholders. The shareholders generally include such distributions in income.

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[13]), stock of such entity is not a USRPI and a

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corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. (Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C)).

[11] Sec. 897(c)(1)(B).

[12] Sec. 897(h)(4)(A)(ii). The provision that expired after December 31, 2014, more generally treating such RICs as qualified investment entities, has expired previously but has subsequently been reinstated through December 31, 2014.

[13] The testing period for this purpose if the shorter of i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, ii) the five-year period ending on the date of the

foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC.[14] Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[15] The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose did not look through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[16]

<u>FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPI's, except for distributions to certain five-percent or smaller shareholders</u>

Code section 897(h) provides that a distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[17] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[18] An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to both nonliquidating and liquidating distributions, and to distributions treated as sales or exchanges of stock by the investor as well as to dividend distributions) and that the IRS will issue regulations to that effect.[19]

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disposition or distribution, as the case may be, or iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[14] As noted previously, after December 31, 2014, a RIC is not included in the definition of a qualified investment entity for purposes of this rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

[15] Treas. Reg. Sec. 1.897-1(c)(2)(i) and Treas. Reg. Sec. 1.857-8(b).

[16] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

[17] Sec. 897(h)(1).

[18] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[19] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt

Code section 897(h)(1) provides an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located within the U.S., during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[20] Such distributions that are dividends are treated as dividends from the qualified investment entity,[21] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are not dividends are not subject to tax under FIRPTA.[22]

<u>FIRPTA withholding and reporting of information regarding USRPHC status</u>

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[23] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[24] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[25]

Treasury regulations[26] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform

from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

[20] Sec. 897(h)(1), second sentence. As noted previously, after December 31, 2014, a RIC is not a qualified investment entity for this purpose.

[21] Secs. 852(b)(3)(E) and 857(b)(3)(F).

[22] AM 2008-003, February 15, 2008.

[23] Sec. 1445.

[24] Sec. 1445(b)(6).

[25] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[26] Treas. Reg. Sec. 1.897-2(h).

that person whether the interest constitutes a USRPI.[27] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT, nor to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[28]

General Code authorization of certain returns by foreign persons

Present law section 6039C provides for returns by foreign persons holding direct investments in U.S. real property interests for the calendar year, to the extent provided by regulations. No regulations have been issued under this section.

Corporate dividends-received deduction for certain U.S. source dividends received from foreign corporations

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[29]

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[27] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation ("USRPHC"). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

[28] Treas. Reg. sec. 1.897-2(h)(3).

[29] Sec. 243.

Dividends from REITs are not eligible for the corporate dividends received deduction.[30] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[31]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[32] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.[33] Treasury regulations section 1.246-1 states that the deductions provided in sections "243… 244… and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

Description of Proposals

1. Publicly traded REITs and certain publicly traded qualified shareholder entities that hold REIT stock

In the case of REIT stock only, the proposal increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The proposal likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of U.S. real property interests, as a dividend, rather than as FIPRTA gain. Any distributions to such 10 percent (or less)

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[30] Secs. 243(d)(3) and 857(c)(1).

[31] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[32] Sec. 245.

[33] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

shareholders that are not dividends (for example, if the qualified investment entity surrendered its stock in a redemption that was not treated as a dividend) would be exempt from U.S. tax.[34]

For these purposes, the attribution rules of section 897(c)(6)(C) are modified to refer to the determination of whether a person holds more than 5 percent of a class of stock that is publicly traded (in the case of a non-REIT shareholder) or more than 10 percent (in the case of a REIT shareholder), as applicable. In either case, however, the proposal retains the present law attribution rules of section 897(c)(6)(C) that trigger attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation.

The proposal also provides that REIT stock held by a qualified shareholder is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as that "more than 10 percent" rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA. Also, the REIT may sell its assets and distribute the proceeds in a transaction that is treated as a sale of the qualified shareholder's REIT stock, without the application of FIRPTA. If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) does hold more than 10 percent of such class of REIT stock, then a percentage of the REIT stock held by the qualified shareholder equal to such investor's percentage ownership of the qualified shareholder is treated as a US real property interest in the hands of the qualified shareholder and is subject to FIRPTA.[35]

A qualified shareholder is defined as an entity that is (i) eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program, (ii) a qualified collective investment vehicle (as defined below), (iii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and (iv) that maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10 percent of that principal class of interests.

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[34] This result would follow from application of the conclusion of AM 2008-83, Feb. 15, 2008. See Present Law, FIRPTA rules for foreign investment through REITs and RICs, *supra*.

[35] As one example, if an individual shareholder owns 10 percent of a REIT's stock directly and also owns 10 percent of the stock of a qualified shareholder that in turn owns 80 percent of that REIT's stock (thus indirectly owning another 8 percent of such REIT's stock), such shareholder is deemed to own more than 10 percent (*i.e.,* 18 percent) of that REIT's stock under the proposal. Accordingly, 10 percent (the investor's percentage ownership of the qualified shareholder) of the REIT stock held by the qualified shareholder is treated as a U.S. real property interest.

A qualified collective investment vehicle is defined as an entity that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT[36] (ii) would be classified as a U.S. real property holding corporation (determined without regard to the proposal's rules that exempt REIT stock held by the entity from treatment as a U.S. real property interest), or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

Effective Date

The disposition provisions of the proposal apply to dispositions on and after the date of enactment. The attribution rule change (to refer to the separate 5 percent and 10 percent limitations) is effective on the date of enactment. The distribution provisions apply to any distribution by a REIT on or after the date of enactment which is treated as a deduction for a taxable year of such REIT ending after such date.

2. Domestically controlled definition

For purposes of determining whether a qualified investment entity is domestically controlled, the proposal provides a number of new rules and presumptions.

First, a qualified investment entity shall be permitted to presume that stock held by a holder of less than five percent of a class of stock regularly traded on an established securities market in the United States is held by U.S. persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership. Second, any stock in the qualified investment held by another qualified investment entity (I) any class of stock of which is regularly traded on an established stock exchange, or (II) which is a regulated investment company which issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined applying the permitted foregoing presumptions) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Effective Date

The proposal is effective on the date of enactment.

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[36] For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

3. Increase 10 percent FIRPTA withholding to 15 percent

The proposal generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The proposal applies to dispositions after the date which is 60 days after the date of the enactment.

4. Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status

The proposal requires disclosures of USRPHC status, by any corporation that is or was a U.S. real property holding corporation at any time during the five-year period ending on the date on which disclosure is made. Such a corporation must attach a statement regarding its status as a USRPHC within the past five years to its annual tax return, filed on or before the due date (including extensions). Such a corporation is also required to disclose such status on Form 1099s sent to shareholders, in annual reports, on websites, and, in the case of privately-held corporations, on stock certificates.

In the absence of disclosure to the contrary (in such form and manner as the Secretary of the Treasury may prescribe), any qualified investment entity (as defined in section 897(h)(4)) will be presumed for purposes of section 897 to be foreign controlled. Thus, if a foreign person disposes of the stock of a qualified investment entity that is domestically controlled under the rules provided in the proposal, but that does not disclose its domestically controlled status, the disposition is treated as one of stock of an entity that is not domestically controlled, and hence FIRPTA would generally apply to the disposition unless another exception applied.

A penalty is imposed for failure to comply with the USRPHC notification requirements. In the case of a corporation with gross receipts of less than $5,000,000, the penalty is $500,000. The penalty increases to $1,500,000 for corporations with gross receipts of $5,000,000 or more. In the case of a corporation that holds U.S. real property interests with a gross fair market value of $1 billion or more, the penalty is $5 million, increased to $10 million in the case of intentional failure to disclose or report. For purposes of determining gross receipts and gross fair market value under these penalty provisions, related-party aggregation rules apply.

Under regulations prescribed by the Secretary of the Treasury, publicly traded partnerships shall also be subject to these rules.

Effective Date

The proposal takes effect on January 1, 2016.

5. Require FIRPTA withholding by brokers

The proposal amends the FIRPTA withholding rules to provide that in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)), such broker shall be required to deduct and withhold a tax equal to 15 percent of the amount realized on the disposition. Certain exceptions apply.

Broker withholding is not required for sales of stock of a domestically controlled qualified investment entity (as defined in section 897(c)(4)) or for stock of a REIT that is not treated as a U.S. real property interest because it is being sold by an entity that is a qualified shareholder under the proposal. With respect to any disposition of any class of stock of a USRPHC which is regularly traded on an established securities market, broker withholding is not required if the transferor, immediately prior to the disposition, holds five percent or less of such class of stock (10 percent or less in the case of REIT stock). For that purpose, brokers are permitted to rely on public statements made by public companies, including statements related to the status of the company as a U.S. real property holding corporation or as a domestically controlled qualified investment entity.[37]

Broker withholding is only required if the broker had actual knowledge (or reasonably should have known) that the disposition was of stock of a U.S. real property holding corporation.

The proposal amends the Code provision that currently exempts from withholding the disposition of a share of a class of stock that is regularly traded on an established securities market, to require the broker withholding in accordance with the foregoing provisions.

Under regulations prescribed by the Secretary of the Treasury, similar withholding rules shall apply to brokers in the case of a disposition of a publicly traded partnership interest where such partnership would be a U.S. real property holding corporation if it were a U.S. corporation.

Effective Date

The proposal applies to dispositions after December 31, 2015.

6. Cleansing rule not applicable to RICs or REITs

Under the proposal, the so-called “cleansing rule” applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

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[37] Under the immediately preceding proposal, any qualified investment entity (as defined in section 897(h)(4)) is presumed for FIPTRA purposes to be foreign controlled unless the entity has made a disclosure to the contrary in such form and manner as the Secretary of the Treasury may prescribe.

Effective Date

The proposal applies to dispositions after the date of enactment.

7. Dividends derived from RICs and REITs ineligible for deduction for U.S. source portion of dividends from certain foreign corporations

Under the proposal, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245 of the Code, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The proposal applies to dividends received from RICs and REITs on or after the date of enactment.

B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2015-20**	**2015-25**
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

[1] Gain of less than $500,000.
[2] Loss of less than $500,000.

C. Increase Continuous Levy Authority on Payments to Medicare Providers and Suppliers

Present Law

In general

Levy is the administrative authority of the IRS to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[38] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[39] the property is not exempt from levy,[40] and the IRS has provided both notice of intention to levy[41] and notice of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[42] at least 30 days before the levy is made. A levy on salary or wages generally is continuously in effect until released.[43] A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[44]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[45]

The CDP notice (and pre-levy CDP hearing) is not required if: (1) the Secretary finds that collection would be jeopardized by delay; (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund; (3) the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served; or (4) the Secretary has served a Federal contractor levy. In each of these four cases,

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[38] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[39] *Ibid*.

[40] Sec. 6334.

[41] Sec. 6331(d).

[42] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[43] Secs. 6331(e) and 6343.

[44] Sec. 6321.

[45] Secs. 6331(d)(3) and 6861.

however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[46]

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[47] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments" by the Federal government if the payees are delinquent on their tax obligations. With respect to payments to vendors of goods, services, or property sold or leased to the Federal government, the continuous levy may be up to 100 percent of each payment.[48] For payments to Medicare providers and suppliers, the levy is up to 15 percent for payments made within 180 days after December 19, 2014. For payments made after that date, the levy is up to 30 percent.[49]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by Treasury's Bureau of Fiscal Service ("BFS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct BFS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

Description of Proposal

The proposal provides that the present limitation of 30 percent of certain specified payments be increased by an amount sufficient to offset the estimated revenue loss of the provisions described in Part A, above.

Effective Date

The proposal is effective for payments made after 180 days after the date of enactment.

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[46] Sec. 6330(f).

[47] Pub. L. No. 105-34.

[48] Sec. 6331(h)(3).

[49] Pub. L. No. 113-295, Division B.

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9 January 2015

SENT VIA E-MAIL TO TAXTREATIES@OECD.ORG

Marlies de Ruiter
Head
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comments on the OECD Discussion Draft on Follow Up Work on BEPS Action 6

Dear Ms. De Ruiter:

The National Association of Real Estate Investment Trusts (NAREIT[1]) appreciates the opportunity to provide comments on the OECD's 21 November 2014 Discussion Draft on Follow Up Work on BEPS Action 6 Preventing Treaty Abuse (Discussion Draft). The Discussion Draft invites comments on a variety of issues with respect to changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 of the BEPS Action Plan with the objective of preventing the granting of treaty benefits in inappropriate circumstances.

The Discussion Draft identifies issues to be addressed with respect to the proposed limitation on benefits (LOB) provision and with respect to the proposed principal purpose test (PPT) provision. The Discussion Draft highlights in particular issues related to the treaty entitlement of collective investment vehicles (CIVs) and certain other investment entities.

EXECUTIVE SUMMARY

This submission focuses on the treaty entitlement issues with respect to U.S. REITs. Our comments build on work already done by the OECD with respect to REITs as reflected in its 2007 Report *Tax Treaty Issues Related to REITs*. As discussed in more detail below, U.S. REITs are different from both CIVs and non-CIV funds in ways that are directly relevant to treaty qualification.

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[1] 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.

Consistent with the OECD's prior work, the eligibility of U.S. REITs for treaty benefits should be determined under the rules applicable to companies. Given that resident status is a threshold question for treaty qualification, we urge the OECD to explicitly reference its prior work on REITs and their residence status in the current work on Action 6. Moreover, in light of the special circumstances of REITs as recognized by the OECD in its prior work, we urge the OECD to provide greater clarity regarding the application of both the proposed LOB provision and the proposed PPT provision to U.S. REITs.

DISCUSSION

I. Differences between U.S. REITs and CIVs and Non-CIV Funds

The first two issues identified in the Discussion Draft are the application of the LOB provision, and treaty entitlement more generally, in the case of CIVs and non-CIV funds. With respect to CIVs, the Discussion Draft references to the work done in connection with the 2010 OECD Report *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*.

The Discussion Draft specifically refers to REITs, stating that "REITs are covered by the 2010 Report on CIVs to the extent that they are widely-held and regulated." In this regard, the CIV Report defines the term "CIV" to mean "funds that are widely-held, hold a diversified portfolio of securities and are subject to investor protection regulation in the country in which they are established."

U.S. REITs do not fall within this definition of a CIV. Unlike U.S. regulated investment companies (RICs), U.S. REITs are not generally within the scope of the Investment Company Act of 1940, which regulates the organization and disclosure of financial information of entities, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. Thus, U.S. REITs are not subject to the type of investor protection regime contemplated in the OECD definition of a CIV.

Many U.S. REITs are registered with the U.S. Securities and Exchange Commission (SEC) and are publicly traded on a stock exchange. Other U.S. REITS that are not listed on a stock exchange are widely-held and therefore also are registered with the SEC. These U.S. REITs are subject to provisions in the Securities Exchange Acts of 1933 and 1934 that contain rigorous disclosure obligations. However, this disclosure regime applies to any public-traded U.S. corporation. We do not believe that rules that generally are applicable to listed companies are what motivated the investor protection regulation requirement in the OECD definition of a CIV.

Moreover, the assets of U.S. REITs generally would not be characterized as a "diversified portfolio of securities." U.S. REITs own, operate, and finance income-producing real estate, such as apartments, shopping centers, office buildings, health care facilities, hotels, and warehouses. Under U.S. tax law requirements, i) at least 75% of the value of a U.S. REIT's total assets must be represented by real estate assets (including mortgages), cash and cash items, and government securities; and, ii) not more than 25% of its total assets may be represented by securities that are not qualifying assets for purposes of i). In addition, U.S. tax law requires that at least 75% of a U.S. REIT's gross income must be in the form of real estate rents, interest on real estate mortgages, gains from real estate sales, and other real estate related income. The types of assets required to be held by U.S. REITs is in contrast to the definition of "securities" contained in the Investment Company Act of 1940.[2] Importantly, Section 3(c)(5)C) of the 1940 Act specifically excludes from the 1940 Act any person who is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate". Given the asset and income tests applicable to U.S. REITs, virtually all U.S. REITs fall outside of 1940 Act governance.

Consequently, while U.S. REITs share some characteristics in common with CIVs, they cannot be considered CIVs for purposes of the Discussion Draft because they do not meet the regulatory regime or asset ownership requirements that are central to the OECD definition of a CIV.

The Discussion Draft briefly refers to REITs that do not qualify as CIVs as potentially facing treaty issues similar to issues faced by alternative funds and private equity funds. In this regard, it is important to recognize that U.S REITs are not "funds." U.S. REITs are not passive investment holding entities. Rather, U.S. REITs are active businesses that engage in a full range of corporate activities. U.S. "equity" REITs acquire, develop and hold properties in order to generate rental income, and they primarily operate such properties (as opposed to developing and selling properties similar to a merchant builder). U.S. "mortgage" REITs actively fund both residential and commercial real estate assets.

The U.S. Internal Revenue Service has affirmed that a U.S. REIT functions as an operating company, as distinguished from a passive manager similar to an investment fund, because a U.S. REIT "is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property."[3] Moreover, as discussed further below, U.S. REITs must be taxable as U.S. corporations.

U.S. REITs also are characterized as operating companies rather than investment vehicles in a variety of other contexts in the United States:

- The North American Industry Classification System (NAICS) lists U.S. REITs in the "Lessors of Real Estate" category, which is where active real estate operators are classified, as opposed to the "Other Financial Vehicles" category, where passive investment entities are classified.

[2] The Investment Company Act of 1940 defines "security" as: "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." (15 U.S.C. § 80-2(a)(36).)
[3] Rev. Rul. 2001-29, 2001-26 I.R.B. 1348.

- The U.S. Commodity Futures Trading Commission (CFTC), in a 2012 Interpretive Letter issued to NAREIT, concluded that U.S. REITs are not commodity pools because they are operating companies rather than pooled investment vehicles.
- Standard & Poor's (S&P) classifies U.S. REITs as operating companies in all of its broad equity indices. As of 31 December 2014, the S&P 100 includes one U.S. REIT, the S&P 500 includes 21 U.S. REITs, the S&P 400 includes 31 U.S. REITs and the S&P 600 includes 34 U.S. REITs.

Finally, in this regard, we note that the Discussion Draft states that treaty qualification issues affecting non-CIV funds can arise because their investor base typically is not restricted to a single country and because they may not meet the active business requirement. Contrary to the suggestion in the Discussion Draft, U.S. REITs do not share these issues. The vast majority of investors in U.S. REITs are U.S. persons and, as discussed above, U.S. REITs conduct active businesses in the United States.

Although U.S. REITs do not constitute CIVs or non-CIV funds, as discussed further below, clarification regarding the treaty status of REITs would be valuable in light of the proposed changes to the OECD Model Tax Convention and related Commentary.

II. Treatment of U.S. REITs as Residents for Treaty Purposes

The starting point in applying both the proposed LOB provision and the proposed PPT provision is a determination of resident status. The Discussion Draft underscores the connection between residence and qualification under the proposed provisions in its discussion of issues with respect to CIVs and non-CIV funds. The status of REITs as residents for treaty purposes was considered and addressed in the OECD's 2007 REIT Report. Given its relevance and importance, the OECD should explicitly incorporate this prior work into the current work on treaty qualification under Action 6.

The primary focus of the 2007 REIT Report was the tax treaty treatment of REIT distributions to foreign shareholders. The Report included proposed treaty provisions regarding the withholding tax treatment of such distributions that could be included by countries in their bilateral treaties. These provisions subsequently were incorporated in the Commentary to the OECD Model Tax Convention with the 2008 update.

Consideration of the question of the tax treaty treatment of distributions by REITs to foreign shareholders first requires a determination of the tax treaty entitlement of the REIT itself. As the 2007 REIT Report noted, this is because Article 10 of the OECD Model applies to dividends paid by a company that is a "resident" of a treaty country. Thus, the resident status of a REIT is relevant to the application of tax treaties, both with respect to the income earned and to distributions made by a REIT

The 2007 REIT Report concluded that REITs generally should be considered to be "residents" for treaty purposes:

> Since the income of a REIT is typically distributed, the REIT is not, in a purely domestic context, taxed on that distributed income. As already mentioned, the tax mechanisms that ensure that result vary from country to country and can include, for example, rules that allow the deduction of REIT dividends or distributions, the tax exemption of a REIT that meets certain conditions, the tax exemption of all the REIT's income, the tax exemption of only the part of the REIT's income that is distributed within a specified period of time or rules that allocate the income to the investors rather than to the REIT itself. It seems, however, that in most cases, the REIT would meet the condition of being liable to tax for purposes of the treaty definition of "resident of a Contracting State", subject to the particular problems arising from the application of tax treaties to trusts. There are a few countries, however, where this may not be the case and this is a question that would need to be clarified on a country-by-country basis during treaty negotiations.

Under this analysis, U.S. REITs are residents of the United States. Under U.S. tax law, a U.S. REIT is taxable as a U.S. corporation (and, in fact, must be taxable as a U.S. corporation in order to qualify as a U.S. REIT). The taxable income of a U.S. REIT is computed in a manner similar to the manner in which taxable income is computed for non-REIT corporations. A U.S. REIT is required to distribute at least 90% of its taxable income on a current basis in order to qualify as a REIT and is entitled to a "dividends paid deduction" to the extent that it distributes its taxable income and any realized capital gains. To the extent that a U.S. REIT does not distribute its net capital gain, it still qualifies as a REIT, and it pays corporate tax on such net capital gain.

It should be noted that, although a U.S. REIT does not pay income tax at the entity level to the extent that it distributes its annual taxable income, the mandatory distribution rules mean that U.S. REITs pay significant amounts of taxable dividends relative to other corporate entities. Further, shareholders pay tax on the REIT dividends they receive at the ordinary income tax rate rather than the lower rates generally applicable to corporate dividends. In 2013, SEC-registered U.S. REITs distributed approximately $34 billion. Thus, the amount of U.S. and state tax collected on a current basis with respect to income distributed by U.S. REITs is high.

The OECD's analysis and conclusion regarding the qualification of REITs as residents for treaty purposes formed the basis for the provisions on the withholding tax treatment of distributions by REITs that were set forth in the 2007 REIT Report and incorporated in the Commentary to the OECD Model Tax Convention. This same matter of the qualification of REITs as residents for treaty purposes is a threshold question in applying both the proposed LOB provision and the proposed PPT provision. Application of these proposed measures to REITs necessarily requires a clear understanding of the threshold question of resident status. The OECD should provide the needed clarity by explicitly referencing its prior work on the resident status of REITs in the Commentary with respect to the proposed provisions.

III. Treatment of U.S. REITs under LOB Provisions

The September 2014 Report under Action 6 *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* describes the proposed LOB provision and its various tests as "based on objective criteria that provide more certainty than the PPT rule." However, that certainty exists for a taxpayer only if it is clear that the tests under the LOB provision are available to be applied to the taxpayer. We believe that many U.S. REITs clearly would satisfy the requirements of one or more of the entity-based tests in the LOB provision if it is made clear that such tests are available to be applied to U.S. REITs.

With respect to U.S. REITs that are registered with the SEC and are publicly-traded on a stock exchange (U.S. Listed REITs), the primary test in the proposed LOB provision is the test under paragraph 2(c) (Exchange Traded Test).

Under the proposed Exchange Traded Test, a resident of a Contracting State would be entitled to benefits under the relevant treaty if such resident is a company or other entity and two requirements are met. First, the principal class of its shares (and any disproportionate class) must be regularly traded on one or more recognized stock exchanges. Second, either: i) its principal class of shares must be primarily traded on one or more recognized stock exchanges located in the Contracting State of which it is a resident; or, ii) its primary place of management and control must be in the Contracting State of which it is a resident.

U.S. Listed REITs typically are listed on the New York Stock Exchange, the NYSE MKT, or the NASDAQ. The shares of U.S. Listed REITs regularly are traded on such market, with active turnover and significant liquidity. In addition, the shares of U.S. Listed REITs primarily are traded on the U.S. market where listed. Moreover, U.S. Listed REITs have their primary place of management and control in the United States, where the day-to-day responsibility for the management of the REIT is exercised.

While the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT provided that it meets the specified conditions with respect to exchange trading and management.

With respect to U.S. REITs that are widely-held but not listed on a stock exchange (U.S. Public Non-listed REITs), the primary test in the proposed LOB provision would be the test under paragraph 2(e) (Ownership and Base Erosion Test).

To satisfy the proposed Ownership and Base Erosion Test, a resident of the Contracting State must satisfy both an ownership requirement and a base erosion requirement.

The ownership requirement would be satisfied if, on at least half the days of the taxable period, persons who are residents of that State and who are entitled to the benefits of the relevant treaty (generally as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) own, directly or indirectly, shares representing at least 50% of the aggregate voting power and value (and at least 50% of any disproportionate class of shares) of the U.S. Public Non-listed REIT. This rule may be subject to a further requirement that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State.

In addition, to satisfy the base erosion requirement, less than 50% of the gross income, as determined in its Contracting State of residence of the U.S. Public Non-listed REIT, for the taxable period could be paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of the relevant treaty (also as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) in the form of payments that are deductible for purposes of the taxes covered by the relevant treaty in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

U.S. Public Non-listed REITs typically would satisfy both prongs of this test. They are predominantly owned by U.S. persons, including U.S. mutual funds, individual investors and pension funds. Moreover, the income of U.S. REITs is distributed to their owners on a current basis, and the owners are subject to tax on such income. Because such distributions are deductible by U.S. REITs, they could be considered to be payments that are taken into account under the base erosion requirement. As noted above, the owners of U.S. REITs are predominantly U.S. persons who would themselves qualify for treaty benefits under one of the specified categories, and the distributions to such persons would not run afoul of the base erosion requirement.

As noted above, while the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT that meets the specified conditions with respect to ownership and base erosion.

IV. Treatment of U.S. REITs under PPT Provision

The September 2014 Report on Action 6 acknowledges that the proposed PPT provision involves relatively less certainty and "requires a case-by-case analysis based on what can reasonably be considered to be one of the principal purposes of transactions or arrangements." The subjectivity of the proposed PPT provision has been subject to significant criticism as involving a level of uncertainty that is unacceptable with respect to a matter as fundamental as the qualification of a company for treaty benefits. The concern about uncertainty is particularly acute in the case of U.S. REITs which, unlike other non-REIT corporations, not only must distribute the majority of their earnings to their investors on a current basis, but also cannot make effective use of foreign tax credits in the United States (and therefore cannot "absorb" any additional foreign tax liability in the same manner as non-REIT U.S. corporations). The risk of having an unexpected tax liability arise after the full distribution of current earnings because of a challenge with respect to potential withholding tax liability under a PPT provision would have a significant chilling effect on cross-border investments. The distribution requirement applicable to U.S. REITs means that a U.S. REIT must have a high degree of certainty regarding the tax treatment of its structure when deciding to make a cross-border investment. The uncertainty inherent in the proposed PPT provision would be a significant negative factor to U.S. REITs when deciding whether to make a cross-border investment. This uncertainty could impede the free flow of capital.

The fact that U.S. REITs are accorded tax treatment that is different than that of other corporations should not be a factor in applying the proposed PPT provision. Guidance should be included in the Commentary to make clear that the fact that a U.S. REIT is subject to a special tax regime (a deduction for dividends paid) should not be considered a factor that weighs in favor of denying benefits under any application of the proposed PPT provision.

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We appreciate the OECD's focus on ensuring that the changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 in order to prevent the granting of treaty benefits in inappropriate circumstances do not operate to inappropriately deny treaty benefits to investment vehicles that have become such an important part of the global economy. NAREIT welcomes this opportunity to provide comments on the need for specific clarification regarding the treaty qualification of U.S. REITS under the proposed provisions. With the focus on clarifying the treatment of other investment vehicles such as CIVs and non-CIV funds, the need is all the greater for these clarifications regarding the entitlement of U.S. REITs to treaty benefits under the proposed LOB provision or the proposed PPT provision.

We would be happy to discuss the matters addressed in this letter or to respond to questions or to provide additional information. I can be reached at (202) 739-9408 or tedwards@nareit.com.

Respectfully submitted,

Tony M. Edwards

Tony M. Edwards
Executive Vice President and General Counsel

Breaking News From NAREIT On All Things REIT

FirstBrief

March 11, 2015

MARKETPLACE FAIRNESS ACT RE-INTRODUCED IN THE SENATE

Yesterday, Senators Mike Enzi (R-WY) and Dick Durbin (D-IL), along with Senators Lamar Alexander (R-TN), Heidi Heitkamp (D-ND), Roy Blunt (R-MO), Jack Reed (D-RI), Bob Corker (R-TN), Sheldon Whitehouse (D-RI), and Angus King (I-ME), introduced the Marketplace Fairness Act, S. 698.

Among other things, the Marketplace Fairness Act would allow states with sales and use tax regimes that meet certain simplification standards to require retailers to collect sales and use taxes from consumers within the state, whether or not those retailers have a physical presence. Additionally, the Marketplace Fairness Act provides an exemption for small businesses and would relieve consumers of having to self-report sales/use taxes they already owe.

The bill introduced today is nearly identical to a proposal that passed the Senate on May 6, 2013 by a vote of 69-27, with two minor changes. First, it would delay implementation for one year after enactment. Second, during the first year it is in effect, sales made during the fourth quarter holiday season would be exempted. If you would like to ask your senator to co-sponsor this important legislation, please click here.

By providing this roadmap for states to gain the ability to collect the sale and use taxes they are already owed, this legislation would provide tax parity for bricks-and-mortar retailers and remote internet and catalogue sellers, simplify state tax filing for individuals, and help address state budget shortfalls at no cost to the federal government. On March 3, 2015, Supreme Court Justice Anthony Kennedy in Direct Marketing Ass'n. v. Brohl questioned the continuing validity of the previousSupreme Court decision that prohibited states from collecting sales or use taxes from remote sellers. Legislation such as the Marketplace Fairness Act provides the preferred method to resolve this complex issue.

NAREIT and its members have been supporting legislative changes along these lines since 1999, and NAREIT now serves on the Management Committee of the Marketplace Fairness Coalition. This coalition is comprised of a broad group of businesses and trade associations led by the International Council of Shopping Centers, and it includes the American Booksellers Association, the National Retail Federation, the Retail Industry Leaders Association, the National Association of College Stores, and online retailer Amazon.com.

NAREIT commends the co-sponsors of the Marketplace Fairness Act for their leadership on this important issue. In particular, NAREIT appreciates the tireless efforts of Senators Enzi and Durbin who have championed the need for a level playing field for all retailers for over a decade.

For more information about the Marketplace Fairness Act and related legislation, visit REIT.com.

CONTACT

For further information, please contact NAREIT's VP of Government Affairs Kirk Freeman atkfreeman@nareit.com.

Private Letter Rulings for Government Relations Committee Meeting Discussion

I. Real Estate Assets/Rents from Real Property

A. Steel Racks:PLR 201503010 http://www.irs.gov/pub/irs-wd/201503010.pdf (steel racking structures are REIT-qualifying real property; payments from storage customers are qualifying rents from real property). PLR 201450017 http://www.irs.gov/pub/irs-wd/201450017.pdf (Electing REIT's fiber optic cable qualifies as a real estate asset)

B. Billboards: PLR 201450004 http://www.irs.gov/pub/irs-wd/201450004.pdf (sign structures and ancillary assets owned by a REIT qualify as "outdoor advertising displays" eligible for section 1033(g)(3) election under to be treated as real property for purposes of federal income taxation); PLR 201431018 http://www.irs.gov/pub/irs-wd/201431018.pdf (REIT earns qualifying rent from billboards); PLR 20143102 http://www.irs.gov/pub/irs-wd/201431020.pdf (REIT earns qualifying rent from billboards)

C. Harvestable Crops: PLR 201424017 http://www.irs.gov/pub/irs-wd/201424017.pdf (Plants that produce a harvestable crop constitute real property for REIT asset tests)

D. Cross-connectivity/"Remote Hands": PLR 201423011 http://www.irs.gov/pub/irs-wd/201423011.pdf (Cross-connectivity/"remote hands" services will not taint rental income; Subpart F, PFIC, CFC inclusions are 75% income)

II. Health Care Properties/Qualified Lodging Facilities

A. PLR 201505019 http://www.irs.gov/pub/irs-wd/201509019.pdf (senior housing property is "healthcare property").

B. PLR 201427001 http://www.irs.gov/pub/irs-wd/201427001.pdf (REIT's restructuring will not cause REIT or its taxable REIT subsidiary to be viewed as operating a health care facility)

C. PLR 201429017 http://www.irs.gov/pub/irs-wd/201429017.pdf (Senior living facilities are qualified health care properties)

III. Section 856(c)(5)(J)

A. PLR 201418022; http://www.irs.gov/pub/irs-wd/1418022.pdf (Section 856(c)(5)(J): income ignored; patronage dividends)

B. PLR 201418037 http://www.irs.gov/pub/irs-wd/1418037.pdf (Section 856(c)(5)(J): amounts received in tenant's bankruptcy would be either qualifying REIT income or excluded income)

C. PLR 201433005 http://www.irs.gov/pub/irs-wd/201433005.pdf (Patronage dividends under Section 856(c)(5)(J))

D. PLR 201429024 http://www.irs.gov/pub/irs-wd/201429024.pdf (On-site/nearby sports club not part of "qualified lodging facilities")

IV. Miscellaneous

A. PLR 201410029 http://www.irs.gov/pub/irs-wd/1410029.pdf (Accounting method change to reflect change in cost recovery period)

B. PLR 201446013 http://www.irs.gov/pub/irs-wd/201446013.pdf (Distribution of accumulated C corporation E&P was a dividend; adjustment to convertible debt conversion rate results in deemed dividend)

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105.—Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 856(c); 1.856-3, 1.856-5.)

Rev. Proc. 2014-51

SECTION 1. PURPOSE

This revenue procedure provides guidance regarding aspects of a taxpayer's qualification as a real estate investment trust (REIT) in the context of transactions involving debt secured by real estate the fair market value of which has declined. This revenue procedure modifies and supersedes Rev. Proc. 2011-16, 2011-5 I.R.B. 440, to address situations in which there is a subsequent increase in the value of real property securing a loan addressed in Rev. Proc. 2011-16. Section 2.14(4) of this revenue procedure describes the modifications made by this revenue procedure to Rev. Proc. 2011-16.

SECTION 2. BACKGROUND

.01 For an entity to qualify as a REIT for a taxable year, section 856(c)(4)(A) of the Internal Revenue Code requires that at the close of each quarter of its taxable year at least 75 percent of the value of the entity's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities (75% Asset Test). That is, the 75% Asset Test involves a fraction the denominator of which is the value of a REIT’s total assets and the numerator of which is the value of the REIT’s real estate assets, cash and cash items (including receivables), and Government securities.

.02 Under section 856(c)(5)(B), the term “real estate assets” includes real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

.03 Section 856(c)(5)(C) provides that the term “interests in real property” includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests.

.04 Section 1.856-3(a) of the Income Tax Regulations defines the term “value” to mean “with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the real estate investment trust.”

.05 For an entity to qualify as a REIT for a taxable year, it must also satisfy two gross income tests.

(1) First, at least 95 percent of the entity's gross income must be derived from the types of income listed in section 856(c)(2) (95% Income Test). All interest is included as qualifying income for the 95% Income Test.

(2) Second, at least 75 percent of the entity's gross income must be derived from the types of income listed in section 856(c)(3) (75% Income Test). Interest on obligations secured by mortgages on real property or on interests in real property is included as qualifying income for purposes of the 75% Income Test.

.06 If a mortgage loan is secured by both real property and other property, then, for purposes of the 75% Income Test, § 1.856-5(c) provides rules for apportioning the interest on the loan between interest on an obligation that is secured by real property (or by an interest in real property) and interest on an obligation that is not so secured.

.07 The regulations define two terms that are to be used in determining apportionment—

(1) Section 1.856-5(c)(3) defines the "amount of the loan" as the highest principal amount of the loan outstanding during the taxable year.

(2) Section 1.856-5(c)(2) generally defines the "loan value of the real property" that secures a loan as the fair market value of the real property, determined as of the date on which a commitment became binding on the REIT either to make the loan or to purchase the loan, as the case may be. (This definition, which focuses on the value of the real property collateral securing a loan, is different from the § 1.856-3(a) "value" of a loan as discussed in section 2.04 of this revenue procedure, which focuses on what a loan can be sold for (whether the loan is secured by real property or by other property)).

.08 To effect apportionment under § 1.856-5(c), the loan value of the real property is compared to the amount of the loan.

(1) If the loan value of the real property is equal to or exceeds the amount of the loan, then all of the interest income from the loan is apportioned to the real property.

(2) If the amount of the loan exceeds the loan value of the real property, then—

(a) The interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan; and

(b) The interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property.

.09 Section 1.1001-3(c)(1)(i) defines a "modification" of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of the debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001-3(e) governs which modifications of debt instruments are "significant." Under § 1.1001-3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.10 Section 1.860G-2(b)(1) concerns modifications of mortgages held by real estate mortgage investment conduits (REMICs). Certain loan modifications are not significant for purposes of § 1.860G-2(b)(1) even if the modifications are significant under the rules in § 1.1001-3. In particular, under § 1.860G-2(b)(3)(i), if a change in the terms of an obligation is "occasioned by default or a reasonably foreseeable default," the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification's status under § 1.1001-3.

.11 Section 857(b)(6) imposes a tax equal to 100 percent of the net income derived from “prohibited transactions.” Section 857(b)(6)(B)(iii) defines the term “prohibited transaction” as a sale or other disposition of property that is described in section 1221(a)(1) and that is not foreclosure property.

.12 Section 4.01 of Rev. Proc. 2011-16 provided a safe harbor to allow REITs to treat certain loan modifications occasioned by default or reasonably foreseeable default as not being a new commitment to make or purchase a loan for purposes of the 75% Income Test.

.13 Section 4.02 of Rev. Proc. 2011-16 also provided a safe harbor (the Asset Test Safe Harbor) for determining the extent to which a REIT may treat certain loans as real estate assets for purposes of the 75% Asset Test. Under this safe harbor, the Internal Revenue Service (Service) will not challenge a REIT’s treatment of a loan as being in part a “real estate asset” for purposes of the 75% Asset Test if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of—

(1) The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure); or

(2) The loan value of the real property securing the loan as determined under § 1.856-5(c) and section 4.01 of Rev. Proc. 2011-16 (see section 2.07(2) of this revenue procedure).

.14 The Service has become aware that when the value of the real property securing the loan (and, thus, generally the value of the loan as well) increases after the

REIT originates or acquires the loan, the Asset Test Safe Harbor may produce anomalous results.

(1) The Asset Test Safe Harbor addresses the numerator of the 75% Asset Test (the value of a REIT's real estate assets, cash and cash items, and Government securities, see section 2.01 and 2.02 of this revenue procedure). As is described in section 2.13 of this revenue procedure, under this safe harbor, the numerator is the *lesser* of the value of the loan (under § 1.856-3(a)) or the loan value of the real property securing the loan (under § 1.856-5(c) and section 4.01 of Rev. Proc. 2011-16). Although the "value of the loan" generally rises with increases in the value of the real property securing a distressed loan, the "loan value of the real property securing the loan" is fixed as of the date that the REIT commits to make or purchase the loan. The loan value of the real property securing the loan, therefore, does not vary with changes in the value of the loan's real property collateral. Thus, the numerator (the *lesser of* the value of the loan or the loan value of real property securing the loan) will generally not vary with increases in the value of the real property collateral.

(2) On the other hand, if there is an increase in the value of the real property collateral, that increase often results in a corresponding increase in the value of the loan and thus in the denominator of the 75% Asset Test (the value of the REIT's total assets, see section 2.01 of this revenue procedure).

(3) Thus, when the value of the real property collateral increases, the portion of a distressed mortgage loan that is treated as a qualifying asset for the 75% Asset Test is the generally constant numerator described above, divided by an increasing denominator. Under the formula in section 4.02 of Rev. Proc. 2011-16, therefore, the

portion of a mortgage loan that is treated as a qualifying asset for this purpose generally *decreases* as the value of the real property securing the loan *increases*.

(4) To prevent this anomaly, this revenue procedure modifies the Asset Test Safe Harbor in section 4.02 of Rev. Proc. 2011-16. This revenue procedure also modifies section 5 of Rev. Proc. 2011-16 by amending Examples 1 and 2 and adding a new Example 3 to illustrate the modified Asset Test Safe Harbor.

SECTION 3. SCOPE

.01 Section 4.01 of this revenue procedure applies to a modification of a mortgage loan which (or an interest in which) is held by a REIT if—

(1) The modification was occasioned by default; or

(2) The modification satisfies the following two conditions:

(a) Based on all the facts and circumstances, the REIT or servicer of the loan (the "pre-modified loan") reasonably believes that there is a significant risk of default of the pre-modified loan upon maturity of the loan or at an earlier date. This reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the REIT or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. For example, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

(b) Based on all the facts and circumstances, the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modified loan.

.02 Section 4.02 of this revenue procedure applies to any corporation that has elected to be taxed as a REIT.

SECTION 4. APPLICATION

.01 *Modifications.* If a modification of a mortgage loan is described in section 3.01 of this revenue procedure—

(1) For purposes of ascertaining under § 1.856-5(c)(2) the loan value of the real property securing that loan, a REIT may treat the modification as not being a new commitment to make or purchase a loan; and

(2) The modification of the mortgage loan is not treated as a prohibited transaction under section 857(b)(6).

.02 *Asset test.* The Service will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of section 856(c)(4) if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of—

(1) The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure); or

(2) The greater of—

(a) The current value of the real property securing the loan; or

(b) The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (see section 2.07(2) of this revenue procedure).

SECTION 5. EXAMPLES

.01 *Example 1*. In 2007, *X*, a REIT, made a $100 mortgage loan to *A*. *X*'s loan to *A* was secured by both real property and personal property. When *X*'s commitment to make the loan became binding on *X*, the real property had a fair market value of $115. At the end of the calendar quarter in which *X* made the loan, the value of the loan as determined under § 1.856-3(a) was $100. At all times through the end of 2010, under § 1.856-5(c)(3), the amount of the loan continued to be $100.

By the start of 2009, the fair market value of the real property securing the loan had fallen to $55 and the fair market value of the personal property was $5. The values remained at these levels throughout 2009 and 2010. Throughout 2009 and 2010, the value of the loan, as determined under § 1.856-3(a), was $60.

During 2009, *X* and *A* modified the terms of the mortgage loan. The modification of the loan is described in section 3.01 of this revenue procedure and is a significant modification under § 1.1001-3.

(1) *Income Test*. When *X* made the mortgage loan in 2007, the loan value of the real property for purposes of § 1.856-5(c) was its fair market value ($115) determined as of the date on which the commitment to make the loan became binding on *X*. This amount exceeded the amount of the loan for that year ($100). Accordingly, in the year that the loan was made, all of the interest from the loan was apportioned to the real property. *See* § 1.856-5(c)(1).

Between the time that the loan was made and the time of the modification, the loan value of the real property continued to be $115, notwithstanding changes in the fair market value of that real property. *See* § 1.856-5(c)(2). Similarly, the amount of the loan continued to be $100. Accordingly, the loan value of the real property ($115) continued to exceed the amount of the loan ($100), and all of the interest on the loan continued to be apportioned to the real property.

The fair market value of the real property that secured the mortgage loan had fallen to $55 by the time that *X* and *A* modified the loan in 2009. That modification, however, is described in section 3.01 of this revenue procedure, and *X* chose to treat the modification as not being a new commitment to make or purchase a loan.

Therefore, the loan value of the real property ($115) does not change. Because the loan value of the real property ($115) continued through the end of 2010 to exceed the amount of the loan ($100), all of the interest from the loan during that year is apportioned to real property.

(2) *Asset Test*. In 2007, at the end of the calendar quarter in which *X* made the mortgage loan, the current value of the real property securing the loan was $100, the value of the loan (as determined under § 1.856-3(a)) was $100, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was $115. For this calendar quarter, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, *X* may use the safe harbor in section 4.02 of this revenue procedure. If *X* does so, the amount of the loan that is a real estate asset for purposes of the 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($100); or
- The greater of—
  - o The current value of the real property securing the loan ($100); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($115).

Accordingly, *X* may treat $100 of the loan as a qualifying asset.

At the end of the calendar quarter immediately preceding the quarter in 2009 in which *X* modified the mortgage loan, the current value of the real property securing the loan was $55, the value of the loan (as determined under § 1.856-3(a)) was $60, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was $115. As described earlier in this section 5.01, beginning with the calendar quarter in which the loan was modified, *X* may use the safe harbor in section 4.01 of this revenue procedure to treat the modification as not being a new commitment to make or purchase the loan. In addition, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, *X* may use the safe harbor in section 4.02 of this revenue procedure. If *X* does so, the amount of the loan that is a real estate asset for purposes of the 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($60); or
- The greater of—
  - o The current value of the real property securing the loan ($55); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is applicable) ($115).

Accordingly, *X* may treat $60 of the loan as a qualifying asset.

.02 *Example 2*. The facts include all of the facts in Example 1. Additionally, during the first quarter of 2010, *Y*, a REIT, committed to purchase, and purchased, the mortgage loan from *X* for $60.

(1) *Income Test*. Under § 1.856-5(c)(2), the loan value of the real property securing the loan is the fair market value of the real property determined as of the date on which *Y*'s commitment to purchase the loan became binding on *Y* ($55). This value is compared to the amount of the loan for the year ($100). Because the amount of the loan exceeds the loan value of the real property, the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction the numerator of which is the loan value of the real property ($55) and the denominator of which is the amount of the loan ($100). Therefore, 55 percent of the interest income from *Y*'s loan is apportioned to the real property securing the loan. Interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property. *See* § 1.856-5(c)(2).

(2) *Asset Test*. At the end of every calendar quarter during 2010, the current value of the real property securing the loan was $55, the value of the loan (as determined under § 1.856-3(a)) was $60, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was $55. For every calendar quarter during 2010, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, *Y* may use the safe harbor in section 4.02 of this revenue procedure. If *Y* does so, the amount of the loan that is a real estate asset for purposes of 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($60); or
- The greater of—
  - o The current value of the real property securing the loan ($55); or
  - o The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($55).

Accordingly, *X* may treat $55 of the loan as a qualifying asset.

.03 *Example 3.* On January 1, 2011, *Z,* a REIT, purchased for $60 a distressed mortgage loan with a principal amount due of $100. During the taxable year 2011, the amount of the loan under § 1.856-5(c)(2) was $100. The value of the real property securing the loan on the date *Z* committed to purchase the loan was $55 and the value of the personal property securing the loan was $5. At the end of the first calendar quarter in 2011, the current value of the real property securing the loan was $55, and the value of the loan (as determined under § 1.856-3(a)) was $60.

Asset Test. Under section 4.02 of this revenue procedure, *Z* may treat $55 of the loan as a "real estate asset" for purposes of the 75% Asset Test. This amount is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($60); or
- The greater of—
  - o The current value of the real property securing the loan ($55); or

  - The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($55).

At the end of the second calendar quarter of 2011, the current value of the real property securing the loan had increased to $65, and the value of the loan (as determined under § 1.856-3(a)) had increased to $70. Accordingly, at the end of the second quarter of 2011, under section 4.02 of this revenue procedure, *Z* may treat $65 of the loan as a "real estate asset" for purposes of the 75% Asset Test. This amount is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) ($70); or
- The greater of—
  - The current value of the real property securing the loan ($65); or
  - The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) ($55).

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for all calendar quarters and all taxable years.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2011-16 is modified and superseded.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Silver at (202) 317-4413 (not a toll-free call).

For Immediate Release
March 11, 2015

Contact: Aaron Fobes, Julia Lawless (202) 224-4515

Hatch, Wyden Launch New Effort to Seek Input on Bipartisan Tax Reform

Stakeholders and the Public Asked to Submit Ideas to Working Groups

WASHINGTON – Finance Committee Chairman Orrin Hatch (R-Utah) and Ranking Member Ron Wyden (D-Ore.) today announced a bipartisan effort to begin soliciting ideas from interested members of the public and stakeholders on how best to overhaul the nation's broken tax code to make it simpler, fairer, and more efficient. The goal of this effort is to provide additional input, data, and information to the Committee's bipartisan tax working groups, which are currently analyzing existing tax law and examining policy trade-offs and available reform options within each group's designated area.

"By opening up our bipartisan working groups to public input, we hope to gain a greater understanding of how tax policy affects individuals, businesses, and civic groups across our nation," **Hatch and Wyden said**. "In doing so, we will also equip our working groups with valuable input, and we hope these suggestions will help guide the groups through the arduous task of putting forth substantive ideas to reform the tax code in each of their areas."

Individuals, businesses, organizations, and advocacy groups interested in submitting comments should send an email to the below bipartisan group or groups that relates to their area of interest. Please send submissions to each group of jurisdiction if an interest area covers more than one group.

Individual Income Tax - Individual@finance.senate.gov

Business Income Tax - Business@finance.senate.gov

Savings & Investment - Savings@finance.senate.gov

International Tax - International@finance.senate.gov

Community Development & Infrastructure - CommunityDevelopment@finance.senate.gov

Additional Submission Requirements:

- All submissions must be submitted as a pdf attachment. The attachment should be saved using the name of the organization/individual submitting the recommendations.
- Parties should list the name of the tax working group they wish to contact in the subject line of the email.
- Please include contact name, organization (if the submission is being submitted on behalf of a group), phone number, and email address, in the body of the email.
- Submissions will be accepted through April 15, 2015, and made public at a later date.
- If the above directions are not followed, the Committee reserves the right to not include the submission.
- If technical problems are incurred, parties can contact the Committee at 202-224-4515.

Each of the five bipartisan working groups is currently working to produce findings on current tax policy and legislative recommendations within its area, with the goal of having recommendations from each of the five working groups completed by the end of May. Submissions from stakeholders will be reviewed by the working groups and ideas can be incorporated into the each working group's final recommendations. The five working group recommendations will be delivered to Chairman Hatch and Ranking Member Wyden, and will be considered in developing bipartisan tax reform legislation.

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Chairman's News

More News »

- 03/17 Five Years Later: Failed Oversight & Security Safeguards Put Americans' Personal Information at Risk [Chair]
- 03/17 Hatch Statement at Finance Hearing on Building a Competitive U.S. International Tax System [Chair]
- 03/16 Five Years Later: Obamacare Hits Americans with Higher Premiums for Healthcare Coverage [Chair]
- 03/13 Hatch Calls for Bipartisan Fix to Restore Social Security Disability Insurance Fund [Chair]
- 03/12 Hatch Statement at Finance Hearing on Tax Schemes and Scams [Chair]

Insurance Committee Meeting

Tuesday, March 31st
4:30pm – 6pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Panelists:
Melissa Lishner, Director, Crystal & Company
James Blinn, EVP & Global Product Manager, Advisen

NAREIT INSURANCE COMMITTEE MEETING AGENDA
JW Marriott Desert Ridge Resort & Spa – Phoenix, AZ
March 31, 2015

NAREIT Insurance Committee Chair:

Michael Horvath, SVP, Risk Management, *Simon Property Group*

NAREIT Executive Staff:

Sheldon Groner, EVP, Finance & Operations

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

REITs: BUILDING DIVIDENDS AND DIVERSIFICATION®

4:30 – 5:30 p.m. **Roundtable Discussion: Key Risk Management Issues/Updates for CFO's, General Counsels, and Risk Managers:**

- **Cyber Liability Insurance**
  - **Do you have it?**
  - **Should you have it?**
  - **What Coverages are Available?**
- **Soft Insurance Markets/Excess Capacity**
  - **How are Prices Affected?**
  - **How Long Can it Last?**
- **Interactive Discussion: Key Risk Areas Affecting REITs**

Michael Horvath, SVP, Risk Management, *Simon Property Group*

Jim Blinn, EVP & Global Product Manager, *Advisen*

Joe Downey, SVP, *Willis*

5:30 – 5:45 p.m. **Terrorism Risk Insurance Act (TRIA)**

Tony Edwards, EVP & General Counsel, *NAREIT*

5:45 – 6:00 p.m. **NAREIT Directors & Officers Liability Insurance Program w/*Arch***

- **Insurance Litigation Trends Affecting Real Estate**
- **New Amendments to Policy Coverage**
- **Program Update**

Melissa Lishner, Director, *Crystal & Company*
Brian Chiolan, Regional Vice President, *Arch*
Michael Chu, Assistant Vice President, *Arch*

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.reit.com

Terrorism Risk Insurance Act Side-by-Side Comparison: Current Law and Extension Legislation

	Current Law	S. 2244 As Passed by Senate (113th Congress)	H.R. 4871 As Reported (113th Congress)	H.R. 26 As Passed by the House (114th Congress)
Expiration	December 31, 2014	December 31, 2021 (Seven-year extension)	December 31, 2019 (Five-year extension)	December 31, 2020 (Six-year extension)
NBCR Terrorism	No separate treatment of NBCR terrorism	*No change*	Bifurcation of program into two types of "acts of terrorism": NBCR terrorism and non-NBCR terrorism. Existing program structure and amounts to remain in place for NBCR terrorism losses.	*No change*
Insurer Deductible	20% of prior year's DEP in TRIA lines	*No change*	*No change*	*No change*
Insurer Co-Share	15% of losses above insurer deductible	16% of losses above deductible in 2016; 17% in 2017; 18% in 2018; 19% in 2019; 20% in 2020-21	*Non-NBCR Terrorism:* 16% of losses above deductible in 2016; 17% in 2017; 18% in 2018; 20% in 2019	16% of losses above deductible in 2016; 17% in 2017; 18% in 2018; 19% in 2019; 20% in 2020
Program Trigger	$100 million in aggregate insured losses	*No change*	*Non-NBCR Terrorism:* $200 million in 2016; $300 million in 2017; $400 million in 2018; $500 million in 2019 Clarifies that multiple events in a single year can be aggregated for purposes of the trigger, but does not allow events of less than $50 million to be counted for this purpose.	$120 million in 2016; $140 million in 2017; $160 million in 2018; $180 million in 2019; $200 million in 2020 Clarifies that multiple events in a single year can be aggregated for purposes of the trigger, but does not allow events of less than $50 million to be counted for this purpose.

Terrorism Risk Insurance Act Side-by-Side Comparison: Current Law and Extension Legislation

	Current Law	S. 2244 As Passed by Senate (113th Congress)	H.R. 4871 As Reported (113th Congress)	H.R. 26 As Passed by the House (114th Congress)
Annual Program Cap	$100 Billion	*No change*	*No change*	*No change*
Insurance Marketplace Aggregate Retention (Mandatory Recoupment)	$27.5 Billion	Increases $2 billion each year through 2019, leveling off at $37.5 billion for 2019-2021	Benchmarked to aggregate insurer deductibles for the preceding year (*i.e.*, 20% of aggregate DEP in TRIA lines), beginning in 2016	Increases $2 billion each year through 2019, when it will be $37.5 billion; in 2020 it will be the annual average of the aggregate insurer deductibles for the three prior calendar years Treasury must complete a rulemaking within three years to provide the procedure for determining this annual average, and a timeline for public notification of such determination
Recoupment Amount	133% of the difference between aggregate retention level and amount of losses already paid by industry (through deductibles and co-pays)	135.5% of the difference between aggregate retention level and amount of losses already paid by industry (through deductibles and co-pays)	150% of the lesser of either: (a) the amount of Federal compensation, or (b) the aggregate retention amount	140% of the difference between aggregate retention level and amount of losses already paid by industry (through deductibles and co-pays)
Discretionary Recoupment	Discretionary recoupment surcharges may not exceed 3%	*No change*	Discretionary recoupment surcharges may not be <u>less</u> than 3%.	*No change*

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Terrorism Risk Insurance Act Side-by-Side Comparison: Current Law and Extension Legislation

	Current Law	S. 2244 As Passed by Senate (113th Congress)	H.R. 4871 As Reported (113th Congress)	H.R. 26 As Passed by the House (114th Congress)
Recoupment Timing	For acts occurring on or after January 1, 2012, recoupment must be completed by September 30, 2017.	For acts occurring on or before December 31, 2017, recoupment must be completed by September 30, 2019. For acts occurring in 2018, 35% of amount must be collected by September 30, 2019, and the remainder by September 30, 2024. For acts on or after January 1, 2019, recoupment must be completed by September 30, 2024.	No timeline for events occurring after 2014.	For acts occurring on or before December 31, 2017, recoupment must be completed by September 30, 2019. For acts occurring in 2018, 35% of amount must be collected by September 30, 2019, and the remainder by September 30, 2024. For acts on or after January 1, 2019, recoupment must be completed by September 30, 2024.
"Make Available" Requirement	Requires "insurers" (as defined in statute) to, in TRIA-eligible lines, make available coverage for terrorism "that does not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism."	*No change*	Provides for small insurer "opt-out" of the make available requirement. Requires State regulator determination of financial hardship exposure.	*No change* Requires Treasury to do an annual study competitive challenge to small insurers participating in the program

Terrorism Risk Insurance Act Side-by-Side Comparison:
Current Law and Extension Legislation

	Current Law	**S. 2244 As Passed by Senate (113th Congress)**	**H.R. 4871 As Reported (113th Congress)**	**H.R. 26 As Passed by the House (114th Congress)**
Pre-Event Reserving	No provision	Requires GAO study on the viability and effects of collecting "upfront premiums" from participating insurers	Requires GAO study on the viability and effects of collecting "upfront premiums" from participating insurers, and on the viability of creating a capital reserve fund	Requires GAO study on the viability and effects of collecting "upfront premiums" from participating insurers, and on the viability of creating a capital reserve fund
Certification	Events must exceed $5 million in aggregate losses to qualify as "act of terrorism" Secretary of the Treasury must certify in concurrence with Secretary of State and Attorney General	Requires Treasury Secretary to study and report to Congress on the certification process and whether to establish a timeline for certification determinations.	Requires determination within 90 days Eliminates $5 million threshold Replaces Secretary of State with Secretary of Homeland Security, and requires only <u>consultation</u> by the Treasury Secretary	Retains $5 million threshold; requires only <u>consultation</u> by the Treasury Secretary with the Secretary of Homeland Security and Attorney General Requires Treasury Secretary to study and report to Congress on certification process and within 9 months of that report, issue final rules on certification process, which must include the establishment of a timeline for certification.
Foreign v. Domestic Terrorism	No distinction	*No change*	*No change*	*No change*
TRIA Notice Requirement	Required to be given at time of offer, purchase, and renewal	*No change*	Removes requirement at time of purchase (still must provide at offer and renewal)	Removes requirement at time of purchase (still must provide at offer and renewal)

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Terrorism Risk Insurance Act Side-by-Side Comparison: Current Law and Extension Legislation

	Current Law	S. 2244 As Passed by Senate (113th Congress)	H.R. 4871 As Reported (113th Congress)	H.R. 26 As Passed by the House (114th Congress)
Risk Spreading Mechanisms	*No provision*	Creates advisory committee to encourage development of private market risk spreading mechanisms	Creates advisory committee to encourage development of private market risk spreading mechanisms	Creates advisory committee to encourage development of private market risk spreading mechanisms
Data Collection	*No provision*	*No provision*	Beginning in 2016, requires Treasury to collect data from insurers on TRIA coverages, premiums, take-up rates, etc.	Beginning in 2016, requires Treasury to collect data from insurers on TRIA coverages, premiums, take-up rates, etc.
Broker Licensing	*No provision*	Adds broker licensing legislation "NARAB II" as Title II (with sunset two-years from first license).	Adds broker licensing legislation "NARAB II" as Title II.	Adds broker licensing legislation "NARAB II" as Title II.
CBO Estimate	*Not applicable*	CBO estimates that S. 2244 would <u>reduce</u> deficits by $460 million over ten years, but spending would continue after ten years resulting in no net effect on the deficit.	CBO estimates that H.R. 4871 would <u>increase</u> deficits by $503 million over ten years, but revenues and spending would continue after ten years resulting in net budgetary savings.	CBO estimates the bill[1] would <u>reduce</u> deficits by $456 million over ten years.

[1] This is based on CBO's estimate for the House-passed version of S. 2244 (113th Congress) in December 2014, which is identical to the House-passed H.R. 26. CBO has not produced a new estimate specifically for H.R. 26.

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REIT Wise®

March 31- April 2
2015

NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

D&O Liability Insurance Program

March 31, 2015

D&O Liability Insurance Program

Agenda

- N E W Coverage Enhancements
- Preparing for Your D&O Renewal
- Selecting Your Primary D&O Carrier
- Conclusion
- Q&A

New Coverage Enhancements

- The updated "Arch Essential Enhancement Endorsement℠ for Members of NAREIT®" will include:
  - Removal of the plaintiffs' counsel fee exclusion for bump-up claims
  - Coverage for Plaintiffs' Attorney Fees Paid by the REIT in a Derivative Lawsuit
  - Waiver of Retention for Class Certification Event Study Costs in a Securities Claim
  - Other Favorable Terms:
    - Narrower Prior Notice Exclusion
    - Narrower Conduct Exclusions
    - Additional Carve-backs to the REIT vs. Insured Exclusion
    - And More…

Preparing for Your D&O Renewal

Key Underwriting Topics

- ✓ Stock Performance (vs. REIT Index and Peer Group)
- ✓ **Mergers & Acquisitions (“Bump-Up” Claims)**
- ✓ Development and Redevelopment Exposure
- ✓ Operations (Major Tenants, Geographic Exposure, Lease Expirations)
- ✓ **Joint Venture / Limited Partner Disputes**
- ✓ Capital Structure (Leverage, Equity/Debt Offering History)
- ✓ Dividend History
- ✓ Financial Results vs. Guidance
- ✓ **Shareholder Base (Activist / Hedge Fund Investors)**
- ✓ Insider Sales / 10b5-1 Trading Plans / Margin Accounts
- ✓ International Exposure (FCPA)
- ✓ **Cyber Security**
- ✓ Executive Compensation / Proxy
- ✓ **Accounting and Regulatory Compliance (i.e. – SEC, IRS)**
- ✓ Corporate Governance / Management Changes

Selecting Your Primary D&O Carrier

- ✓ Best in Class Language protecting YOUR Board
  - ✓ Integrated Claims Model
    - Underwriting and Claims work closely together
    - Experience handling wide variety of real estate related claims, not just SCAs
  - ✓ Deep understanding of REIT structure
  - ✓ Consistent Underwriting Approach
  - ✓ Commitment to REIT Industry
  - ✓ Financial Strength
  - ✓ Focus on Best-in-Class Service

Conclusion

- Commitment to the REIT community for over 20 years
- NAREIT D&O policy available only to NAREIT corporate members
- *The **only** Primary D&O policy form endorsed by NAREIT*
- Exclusive program administrator
- Strong underwriting partners
- Additional management liability options available

Contacts

CRYSTAL & COMPANY

The integrity of independence.

Ken Gamble	212-504-5873 or kenneth.gamble@crystalco.com
Stephen Kelly	212-504-5847 or steve.kelly@crystalco.com
Melissa Lishner	212-504-5829 or melissa.lishner@crystalco.com

Arch | Insurance

Brian Chiolan	646-563-6372 or bchiolan@archinsurance.com
Michael Chu	646-563-6373 or michu@archinsurance.com
Jeffrey Zaffino	646-563-6353 or jzaffino@archinsurance.com

State & Local Tax Subcommittee Meeting

Tuesday, March 31st
4:30pm – 6pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Sam Melehani, Partner, PwC

Panelists:
Thomas Bone, VP-Tax, Crown Castle International Corp.
Theresa Esparza, VP-Tax, Spirit Realty Capital
Joe Gurney, Director, Deloitte LLP
Sean Kanousis, Partner-State & Local Tax, PwC
Michele Randall, Tax Partner, Ernst & Young LLP

REIT Wise March 31- April 2 2015

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa

Phoenix, AZ

State Tax Update

March 31-April 2, 2015

State Tax Update

Agenda

- Real Estate Income/Franchise Tax Update
  - California Update
  - New York Update
- Other Significant Tax Legislation – enacted and proposed
  - Combined Reporting
  - Nexus
  - Tax Base
  - Allocation and Apportionment
- Other State Tax Developments

California Update

California – Like-kind Exchanges

Required disclosure for like-kind exchanges of out-of-state property

- *Enacted on June 27, 2013, A.B. 92* personal and corporate taxpayers are required to file an information return with the Franchise Tax Board if the taxpayer exchanges California property for out-of-state property in an IRC Sec. 1031 like-kind exchange.
- Return must be filed in the taxable year of the exchange, and each subsequent year in which the gain or loss has not been recognized.
- Effective for tax years beginning on or after January 1, 2014.

California – Economic Nexus

Asset management limited liability companies are facing unique challenges under California's new 'doing business' standard

- Over the past several years, the standard for 'doing business' in California has evolved due to statutory changes in the definition of 'doing business' and apportionment sourcing rules.
  - 'Doing business,' is determined by the amount of gross receipts derived from California, subject to thresholds.
- California's recent switch to mandatory market-based sourcing could result in an out-of-state asset manager, organized as an LLC to be subject to the LLC tax, individual income taxes and income tax withholding, even though the company has no property or payroll in the state.

California Proposition 13 Update

- *Ocean Avenue LLC v. County of Los Angeles*
  - Facts
    - 100% of the interest in an LLC owning a hotel in California was sold to multiple persons and entities
    - Following the purchase, Mr. Dell effectively owned 48% while his wife's separate property trust owned 49%
    - A change of ownership was found to have occurred despite no one party acquiring a greater than 50% interest because 100% of the ownership rights in the LCC had been transferred
  - Holding
    - The Court of Appeals agreed with the Superior Court's ruling that there was no change in ownership because no one person acquired a greater than 50% interest in the LLC
- For now, legislative changes to Prop 13 are on hold

California Documentary Transfer Tax Update

- Local Controlling Interest Transfer Taxes - Prior Rule:
  - Generally, transfer taxes were imposed at the local level only when a direct interest in realty was sold unless an IRC Sec 708 tech term occurs
  - The majority of localities had not attempted to apply the tax following a Change in Ownership under Prop13
- *926 North Ardmore Avenue, LLC v County of Los Angeles*
  - The court equated the terms “realty sold” and “change in ownership”
  - As applied, all localities would be authorized to levy a controlling interest transfer tax whenever there is a change in ownership under Prop 13
  - An appeal is being filed with the California Supreme Court

California Mandatory e-filing

- For taxable years beginning on or after January 1, 2014, California requires all business entities, e.g., corps, S corps, partnerships and LLCs, that prepare an original or amended return using tax preparation software to electronically file (e-file) their return with the Franchise Tax Board (FTB)
- Note that an amended return filed after January 1, 2015, for a tax year beginning prior to January 1, 2014, is not required to be e-filed
- Failing to e-file will result in a noncompliance penalty, but the penalty will not take effect until tax years beginning on or after January 1, 2017
- In limited circumstances, taxpayers may request a waiver of this requirement
- Consider impact of DRE's filing under this rule

New York Update

New York State Tax Reform

- Effects on Real Estate/Private Equity Industry
  - Interest on loans secured by real property are sourced to location of real property (corporate taxpayers)
  - Economic nexus for corporate taxpayers with receipts from New York of $1M or greater (including as a corporate partner).
  - No economic nexus for partnerships (reporting for above unclear)
  - Market sourcing for Article 9-A (corporate taxpayers)
  - Will we see a shift to S-Corporations for management companies?

New York State Tax Reform

- Effects on Non-Captive REITs
  - Non-captive REITS are excluded from combined reporting
- Effects on Captive REITs
  - The definition of a captive REIT remains unchanged
  - Captive REITs will be required to file a combined report with any related corporation that meets the new combined filing requirements
  - A captive REIT included in a combined report will still be denied the DPD for any dividends paid to members of its affiliated group and will be subject to the state’s FT
  - Care should be taken to analyze the impact of any captive REIT filing a combined return with any related corporations

Proposed - New York City

A.3009/B. 2009 Introduced on January 21, 2015

- Current Proposal:
  - The changes would mirror the changes enacted by New York State last year, and will be retroactive to January 1, 2015.
  - The proposed city changes include:
    - adopting a unitary combined reporting system;
    - instituting market-based sourcing;
    - modifying the corporate tax base;
    - and providing tax breaks to manufacturers.
  - Notably, the bills do not modify the city unincorporated business tax
- Captive REITs in New York City
  - Currently the definition of a captive REIT in the City is not exactly the same as at the state level. Consider the impact of any differences on your privately owned REITs

Significant Tax Enactments and Proposals

District of Columbia

FY2015 Budget Support Second Congressional Review Emergency Act of 2014 enacted December 17, 2014, set to expire April 8, 2015.

- Reduces the rate on the new individual income tax middle bracket
- The unincorporated and incorporated business franchise tax rate will be phased in reductions in subsequent years to 8.25%
- Adopts single weighted sales factor formula and market-based sourcing for sales of other than tangible personal property
- Exempts certain investment funds' income from the Unincorporated Business Franchise Tax via a 'trading safe harbor'
- Effective Date??

Hawaii – proposed legislation would remove DPD

- On January 22, 2015, S.B. 118 was introduced in the Hawaii Senate to remove the dividends paid deduction for REITs in the state. S.B. 118 was referred to the Senate Ways and means Committee, and has been scheduled for a public hearing on February 18, 2015.
- S.B. 118 was revised to require "the department of business, economic development, and tourism, with the assistance of the department of taxation, shall study the impact of real estate investment trusts in Hawaii and the possible effect of repealing the dividends paid deduction for real estate investment trusts." Passed Senate as amended (S.B. 118 SD1) on March 10, 2015. Joint hearing scheduled before House Consumer Protection & Commerce/Judiciary Committees for March 18, 2015.
- A similar bill, H.B. 82, was also introduced in the Hawaii House of Representatives, however, on February 4, 2015, this bill was deferred by the Committee on Consumer Protection & Commerce/Committee on Judiciary. No further action is expected.

Indiana

Senate Bill 1, enacted on March 25, 2014

- Phases down the corporate income tax rate.
- Currently, the rate from July 1, 2013 to June 30, 2014, is 7.5%; from July 1, 2014 to June 30, 2015 the rate is 7.0%; and after June 30, 2015 the rate is 6.5%.
- Continues an annual rate reduction of 0.25% until the rate settles at 4.9% after June 30, 2021.
- Accordingly, the first rate change created under S.B. 1 is the 6.25% imposed from July 1, 2016 to June 30, 2017.

Massachusetts

Budget Bill (H.B. 4001), enacted on July 11, 2014

- Delays the FAS 109 deduction until 2016
- Provides that filing of a combined report will satisfy the filing requirements for any business corporation or financial institution that calculates and reports the income or non-income measure of its own individual corporate excise tax liability and the minimum excise tax.
- Provides the framework for an amnesty, the scope of the program, including types of tax and periods covered will be determined by the commissioner.
- Provides a property tax exemption for certain financial institutions and corporations.
- Simplifies the Appellate Tax Board small claims process.

Massachusetts

H.B 52 Signed by Governor February 13, 2015

- Enacted Massachusetts legislation provides for a tax amnesty program for a 60-day period during fiscal year 2015 that must apply to, at the minimum, corporate excise taxes.
- Amnesty participants will be granted a waiver of penalties. The legislation requires the Commissioner of Revenue to determine the exact periods covered, including any look back period for unfiled returns, and the other taxes that are eligible for the program.

•Massachusetts had a limited amnesty program in 2014, that did not apply to corporate excise tax.

New Hampshire Transfer Tax Update

- The general imposition statute has been expanded to cover "each sale, granting and transfer" rather than just transfers
  - The term "sale, granting and transfer" is statutorily defined as a "contractual transfer" which is defined as "a bargained-for exchange"
- Taxation of Restructuring Transactions
  - Transfer tax will not apply to single-entity reorganizations under IRC § 368(a)(1)(F) or IRC § 368(a)(1)(E)
  - Changes in an owner's carried interest in a REHC or an entity owning an REHC are exempt from transfer taxes
  - The conversion of a business entity to an LLC under New Hampshire law will be viewed as a contractual transfer without consideration only subject to the $20 minimum transfer tax

New Jersey

- **A.B. 3486, enacted June 30, 2014**
  - Applicable to privilege periods ending on or after July 1, 2014
    - the business income functional test is modified
      - the definition of operational income has been modified to include income from tangible or intangible property if the acquisition, management, **or** (*was* ‘and’) disposition of the property constitute an integral part of the taxpayer’s regular trade or business operations.
    - requires certain nonresident partners to file a tax return as a prerequisite to receive credit and refunds related to partnership activities taxable to New Jersey
    - net operating losses reduced for certain debt cancellations

Rhode Island

H.B. 7133, enacted June 19, 2014

- adopts unitary combined reporting
- reduces tax rate from 9% to 7%
- provides for special treatment for entities organized in tax haven countries
- adopts single sales factor apportionment
- repeals related party expense addbacks
- repeals the state's franchise tax
- requires the establishment of an independent appeals process to resolve alternative apportionment disputes

Ohio

H.B. 5, signed December 19, 2014

- Implements substantial modifications to Ohio's municipal income tax law.
- Key modifications include:
  - Five year NOL carry forward deduction, for NOLs incurred in taxable years beginning after 2016
  - A taxpayer may elect to file a 'full' consolidated, pre-apportionment income tax return. Election binding for five years
  - Alternative apportionment method
  - Pass-through entities taxed on net profits and losses at the entity level
  - Other municipal tax matters

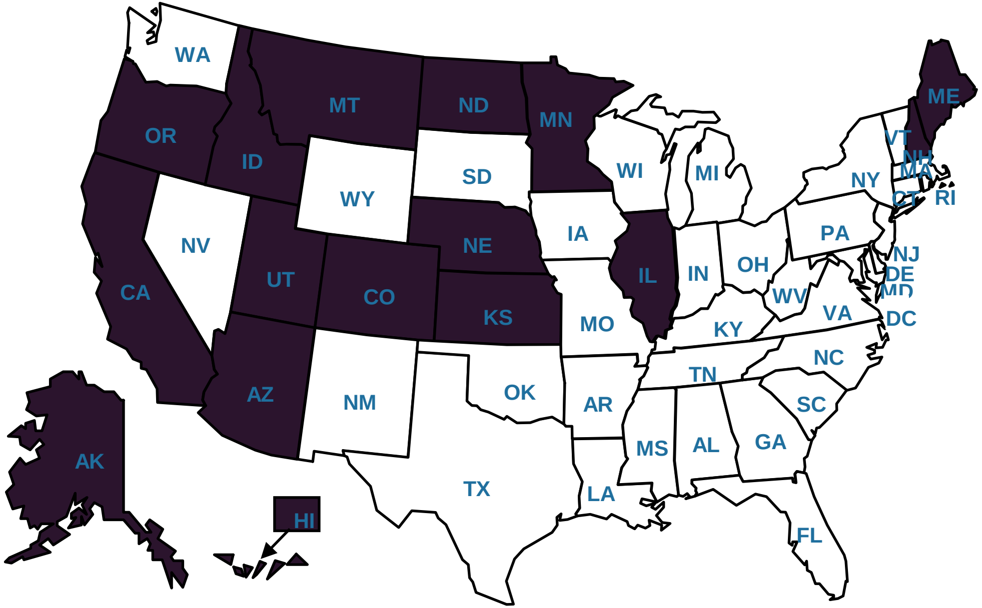
Tennessee

H.B. 644; S.B. 603, introduced, February 10, 2015

- Adopts factor presence nexus standards for corporate excise (income) tax
- Adopts market based sourcing provisions for sales of other than tangible personal property
- Creates alternative excise tax calculation for taxpayers that use Tennessee distribution centers and that have sales of tangible personal property in the state in excess of $1 billon
- Modifies provisions regarded related party deductions
- Adopts click-through nexus for sales tax
- The unincorporated and incorporated business franchise tax

Combined Reporting

Combined Reporting - 2001

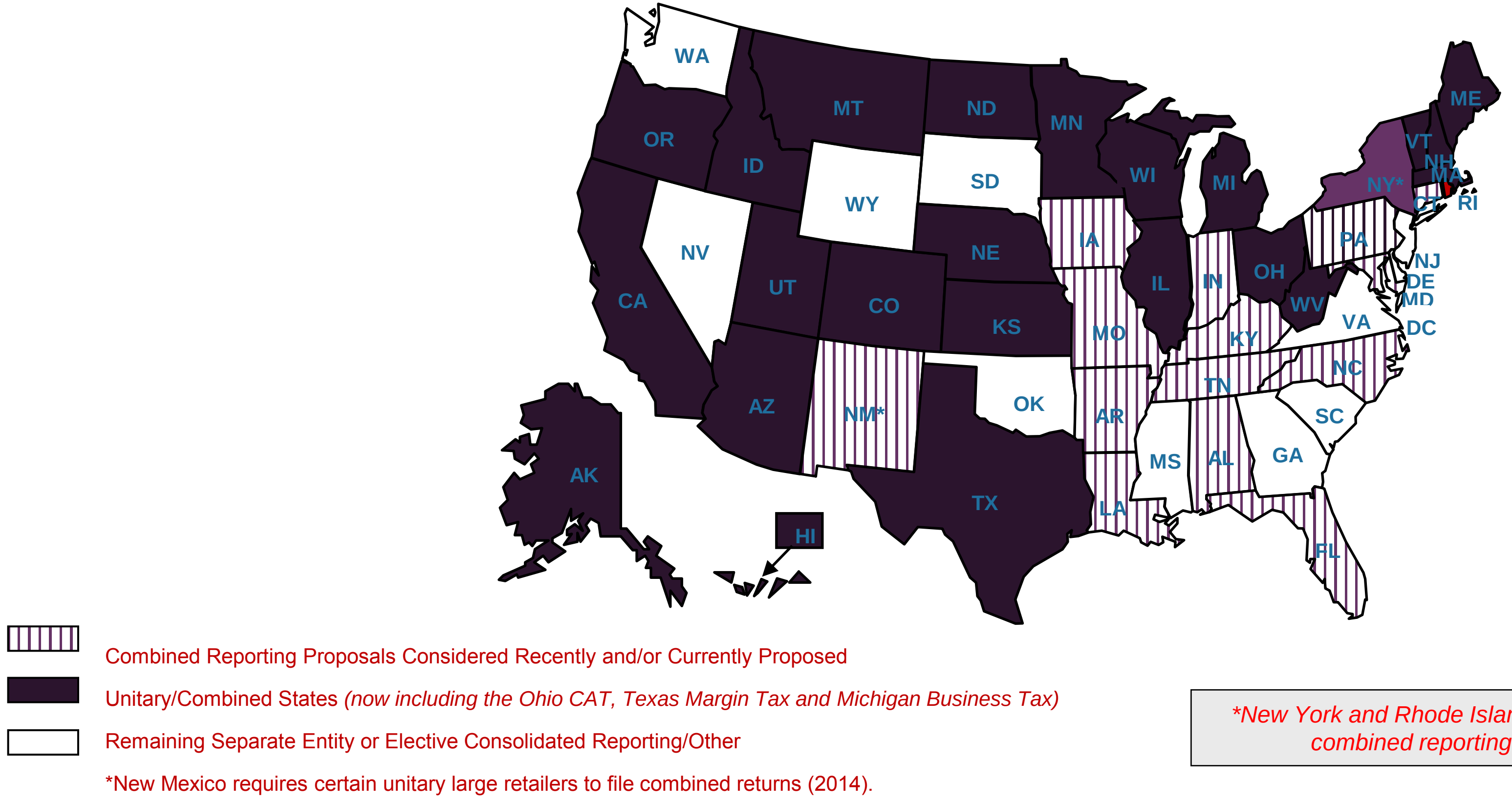


Combined Reporting Proposals

Unitary/Combined States

Remaining Separate Entity or Elective Consolidated Reporting/Other

Combined Reporting – 2014



**New York and Rhode Island adopt unitary combined reporting in 2015*

Combined Reporting Legislation – 2014 Activity

Kentucky	H.B. 220, introduced 1/16/14, (1/21/14 to House), information hearing on 2/11/14, no additional hearings on tax reform took place
Maryland	S.B. 395, introduced to Senate 1/23/14
New Mexico	S.B. 17, introduced 1/21/14 (requires combined reporting for a bank that is unitary corporation), Action postponed indefinitely
New York	A.B. 8559 and S.B. 6359, enacted 3/31/14
Rhode Island	H.B. 7133, enacted 6/19/14

Legislation – Rhode Island

- H.B. 7133, enacted on June 19, 2014
  - Require combined reporting for corporations that are part of a unitary business.
    - An affiliated group of corporations may elect to be treated as a combined group.
  - Special rules for tax haven entities
  - Effective for tax years beginning on or after January 1, 2015.

Cases – New York

- *SunGard Capital Corporation and Subsidiaries, et al.*, New York, Division of Tax Appeals Nos., 823631, 823632, 823680, 824167, and 824256, April 3, 2014

- A New York administrative law judge concluded that a corporate group was not engaged in a unitary business, notwithstanding numerous unreimbursed services provided by the parent to the subsidiaries.

- In ruling that the entities did not exhibit the requisite flow of value, the ALJ drew a distinction between management oversight activities versus centralized management based on operational expertise.

- The group's attempt to file on a combined basis so as to prevent distortion was rejected.

Cases – Vermont

- *AIG Insurance Management Services Inc. v. Department of Taxes, Vermont Superior Court*, Docket No. 589-9-13, July 30, 2014

- The Vermont Superior Court held that the Commissioner's determination that a ski resort was part of the parent's unitary group was not within the constitutional scope of the unitary business principle.

- The ski resort was determined to run a discrete business enterprise unrelated to the parent's insurance and financial businesses.

Nexus

Nationwide Trends – Nexus and Related Developments

- Economic Nexus and Factor Presence
- Nexus - Agency
- Business Activity Tax Legislation

California

- *Swart Enterprises, Inc. v. California Franchise Tax Board*, Superior Court of California, Fresno County, No, 13CECG02171 (November 14, 2014)
  - A California trial court held that a corporate taxpayer was not doing business in California based on its 0.2% interest in an LLC that leased and disposed of interests in California capital equipment.
  - The taxpayer had no connection to California aside from its LLC interest.
  - The court held that the doing business exception is dependent on a limited partner's lack of right to manage or control the decision making process of the entity.

California

- **California Franchise Tax Board, Legal Ruling 2014-01 (July 22, 2014)**

- The California Franchise Tax Board provided in a letter ruling, that LLC corporate members are not ‘doing business’ in the state when the LLC’s only California activity consists of:

  (1) registering to do business or

  (2) being organized in the state.

- If the LLC’s only contact with the state is registering or being organized in the state the Corporate LLC members are not subject to the requirement to file a tax return based on 'doing business' in the state and are not subject to the state's franchise tax regime.

Cases - Maryland

- *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, Md. Ct. App., No 36 (March 24, 2014)
  - The Maryland Court of Appeals ruled that two subsidiaries of an in-state parent had nexus with Maryland because the subsidiaries had no real economic substance as business entities separate from their parent.
  - The court rejected the lower court's ruling that established nexus between Maryland and the subsidiaries due to their unitary relationship with their in-state parent.
  - Although rejecting unitary nexus, the entities' unitary relationship justified the state applying to the subsidiaries an alternative apportionment formula that incorporated unitary elements.

Cases - Missouri

UTELCOM, Inc. and UCOM, Inc. v. Dept. of Rev., writ denied, La. Sup. Ct., No. 2011-C-2632, 3/2/12; La. Ct. of App., Dkt. No. 535, 407, Division "D", 9/12/11

◆Taxpayers that have filed franchise tax refund claims consistent with *UTELCOM*, a 2011 Louisiana appellate court decision holding that a passive ownership interest in a limited partnership doing business in the state, by itself, is not sufficient to subject an out-of-state foreign corporate limited partner to Louisiana corporate franchise tax.

◆Recent Board decision in KCS Holdings I, Inc. impact on refund claims and audits

Tax Base

Nationwide Trends – Tax Base/Decoupling From I.R.C. Stimulus Provisions

- Internal Revenue Code conformity
  - Rolling conformity
  - Fixed-date conformity
  - Select provisions adopted
- States likely to decouple from provisions deemed too costly
  - Majority of states decoupled from bonus depreciation
  - Numerous states limited expense allowance
  - State-specific NOL provisions often limit carryover
  - Section 199 Domestic Production Activity
  - COD income deferral

Nationwide Trends – Tax Base/Related Party Addbacks

- Inclusion of related member interest payments and management fees, as well as royalties
- Broader provisions which require addback of intangible expenses along with expansive definitions of "intangibles"
- Typical "safe harbors"
  - Economic substance/arm's length rates & terms for transactions
  - Purpose other than state income tax avoidance
  - Payment of income tax by royalty recipient
  - Royalty recipient not "primarily engaged" in maintenance and management of intangibles (i.e., not an IHC)
  - Ultimate pass-through of expense to unrelated party
  - Requirement to "make a disclosure" to become eligible for a safe harbor
  - "Unreasonableness" exceptions

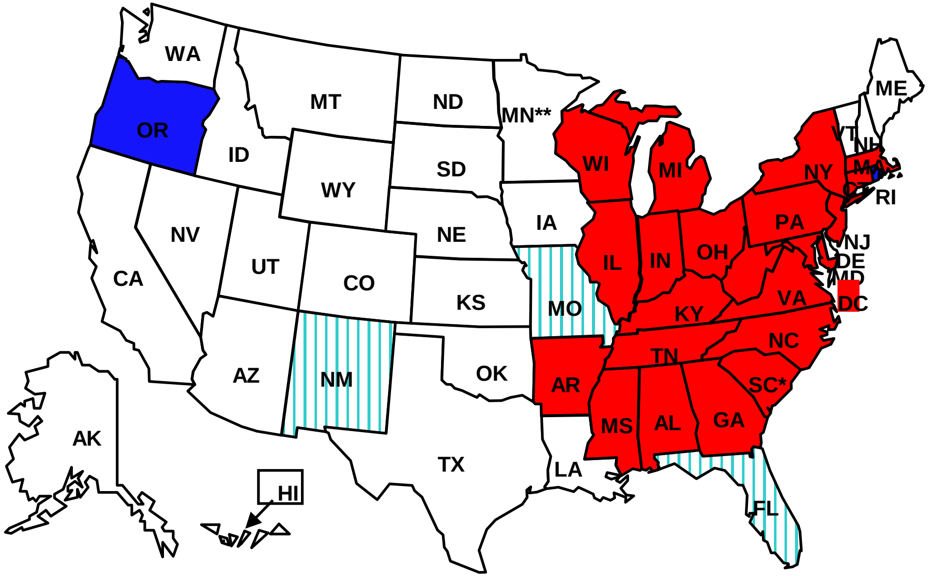
Nationwide Trends – Tax Base/Related Party Addbacks

- Deductibility of all types of intercompany charges are being challenged by state auditors, including intercompany management fees, finance charges and other overhead costs.
- States are concerned that deductions do not have a valid business purpose, are not based on arm's length pricing or are otherwise not "legitimate."
- States are looking for transfer pricing studies for each type of charge.
- If taxpayers do not have transfer pricing studies, states are disallowing deductions, reallocating income and expenses, or adjusting mark-ups.

Nationwide Trends – Tax Base/Related Party Addbacks

- Intercompany Expenses: Questions
  - Intercompany expenses subject to addback –
    - does an exemption apply and can a claim of exemption be supported?
  - Intercompany charges other than interest and royalties –
    - are deductions valid, what is business purpose, is charge at arm’s length, are charges “settled”?
  - Challenges to the "Add-back" statutes
    - Will taxpayer more likely than not be able to sustain a challenge when states' interpretation of "subject to tax in another state" or other exceptions are vague.

Nationwide Trends – Related Party Addbacks



- Related member expense addback required (including DC, NYC)
- Related member expense addback legislative proposals considered in recent years
- No related party addback provisions imposed
- Repealed in OR eff. 1/1/13 and in RI eff. 1/1/15

*South Carolina disallows deductions for an expense between related parties where a payment is accrued, but not actually paid and on interest deductions on obligations issued as a dividend or paid instead of a dividend

**Minnesota requires addback of interest and intangible expenses, losses, and costs paid, accrued, or incurred by any member of the taxpayer's unitary group to a foreign operating corporation that is a member of the taxpayer's unitary business group,

Other Developments – Texas

Texas Policy Letter Ruling 201404878L, April 9, 2014

- Effective April 9, 2014, a change to a group's common owner will no longer determine whether the Texas temporary credit for business loss carryforwards terminates.
- Under the new policy, the credit disallowance will be determined on an entity-by-entity basis and lays out three situations in which an entity changes combined groups:
    1. the entity leaves a combined group,
    2. an entity joins an existing combined group, or
    3. an entity's acquisition results in the creation of a new combined group.

Other Developments – Texas

Texas Policy Letter Ruling 201411985L, November 20, 2014

◆Effective November 20, 2014, the Texas Comptroller's Tax Policy Division issued revised guidance on a recent policy change concerning when a taxable entity that changes combined groups may claim a temporary credit for business loss carryforward.

◆Under the new policy, a taxable entity changes combined groups and will lose the right to claim the credit in three situations

1. entity leaves a combined group
2. entity joins an existing combined group
3. entity's acquisition results in the creation of a new combined group

◆The recently revised policy provides taxpayers an exception by establishing that if a common owner changes without any change in the members of the combined group, other than the addition of a newly-formed entity, the group is considered to have not changed and may continue to claim the credit of the member entities.

Other Developments – Texas

Texas Comptroller of Public Accounts, Decision, Hearing No. 109,310, Docket No. 304-14-2297, November 13, 2014, (released, January 2015)

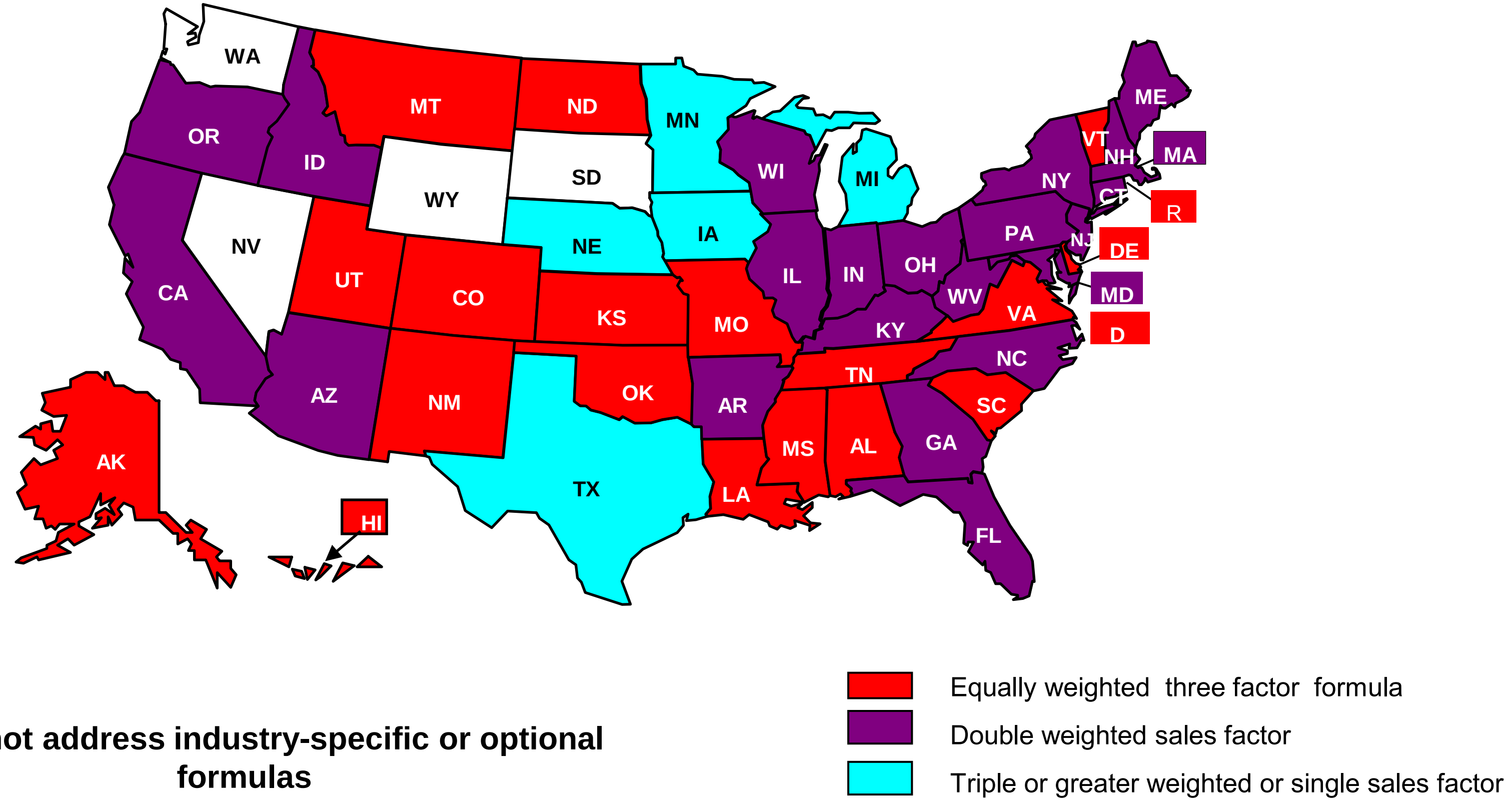
- A taxpayer, the designated reporting entity of a combined group, was not entitled to Texas temporary business loss carryover credits because the entities of the combined group had changed.
- In order to claim the credit, a member of a combined group may not change combined groups after June 30, 2007.
- During an audit, it was determined that on July 31, 2007, a corporation acquired the stock of all the entities in the taxpayer's combined group, including the taxpayer.
- This constituted the forming of a new combined group and thus made the taxpayer ineligible to claim the credit as the new group was created after June 30, 2007.

Allocation and Apportionment

Nationwide Trends – Allocation and Apportionment

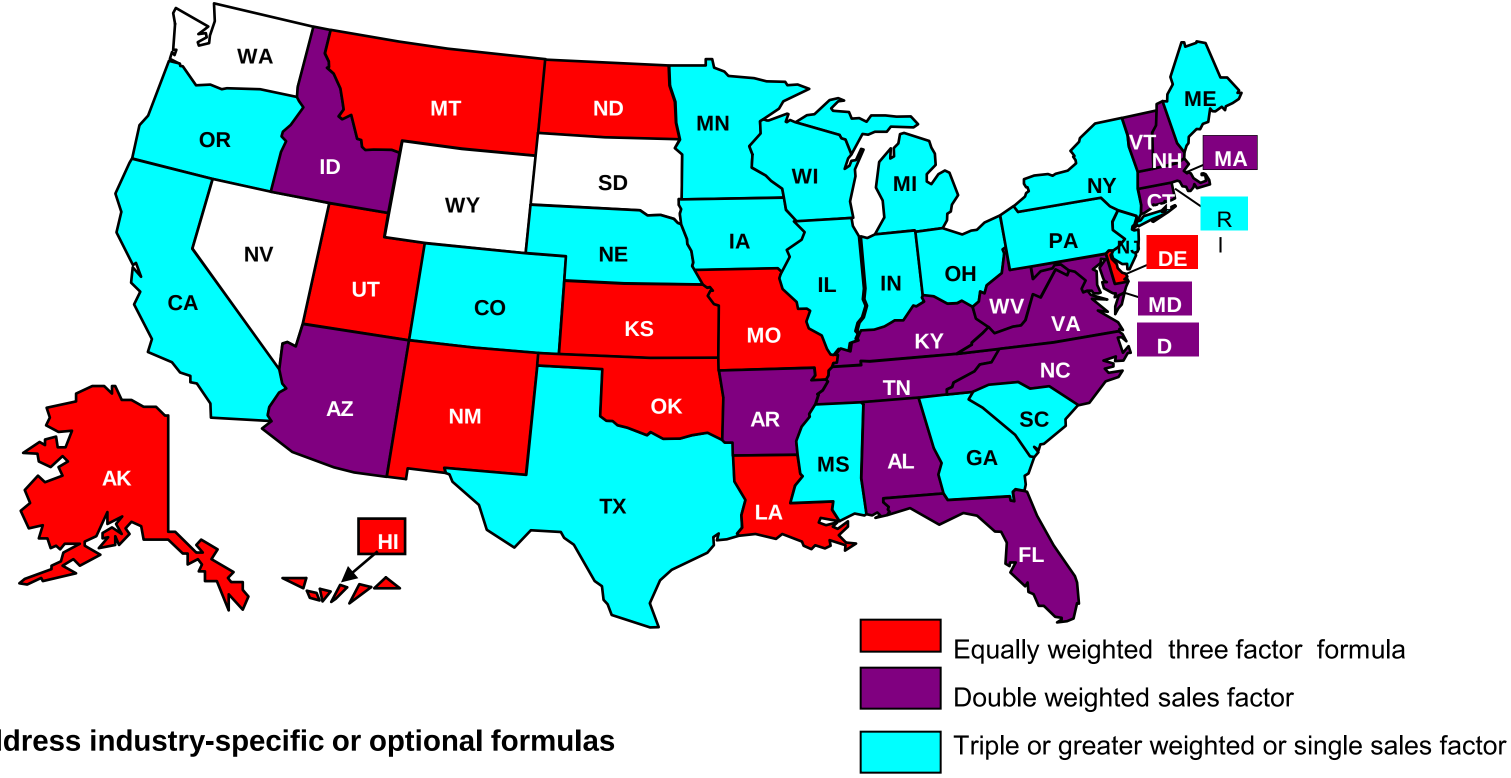
- Apportionment Trends
  - Shift in factor weighting
  - Sales factor
    - Gross versus net
    - Market source versus cost of performance
  - Use of discretionary authority to adjust formula (UDIPTA Sec. 18)

Apportionment Formulas* - 1998



***Does not address industry-specific or optional formulas**

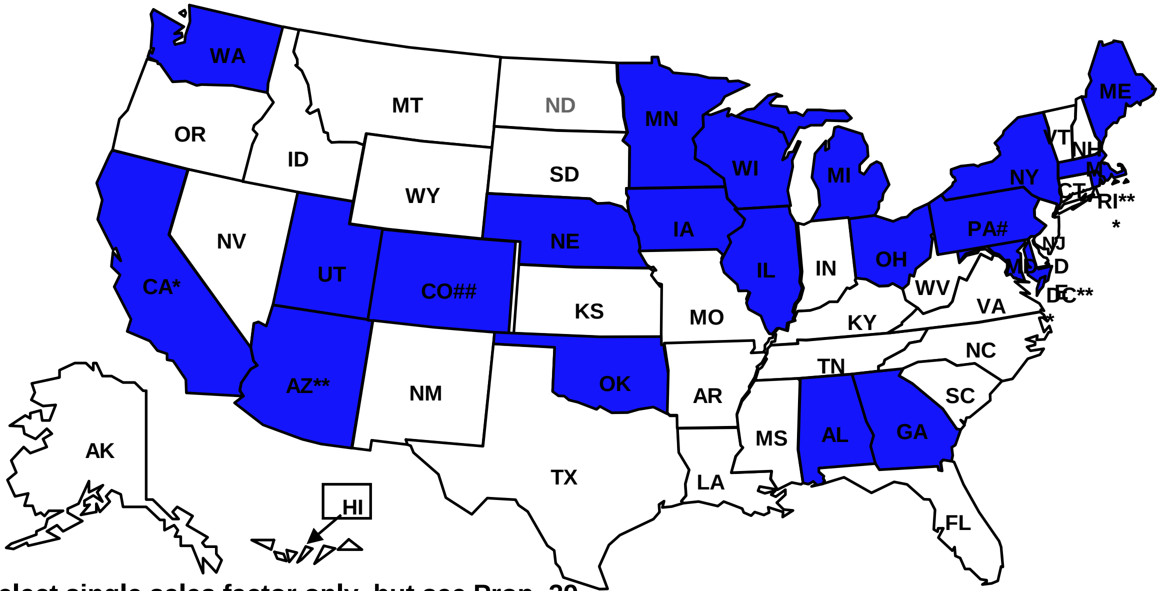
Apportionment Formulas* - 2014



***Does not address industry-specific or optional formulas**

Reflects changes enacted in 2014 that might take effect later

Market-Based Sourcing



***Effective in 2011, for taxpayers that elect single sales factor only, but see Prop. 39**

****Elective for deemed multistate service providers**

*****in 2015**

#service receipts only effective in 2014

intangible property receipts only

Cases and Administrative Guidance

Tennessee Clarification and Ruling on DREs

- Prior Rule
  - Notice #13-16 provided that a SMLLC is disregarded for TN franchise and excise tax purposes if:
    - It is a DRE for federal tax purposes
    - Its sole owner must be treated as a corporation for federal tax purposes
  - Tennessee took the position that a REIT did not qualify as a "corporation" in this context
    - This resulted in SMLLCs owned by REITs being treated a separate taxpayers for franchise and excise tax purposes
  - Under prior Tennessee law, it was unclear whether any DREs owned by a REIT could benefit from the DPD

Tennessee Clarification and Ruling on DREs (Continued)

- New Rule
  - Notice #14-12 reversed Tennessee's prior stance on REITs and clarified that they can be considered "corporations"
    - SMLLCs owned by REITs will now be treated as DREs for franchise and excise tax purposes
    - A REIT owning a SMLLC will now have a Tennessee filing requirement but will receive a deduction for the DPD as long as it is not a captive REIT
  - However, Rev. Rul. #13-22 states that non-SMLLC DREs owned by REITs (such as QRSs and disregarded partnerships) will still be treated as separate taxpayers for franchise and excise tax purposes

Pennsylvania Local Business Privilege Tax

- Previously, all localities (other than Philadelphia) were able to subject rental real estate receipts to local Business Privilege Taxes pursuant to the Local Tax Enabling Act (LTEA)
- In *Fish, Hrabrick and Briskin v. Township of Lower Merion*, the Commonwealth Court held that the LTEA does not authorize direct or indirect taxes on "leases or lease transactions"
  - This ruling prevents future taxation of rental real estate receipts
  - This ruling also allows taxpayers to claim refunds for taxes paid on rental real estate receipts on any returns still within the statute of limitations
  - This ruling may still be appealed to the Pennsylvania Supreme Court

Other Developments

General State Tax Updates

- Louisiana Franchise Tax – Refund Claims
- Others??

Communications Issues for REITs – Analysts, Investors & Social Media Meeting

Wednesday, April 1st
11:15am – 12:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
David Bonser, Head-Equity & US Debt Capital Markets, Hogan Lovells LLP

Panelists:
Kay Tidwell, EVP & General Counsel, Hudson Pacific Properties, Inc.
Jerry Cummins, Partner, Sidley Austin LLP
Julian Kleindorfer, Partner, Latham & Watkins LLP

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

®

Regulation FD

March 31-April 2, 2015

Regulation FD - Purpose

- How are we sure everyone gets the same important information at the same time?
  - Problem: "Selective disclosure" of material nonpublic information to securities analysts, institutional shareholders and others but not to the public causes an imbalance in disclosure system
  - Response: In 2000, the SEC adopted Regulation FD (Fair Disclosure) requiring an issuer that discloses material nonpublic information to securities market professionals or to a security holder to make public disclosure of such information
  - Goal: To "level the playing field" between small and institutional investors

Regulation FD – The Rule

- Disclosures of material nonpublic information concerning the company or its securities
- Made by (i) a director, (ii) an executive officer or (iii) an IR person to
- (i) securities industry professionals or (ii) security holders who are likely to trade on the information
- That are not exempt

Violate Regulation FD

Applying Materiality Standards

- Amorphous definitions established by case law
  - Information is material if (i) “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision or (ii) there is a substantial likelihood that it “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”
- Information regarding certain topics will almost always be considered material:
  - Earnings (including ballpark guidance)
  - Sales figures
  - Significant transactions
  - Changes in control
  - Difficulties with auditors
- Confirmation of prior guidance contains a significant risk of an FD violation as such confirmation itself may be material (including statements like “has not changed” or “still comfortable with”)

Communications Not Covered by Regulation FD

- Communications by persons who are not (i) senior officials (i.e., directors or executive officers) or (ii) IR personnel
- Communications to persons who are not (i) securities industry professionals or (ii) security holders who are likely to trade on the information
- Communications of non-material information
- Exempt communications

Exempt Communications

- Communications made to a person who owes a duty of confidence (e.g., attorney, investment banker or accountant)
- Communications made to a person who expressly agrees to maintain the disclosed information in confidence (which need not be in writing)
    - Communications made to ratings agencies were previously exempt from Reg FD but the SEC removed that exemption in 2010 as required by the Dodd-Frank Act. Nevertheless, engagement letters between companies and ratings agencies generally include confidentiality provisions, so the change to the rule has little substantive effect
- Communications made in connection with many types of registered securities offerings

Timing of Public Disclosure

- Intentional or planned disclosures
  - Examples: planned remarks, speeches, presentations, letters to a public audience
  - Timing: Requires prior or **simultaneous** disclosure to the public of any material information
- "Non-intentional" selective disclosures
  - Examples: Responses to questions, unscripted interviews, unplanned comments
  - Requires disclosure to the public of any material information within the later of **24 hours** or the commencement of the **next day's trading on the NYSE** after a senior official learns of the selective disclosure.

Methods of Public Disclosure

- Disclosure must be made by a method or combination of methods that are "reasonably designed to provide broad, non-exclusionary distribution of the information to the public"
- Compliant methods include:
  - filing (or furnishing) a Form 8-K with the SEC
  - disseminating a press release through a widely circulated news or wire service
  - conference calls, press conferences or webcasts (with adequate notice and access)
  - in some cases posting material on company website or through social media

Is Website Posting Public Disclosure

- SEC released guidance in 2008
- Public companies must consider whether:
  - a company website is a “recognized channel of distribution”
  - posting disseminates the information in a manner making it available to the marketplace in general
  - there has been a reasonable waiting period for investors and the market to react to the posted information
- What steps has company taken to identify website as channel of distribution? Is website posting publicized through an email alert?

Evaluating Whether Social Media Disclosures are “Public”

- In April 2013, the SEC issued guidance on the application of Reg FD to disclosures made through social media in its Report of Investigation of Netflix
- According to prior Reg FD guidance regarding websites, a company makes “public” disclosure when it distributes information “through a recognized channel of distribution.”
- Whether a company’s social media channel is a “recognized channel of distribution” will depend on the steps the company has taken to alert the market to its social media channel and its disclosure practices—as well as the use by investors and the market of the company’s social media channel
- Companies are required to conduct a thorough facts and circumstances analysis to conclude that disclosures made via a social media channel will be a “recognized channel of distribution” and thus “public” for Reg FD purposes

Consequences of Violating Reg FD

- Possibility of SEC enforcement action
- Does not create private right of action
- Sanctions against company and individual
  - Cease-and-desist order in administrative action
  - Injunction and/or monetary penalties in civil action
- Could complicate Exchange Act reporting
  - SEC position that failure to comply with Reg FD is a violation of disclosure controls and procedures could complicate control disclosures and CEO and CFO SOX certifications

SEC Enforcement Actions under Regulation FD

- Though adopted in 2000, no actions until November 2002
- 2002: Four actions disclosed simultaneously in November (*Raytheon, Secure Computing, Siebel Systems I, Motorola*)
- 2003: One action (*Schering-Plough*)
- 2004: Two actions (*Siebel Systems II, Senetek*)
- 2005: One action (*Flowserve*)
- 2007: One action (*Electronic Data Systems*)
- 2009: One action (*Black*)
- 2010: Two actions (*Presstek, Office Depot*)
- 2011: One action (*Fifth Third Bancorp*)
- 2013: One action (*First Solar*)

Lessons From SEC Enforcement Actions

- Need for coordination in communications policy and understanding what has been publicly disclosed
  - Particular sensitivity to statements that could be seen to contradict previous public disclosure
- Extreme caution in discussing forward-looking information (particularly earnings guidance) in private meetings with analysts and investors
- Disclosures at industry conferences can lead to Reg FD violations if not broadly available to the public
- Material information can be conveyed by <u>how</u> something is said as well as by <u>what</u> is said
- Importance of adopting and complying with a corporate disclosure policy
  - Anything relating to or impacting earnings will be considered material
  - Establish procedures for rapid public dissemination in the event of “non-intentional” selectively disclosed information
- SEC has increasingly imposed financial penalties on officers and companies for Reg FD violations

Early SEC Enforcement Actions

- ***Raytheon*** - Raytheon's CFO held one-on-one telephone calls with sell-side analysts. During the calls, the CFO indicated that the analysts' quarterly EPS estimates were based on incorrect assumptions regarding the seasonality of Raytheon's earnings and were therefore too high. The analysts all lowered their estimates. Raytheon provided no comparable quarterly guidance in its publicly-accessible investor calls.

- ***Secure Computing*** - Secure Computing entered into a contract that would clearly have a material impact on earnings. The CEO disclosed the contract to two portfolio managers from investment advisory companies prior to public announcement. A Reg FD violation was found notwithstanding that the company issued a press release on the evening of the same day on which the CEO made the second of his two nonpublic disclosures.

Early SEC Enforcement Actions

- ***Siebel Systems I*** - During Q&A session at invitation-only conference hosted by bank, CEO made optimistic comments regarding short-term results. This was in direct contradiction to negative statements that he had made three weeks earlier on a publicly-accessible earnings call. Siebel's stock price and trading volume increased sharply on day of conference. Siebel paid $250,000 penalty as part of settlement.

- ***Motorola*** - Motorola disclosed in press release that it was experiencing "significant" weakness in sales and orders. After seeking the advice of in-house counsel, Director of IR called analysts individually and explained that "significant" means 25% or more. SEC concluded that in-house counsel was incorrect in advising that this clarification was not material nonpublic information. Nevertheless determined not to take enforcement action on ground that advice of counsel was sought and given in good faith.

Early SEC Enforcement Actions

- ***Schering-Plough***
  - CEO and Director of IR had one-on-one Q&A sessions with four institutional investors. SEC contended that during these meetings, CEO, "through a combination of spoken language, tone, emphasis and demeanor . . . disclosed negative and material, nonpublic information" regarding the company. Immediately after the meetings, analysts downgraded stock and trading volume increased significantly.
  - SEC imposed $1 million fine on Schering-Plough and $50,000 fine on CEO.

Early SEC Enforcement Actions

- ***Siebel Systems II***
  - During earnings call, CEO expressed pessimism and refused to answer questions about deals in pipeline.
  - At private meetings with analysts and investors three weeks later, CFO, with Director of IR present, made statements that "materially contrast with the negative public statements" previously made by CEO. CFO answered questions that CEO ducked regarding transactions in pipeline.
  - Stock price and volume spiked on day after disclosures.
  - GC asked CFO and Director of IR what was said at meeting. They each indicated that no material nonpublic information was disclosed.
  - SEC brought complaint against Siebel itself and against the CFO and Director of IR individually.

Siebel Systems II (Cont'd)

- Complaint notes that the Director of IR had been appointed after Siebel I and charged with doing everything possible to comply with Reg FD.
  - In his own job description, Director of IR identified one job priority was to "fully comply with Regulation FD." This was given a 10% weighting, which the SEC suggested showed it was a low priority.
- Complaint notes that company did little to improve its compliance with Reg FD following Siebel I.
  - No formal training was given. No policy was promulgated or additional safeguards implemented.
- Siebel elected to fight SEC rather than settle complaint.
- In August 2005, district court threw out complaint, stating that Reg FD does not require management to become "linguistic experts" who "only utter verbatim statements that were previously publicly made."
- No violation of Reg FD because the private statements did not constitute material nonpublic information.

Early SEC Enforcement Actions

- ***Senetek***
  - Two firms engaged by Senetek PLC prepared and submitted for review draft research reports containing financial projections about the company for the 2002 fiscal year.
  - Senetek’s CEO and CFO provided the firms with revisions to their financial projections based on material nonpublic information, but did not disclose that information to the public.
  - The nonpublic data provided by the CEO and CFO caused the firms to lower the revenues and earnings projections contained in their final reports from those included in the draft reports.
  - SEC brought administrative action against Senetek resulting in Senetek consenting to a cease-and-desist order.

Early SEC Enforcement Actions

- ***Flowserve***
  - On two occasions during 2002, Flowserve publicly lowered its earnings guidance. On October 22, 2002, it reaffirmed its lowered guidance in a press release.
  - On November 19, the CEO reaffirmed the lowered guidance in a non-webcast meeting with analysts.
  - On November 20, an analyst who attended the meeting issued a report stating that Flowserve had reaffirmed.
  - On November 21, Flowserve's stock price was up 6% and volume was up 75%.
  - On November 21, after the close of trading, Flowserve issued a Form 8-K regarding the reaffirmation.
  - SEC charges company, CEO and Director of IR.
  - Charges are settled, company pays $350,000 fine, CEO pays $50,000 fine.

More Recent SEC Enforcement Actions

- ***Electronic Data Systems***
  - EDS entered into “capped collar contracts” which required cash payments by EDS if EDS’ stock price fell below a certain threshold. In 2002, following a disappointing earnings announcement, EDS stock fell far enough to trigger the settlement requirement.
  - Prior to public disclosure, EDS personnel informed analysts of settlement obligation and that it intended to settle its $225 million obligation under the contracts by issuing commercial paper. Public disclosure was made 5 days after first analyst was notified.
  - In 2007, SEC took enforcement action, despite no direct earnings impact of the settlement; SEC concluded that payment was material to EDS.
  - However, EDS admitted to various other violations of the securities laws:
    - Derivative contracts at issue had not been properly disclosed in EDS’ 10-Ks and 10-Qs
    - FCPA violation

More Recent SEC Enforcement Actions

- ***SEC v. Christopher A. Black***
  - Black was CFO of American Commercial Lines and served as ACL's designated investor relations contact.
  - On Monday, June 11, 2007, ACL revised its previously-issued 2007 earnings guidance. In the release, ACL stated that the company expected "2007 second quarter results to look <u>similar to the first quarter</u>." (Emphasis added). First quarter EPS were $0.20.
  - During that week, Black and ACL's CEO met with analysts covering ACL's stock.
  - Following the meetings, ACL's CEO requested that Black send a "recap" email to the analysts (not all of whom had been present for all meetings) summarizing the information discussed in the analyst meetings.
  - ACL's CEO instructed Black to send the email by close of business on Friday, June 15, 2007. CEO also instructed Black to provide a draft of the email to outside counsel prior to sending it.
  - Black was unable to finalize the email to analysts before close of business on Friday, June 15, 2007. Before leaving work, Black forwarded the email to his personal email account so that he might work on it over the weekend.
  - Sometime before leaving work on June 15th, however, Black received an updated internal analysis indicating that ACL's EPS for the second quarter could be as low as $0.13 (much lower than the first quarter's actual results).

SEC v. Black (Cont'd)

- On Saturday, June 16, 2007, Black sent an email from his personal email account to eight sell-side analysts who covered ACL.
  - Email provided additional detail regarding the previously-disclosed weakness in shipping volumes.
  - In addition, stated that the company expected that "EPS for the second quarter will likely be in the neighborhood of about a <u>dime below that of the first quarter based on this pressure</u>." (Emphasis added).
- Black never provided his email to anyone else at ACL, or to outside counsel, before transmission.
- Upon learning of Black's email, ACL notified the SEC. Within two months after the incident, Black announced plans to leave ACL.
- In September 2009, the SEC filed an enforcement proceeding against Black, but not against ACL. In determining not to bring charges against ACL, the SEC noted:
  - "Culture of compliance" created at ACL as a result of Reg FD training
  - Black's sole responsibility for the violation; Black acted outside of the controls established by ACL to prevent such disclosures
  - Prompt filing of a Form 8-K
  - ACL's "extraordinary cooperation" with the SEC's investigation
- Black consented to a settlement and agreed to pay a fine of $25,000.

Recent SEC Enforcement Actions

- ***SEC v. Presstek***
  - Edward Marino was Presstek's CEO, and 1 of 3 persons authorized to speak to investors, analysts and other securities industry professionals.
  - Presstek maintained an internal policy of "corporate silence" beginning on the 15th day of the last month of any given quarter.
  - In September 2006, Marino was informed that Presstek's forecast for the quarter would be lower than expected and that a preliminary announcement would be made in early October 2006 to report such performance.
  - On the morning of September 28, 2006, Marino spoke with the managing partner of a registered investment advisor regarding Presstek's lower-than-expected financial performance for the third quarter.

SEC v. Presstek (Cont'd)

- Specifically, Marino stated that "[s]ummer [was] not as vibrant as [they] expected in North America and Europe" and that although "Europe [had] gotten better since [the summer]" it was "overall a mixed picture [for Presstek's performance that quarter]."
- Promptly after the telephone conversation, the registered investment advisor sold substantially all of its Presstek holdings. Presstek's stock price dropped approximately 19%.
- At or about 12:01 a.m. on September 29, 2006, Presstek issued its preliminary announcement for the third quarter 2006, stating that its performance was below its earlier publicly disclosed estimates. That day, Presstek's opening stock price was 20% lower than the prior day's closing price, and its closing price was 10% lower than the prior day's closing price.
- Presstek settled the SEC's charges for $400,000.
- Marino settled the SEC's charges that he aided and abetted Presstek's violations by agreeing to pay a $50,000 civil penalty.

SEC v. Presstek (Cont'd)

- Though the facts look similar to those in Black, SEC instituted enforcement action against Presstek but not American Commercial Lines.
  - Both executives behaved similarly and each alone were responsible for violating the policy.
  - The companies both had disclosure policies in place to prevent improper disclosures by company officials.
  - Each company promptly disclosed the information to the public upon learning of the selective disclosure and took significant remedial actions to prevent future violations.
- However, SEC noted that ACL had:
  - "cultivated an environment of compliance" by
    - training its employees regarding the requirements of Reg FD
    - adopting policies that implemented controls to prevent violations
  - self-reported the violation to the SEC staff the day after it was discovered and
  - subsequently provided "extraordinary cooperation" with the SEC's investigation.
- Significantly, the SEC did not make any similar comments with respect to Presstek.

Recent SEC Enforcement Actions

- ***SEC v. Office Depot***
  - In October 2010, SEC charged Office Depot and two of its executives with violations of Reg FD for making statements to analysts that included implicit warnings about declining earnings.
  - SEC alleged that the company executives made telephone calls to analysts in an attempt to encourage them to lower previous estimates, which company executives deemed no longer feasible.
  - In February and April 2007, Office Depot held two public conference calls in which CEO and CFO (i) described a business model which contemplated mid- to upper-teens EPS growth over the long-term and (ii) warned that its largest business segments were facing a softening in demand. In early May, in another publicly available investor conference, Office Depot made similar disclosures.
  - In late May, CEO alerted Board of Directors that Office Depot would not meet the analysts' consensus EPS estimate for the second quarter and that senior management was discussing a strategy for advance communication to avoid a complete surprise to the market.
  - In mid June, CEO and CFO jointly decided that instead of telling analysts that Office Depot would not meet expectations, the company would talk individually with each of its eighteen analysts "just to touch base" and to point them towards earnings releases of comparable companies noting slowed growth, noting that such releases were "interesting" and repeating warnings of a softening economy.

SEC v. Office Depot (Cont'd)

- The Director of IR made these calls initially on Friday, June 22. Over the weekend he reported back to the CEO and CFO and they both encouraged the calls to continue on Monday, June 25.
- Also on Monday, the CEO obtained an update on analyst estimates, which were still a bit too high. In response, the CFO asked the Director of IR to call the top 20 institutional investors and relay same talking points, which was done on Tuesday.
- More than one analyst expressed concern that the company had not released the information to the public, and the executives noted that the analysts were lowering their estimates in response to the calls; nevertheless, the executives continued to encourage the calls.
- Office Depot filed Form 8-K on Thursday, six days after the calls initially began. From Friday to Thursday, the stock price dropped 7.7%.

SEC v. Office Depot (Cont'd)

- Office Depot and the executives settled the charges. The company agreed to pay a $1 million penalty and each of the executives agreed to pay a $50,000 penalty and sign a cease-and-desist order.

Recent SEC Enforcement Actions

- ***Fifth Third Bancorp***
  - In May 2011, Fifth Third selectively disclosed to certain investors its intention to redeem a class of its trust preferred securities (TruPS) for approximately $25 per share. The securities were then trading at approximately $26.50 per share.
  - Fifth Third did not issue a Form 8-K or other public notice of the redemption until it became aware that investors with knowledge of the redemption were selling the securities to purchasers who were unaware of the redemption.
  - In settling the charges with the SEC, Fifth Third agreed to compensate harmed investors, adopt various additional policies and procedures relating to the redemption of securities and sign a cease-and-desist order. No civil penalty was imposed upon Fifth Third based on its cooperation with the investigation.

Recent SEC Enforcement Actions

- ***SEC v. Polizzotto***
  - After learning that the U.S. Department of Energy would not award First Solar, Inc. one of the loan guarantees that it had sought from the DOE, Polizzotto, the head of investor relations of First Solar, communicated privately with more than 30 analysts and investors to notify them that there was a "low probability" that First Solar would receive that guarantee but there was a "high probability" it would receive others.
  - Less than 10 days before that, First Solar's CEO had expressed confidence at an investor conference that First Solar would receive the lost guarantee.
  - In-house counsel had specifically advised Polizzotto (and others at First Solar) by email that news of the failure to obtain the loan guarantee could not be selectively disclosed, including in response to questions from analysts and investors.
  - Polizzotto had sent internal emails noting that the news was "material" and could create a "huge concern."

SEC v. Polizzotto (Cont'd)

- At the time of Polizzotto's disclosures, First Solar had not received a formal notice from the DOE, but knew of its decision. At the time of Polizzotto's statements, analyst reports regarding Congressional oversight of the loan guarantee program had resulted in concern within the solar industry regarding the DOE's ability to move ahead with the guarantee.
- These concerns had resulted in numerous inbound calls to First Solar's IR department and an 8% drop in First Solar's stock price.
- The SEC did not charge First Solar, citing its "extraordinary cooperation" with the SEC's investigation, as well as its cultivation of an "environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD". The SEC also noted that First Solar had immediately discovered Polizzotto's misconduct and had issued a press release regarding the matter early on the next day following the disclosures and quickly self-reported the matter to the SEC.
- The SEC settled with Polizzotto for a $50,000 fine and a cease-and-desist order.

Client Alert

Latham & Watkins Corporate Department

Giving Good Guidance: What Every Public Company Should Know

Every public company must decide whether and to what extent to give the market guidance about future operating results. Questions from the buy side will begin at the IPO road show and will likely continue on every quarterly earnings call and at investor meetings and conferences between earnings calls. The decision whether to give guidance and how much guidance to give is an intensely individual one. There is no one-size-fits-all approach in this area. The only universal truths are (1) a public company should have a policy on guidance and (2) the policy should be the subject of careful thought.

The purpose of this *Client Alert* is to provide an updated discussion of the issues that CEOs, CFOs and audit committee members should consider before formulating a guidance policy.[1] In Annex A, we answer some frequently asked questions about guidance and offer some practical guidelines to consider when drafting a guidance policy.

"It is possible to give guidance in a deliberate and careful way without incurring undue liability, and it is also possible to make critical mistakes that can have significant economic consequences under the federal securities laws and in the financial markets."

A Review of the Basics

Public companies are not required by stock exchange rules or the SEC's rules to provide investors with projections of future operating results.[2] However, investors and analysts can be demanding, and many public companies elect to provide the market with guidance about their expectations for the future. The decision to give guidance can spring from a desire to share good news with investors in order to help the market get to a higher valuation for the company's stock or it can spring from a desire to correct analysts' overly optimistic earnings expectations. Whatever the motivation, the legal landscape should be carefully understood before management takes the plunge. It is possible to give guidance in a deliberate and careful way without incurring undue liability. It is also possible to make critical mistakes that can have significant economic consequences under the federal securities laws and in the financial markets.

Primary Liability Provisions

There are a number of provisions in the federal securities laws that can create liability for forward-looking statements. In the context of a public offering, Section 11 and Section 12 of the Securities Act of 1933 impose liability on issuers, their officers and directors, and underwriters for misstatements of material fact or omissions of material facts necessary to make included statements not misleading. Rule 10b-5 under the Securities Exchange Act of 1934 imposes liability in a broadly similar manner, although the burden of proof on a plaintiff bringing a Rule 10b-5 claim is higher.[3] Rule 10b-5 applies to statements made in the context of securities offerings as well as in periodic reports and day-to-day communications with analysts and investors. Because of the potential for liability, it is prudent for those giving guidance to speak carefully, completely and deliberately.

Safe Harbors

The Private Securities Litigation Reform Act of 1995 (PSLRA) enacted safe harbor provisions in both the Securities Act and the Exchange Act for forward-looking statements[4] that are (1) identified as such and (2) accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[5] These safe harbors also provide protection where a plaintiff fails to prove that a statement was made with actual knowledge that the statement was false or misleading if made by a natural person, or was made by or with the approval of an executive officer if made by a company.[6] The PSLRA safe harbor provisions do not apply in the context of an IPO or to enforcement proceedings brought by the SEC.

Forward-Looking Statements

The federal courts have held that forward-looking statements that are accompanied by appropriate cautionary language do not give rise to a claim for liability under the federal securities laws because the predictive statement read in context with the risk disclosure is not misleading as a matter of law. However, despite the broad protections of the PSLRA's safe harbor, boilerplate cautionary language may not be sufficient. Some courts have declined to allow the protections of the safe harbor where risk disclosures did not change over time or did not identify the risks that ultimately caused the prediction not to come to pass. Specific, robust and dynamic cautionary language is often the best defense to a review of forward-looking statements that may (especially with the benefit of hindsight) ultimately prove to be inaccurate.[7] As a result, public companies should routinely evaluate and tailor cautionary language for each significant forward-looking statement. Any areas of heightened risk or known uncertainties warrant fact-specific disclosures that are customized to the particular risks underlying each forward-looking statement. Well-crafted disclosure can serve as a shield against future challenges if good-faith predictions of future results do not materialize.

Whether to Update

Although the PSLRA explicitly states that it does not "impose upon any person a duty to update a forward-looking statement,"[8] some courts have suggested that a duty to update may apply if events transpire that cause a company's prior disclosure to become materially inaccurate, even though that prior disclosure was accurate when made.[9] There is no requirement that a public company immediately make public all material facts that come into its possession on a real-time basis,[10] but where a public company's affirmative and definitive prior statement becomes clearly and materially false, it should consider issuing a clarifying, correcting or updating statement.

What does all this mean for public companies? Among other things, it means a company can answer the question "Are you in merger negotiations with XYZ, Inc.?" with a "no comment" and not be obligated to later update that statement if it enters into merger negotiations.[11] However, if the answer to the first question was "This company will never enter into merger negotiations with XYZ, Inc.," then the company may want to consider an updating disclosure if merger negotiations begin in earnest. In other words, once the decision to speak on a particular topic — expected earnings for the year, for example — is made, it may be problematic to stop talking about it in the future as the facts change.

Considering whether to update earnings guidance is particularly complicated and depends very much on the facts and circumstances at hand. The analysis should always begin with a review of what was said in the first place. As an example, let's consider a company that issues guidance only once per year, in the first quarter, projecting earnings for the full year then in progress. In order to answer the question whether our hypothetical company needs to update its guidance every quarter as more facts become available and its expectations about the likely outcome for the full year move around, we must first ask what was said when the guidance was originally issued. Did the company specifically say that it would not be updating the full-year guidance every quarter? Did the company say it would only update guidance if a material corporate transaction occurs?

The next series of questions to consider focuses on the facts that have transpired since the original guidance was issued. Is it obvious that the original guidance no longer holds because of well-understood changes in industry trends or market conditions or an intervening acquisition or disposition? Did the original guidance include a clear explanation of the assumptions on which it was based? Is it clear that those assumptions have not come to pass? Has the Wall Street analyst community revised its estimate of full-year earnings down to a level that the company believes it can deliver?

Still other questions focus on the unique facts of the company's circumstances. Is the company in a line of business where it is difficult to know how the year will turn out until the last bottle of New Year's champagne has been poured? Will the company realistically be able to avoid questions from analysts about the continuing validity of its earlier guidance? All of these considerations will come into play in analyzing the legal landscape and deciding whether to confirm or update prior guidance. Also very relevant to the decision is the investor relations department's desire to avoid unpleasant surprises among the company's constituents. An important further complication, which we will discuss below, is whether the company is selling or purchasing its own securities.

Regulation FD

Regulation FD's prohibition on selective disclosure of material nonpublic information must also be taken into account in any discussion of whether to give or update guidance.

Regulation FD and subsequent SEC enforcement actions have effectively eliminated the historical practice of privately "walking" analysts' earnings estimates up or down to avoid unpleasant surprises at quarter-end or year-end. Guiding analysts about future earnings is still permissible under Regulation FD, so long as the analysts and the general public learn all material information at the same time.

Updating or confirming prior guidance is treated the same way under Regulation FD — it's all fine as long as the public gets the same material information at the same time that the analysts do. Therefore, the question "Are you still comfortable with your guidance for this year?" is right in the center of Regulation FD's bull's eye. When answering that question, Regulation FD considerations need to be taken into account. An officer who provides direct or indirect guidance to an analyst regarding earnings forecasts "takes on a high degree of risk under Regulation FD."[12]

Two Basic Questions

Many companies will sort through the overlapping webs of safe harbors, case law and liability provisions and conclude that guidance is simply not worth the headaches. Other companies will conclude that the benefits of managing market expectations outweigh these headaches and will take the guidance plunge. The remainder of this *Client Alert* is aimed at providing some practical suggestions on how to survive as a giver of guidance.

How Far to Go

The most basic decision is whether to give guidance on a quarter-by-quarter basis or on a year-by-year basis. The next question is how far forward to project results. There is no one-size-fits-all answer here. Some businesses are stable and predictable. For them, predicting earnings on a quarter-by-quarter basis may be an option. Many energy companies, for example, have presold the majority of their output multiple years into the future. A company with a predictable earnings stream is in a very different position than a company with unpredictable operating results.

Businesses with lumpy revenue streams or that experience seasonality or weather issues may not feel they can make quarterly projections prudently. A September 2012 survey performed by the National Investor Relations Institute (NIRI) found that guidance-giving companies most often communicate annual estimates only. The most common frequency for communicating those estimates is on a quarterly basis.[13] Even the most stable businesses typically elect not to provide earnings guidance beyond the year in progress, although some businesses will provide long-term estimates or goals for longer periods.

What to Say

Directly related to the decision of how far forward to look when guiding investors is the decision of what to say about the periods in question. Guidance takes many forms, not just earnings per share for the year. Some companies will guide investor expectations by giving a range of anticipated earnings per share or simply by saying that they are "comfortable with the Wall Street analysts' consensus" regarding earnings per share for the year. However, explicitly blessing a specific analyst's estimate can be viewed under the case law as "adopting" it, which has the same liability considerations as issuing guidance directly. This casual approach to guidance usually does not offer an opportunity to include appropriate cautionary disclosure and should generally be avoided.

Many companies prefer to provide the market with forecasts of an Adjusted Net Income or Adjusted EBITDA metric that excludes the impact of expected (or unexpected) non-recurring, non-cash and/or unusual items. Adjusted measures of operating performance are easier to predict accurately since they are unaffected by many of the income statement items that impact earnings per share. Of course, public release of these non-GAAP financial measures will need to comply with Regulation G.[14]

Other companies stop their numerical guidance at the revenue line, projecting only a targeted revenue growth in percentage terms. Revenue-only guidance may be supplemented with a comment about profit margins — "We expect to see an improvement in profit margins as we do not expect anticipated revenue increases to be accompanied by a corresponding increase in our fixed costs" — or not. Still another form of guidance involves non-financial measures — "We expect to open 25 new company-owned stores this year" or "We currently expect to complete construction of the facility in the fourth quarter of 2012."[15] There is no limit to the forms that guidance can take. What is appropriate for one company in one industry may be totally inappropriate for another company, even one in the same industry.

Guidance Guidelines

Scope

Each company's decision of what to say and how far to go needs to be made in light of the nature of its industry and the circumstances of its business. Careful thought should be given to the tradeoff that going further down the income statement presents — more precise information will please analysts in the short run but it can create sharper liability issues in the long run. Much more agility is needed to predict earnings per share successfully than to predict revenue, Adjusted Net Income, Adjusted EBITDA or another "normalized" measure of performance that is less likely to be affected by surprises on the business front or in the accounting literature. We recommend that companies only give guidance on a metric that they feel comfortable they can accurately predict.

Cautionary Statements

All good guidance should be accompanied by dynamic, carefully tailored cautionary statements. These disclaimers should temper the predictions of a rosy future with a balanced discussion of what could go wrong. Risk factor disclosure should also be appropriately updated with each publication — don't just use the same old boilerplate from prior years. It is also helpful if some of the material assumptions on which the guidance is based are disclosed and if the company's risk factors tie to the achievement of those assumptions. A 10 percent increase in earnings that is premised on cutting redundant overhead costs is not the same as a 10 percent increase that is premised on a substantial increase in market share. The point of cautionary language is to explain what goes into the sausage so investors can make their own intelligent decisions about the likelihood of the projected outcome actually being realized. Good cautionary disclosure can be an effective insurance policy against future liability if the guidance turns out to be incorrect.

The Delivery

It is best if guidance and the related cautionary disclosures are given in a controlled environment. The most popular forums are the year-end or quarter-end press release and the related quarterly earnings calls. The press release and the script for an earnings call are usually the subject of a greater degree of oversight than any casual encounter, and earnings calls are always Regulation FD-driven events since the public is invited to listen in and a recording is typically available on the company's website for a period of time after the call. Many companies prefer to give guidance orally on their earnings calls and do not produce a written version of their statements for the related earnings press release. For a CFO who is comfortable sticking tightly to a prepared script, this is a perfectly acceptable choice. For others, putting it down in writing in the earnings release may be a wise precaution. Regardless of the method of delivery of guidance, every company should carefully evaluate its internal processes for preparing and providing guidance.

The earnings release or call should include carefully tailored disclaimer language and the actual guidance statements should be carefully vetted and scripted. Oral forward-looking statements should be accompanied by an oral statement that cautionary disclosures are contained in a readily available written document. Similarly, statements regarding non-GAAP financial measures should identify where the required reconciliations can be found.

Anticipating Questions

There are at least three good reasons to anticipate the questions about guidance that analysts are likely to ask on an earnings call. First, there are some questions the company will want to answer. If the answer has not been scripted, it may not come out with all of the nuance that is appropriate. Second, there are some questions the company will not want to answer. It helps to have worked out in advance which questions the company is prepared to answer and which questions merit only a "no comment" response. Finally, Regulation FD frowns on answering follow-up questions in private calls or meetings where the public does not have access, so what is said on the earnings call will set the boundaries of what can be discussed in private meetings between earnings calls. Answering questions that were asked on the earnings call or providing additional detail on topics that have been covered at an appropriate level of materiality on the earnings call will generally be acceptable in follow up one-on-one investor meetings. Venturing into territories that were not covered on the earnings call in subsequent private meetings can raise selective disclosure issues under Regulation FD.

Updating or Confirming Prior Guidance

When management begins to doubt whether the company's actual results will be in line with prior guidance, the decision whether to make a public statement to that effect is entirely dependent on context — all facts and circumstances must be considered. As always, the analysis should start with a review of what was said in the first place. Did the company say that it would confirm annual guidance every quarter? Did the company say that it would not? Is it obvious from the facts that the prior guidance is no longer reliable (due to an important acquisition, disposition or industry development)?

If a company expects to exceed its prior guidance by a modest amount, it is probably safe to keep that information confidential and pleasantly surprise the investment community. On the other hand, if a company is reasonably sure that it will miss the mark by a material amount, intervening events or market pressures may force an out-of-sequence guidance update. Context is everything. For a company repurchasing its own shares or one involved in a going-private transaction, the fact that current guidance is materially low may be problematic. In the context of a securities offering, the opposite is true — materially high guidance is the concern. Managing expectations to maintain credibility, provide transparency and avoid unpleasant surprises is always the goal.

Below is a list of key considerations to keep in mind when giving guidance:

10 Rules for Giving Good Guidance

1. Designate a limited number of company personnel to communicate with analysts and investors about future plans and prospects.
2. Adopt an appropriate guidance policy early and follow it.
3. Do not rely on boilerplate. Explain the assumptions underlying each forward-looking statement and disclose the risks that may cause anticipated results not to be realized — the cautionary statements should be tailored to fit the guidance.
4. Have prepared remarks reviewed by counsel and stick to the script.
5. Remember Regulation FD: Disclose guidance and other material information only in an FD-compliant manner.
6. Do not be afraid to say "no comment" in response to questions or to deflect uncomfortable questions by restating the company's guidance policy.
7. Do not comment on or redistribute analysts' reports, and only review advance copies of analysts' reports for factual errors.
8. Remember Regulation G: Include appropriate disclosure for non-GAAP financial measures where required.
9. Continually evaluate whether changed circumstances argue in favor of an update of prior disclosures.
10. Be particularly sensitive to Rules 1 through 9 in the context of an intervening event between quarterly earnings releases and calls such as an offering of securities, share repurchase program or acquisition, or when insiders are buying or selling company securities.

Special Considerations

Securities Offerings

The pendency of a securities offering creates special issues for guidance-giving companies. It is rare to find written guidance in a prospectus or offering memorandum and most earnings releases are furnished on Form 8-K rather than filed and hence are not incorporated by reference into the offering document. This means that guidance is rarely part of the landscape for purposes of Section 11 of the Securities Act.[16] However, there remains an important question of whether the prior guidance can be considered part of the offering for Section 12 and Rule 10b-5 purposes. The answer depends on the facts and circumstances. Where the prior guidance was given only orally at an earnings call many months previously, and if no reference is made to the prior guidance in the selling process, it may be possible to argue successfully that it is not part of the liability file for Section 12 purposes.[17] That fact pattern could occur, for example, in a block trade context where there is no road show. However, where actual results are expected to be materially lower than the prior guidance, most companies elect to stay out of the market until they can properly adjust investor expectations by amending or updating their prior guidance.[18] Even when it is possible to conclude that there is no legal duty to do so, investor relations considerations usually prevail. It is easy to see how a new investor who purchased securities at a time when the prior guidance indicated earnings per share for the year in the range of $1.05 to $1.10 might feel wronged if shortly after his or her purchase the company reports earnings per share of $0.90. In the context of a securities offering, managing expectations becomes even more important. Investors who get what they expected generally don't sue issuers. Disappointed investors sometimes do.

In the event of an out-of-sequence guidance update prior to a securities offering, special consideration should be given as to whether the update constitutes an "offer" under the Securities Act.[19] The SEC has adopted a number of safe harbors to protect various activities that are either harmless or necessary to the proper functioning of the capital markets.

Rule 168 is a non-exclusive safe harbor from Section 5(c)'s prohibition on pre-filing offers (and from Section 2(a)(10)'s definition of prospectus) that is available only to reporting issuers with a history of making similar public disclosures. It allows a reporting issuer and certain widely traded non-reporting foreign private issuers to make continued regular release or dissemination of "factual business information" and "forward-looking information,"[20] but not information about an offering or information released as part of offering activities. Rule 168 is not available to underwriters.

Disclosure of Rule 168 information is permitted at any time, including before and after the filing of a registration statement, but only if:

- the issuer has previously released or disseminated Rule 168 information in the ordinary course of its business and
- the timing, manner and form in which the information is released is materially consistent with similar past disclosures.

For the information to be considered previously released in the ordinary course of business, the method of releasing or disseminating the information, and not just the content, is required to be materially consistent with prior practice.[21] The SEC has acknowledged that one prior release could establish a sufficient track record,[22] although it has also cautioned that an issuer's release of "new types of financial information or projections just before or during a registered offering will likely prevent a conclusion" that the issuer regularly releases that information.[23]

What should public companies do in light of the Rule 168 safe harbor? Because Rule 168 looks to track record, public companies should establish a pattern of issuing information and then stick to it. Concluding that the safe harbor for any particular situation is available is going to be easier if there is a prior record of releasing the same general information on reasonably similar timing.

Share Repurchase Programs

Like pending offerings or strategic transactions, share repurchases require careful attention to guidance practices since the potential for liability under Rule 10b-5 exists equally in all of these contexts.[24] However, there are some important differences. Few purchasers in an offering will be disappointed if the company's guidance turns out to have been unduly conservative and earnings come in higher than projected. Shareholders who sold stock back to the company following gloomy projections, on the other hand, may feel aggrieved if subsequent actual earnings are strong. In other words, overly conservative guidance given during, or before commencing, a share repurchase program can be just as problematic as overly rosy guidance in the context of a securities offering.

The key to avoiding liability is careful forethought to the timing of the guidance and the share repurchases. For example, consider limiting share repurchases to time periods that closely follow guidance announcements. The more closely in time the repurchases follow the guidance, the less likely that intervening events have undermined the guidance. Companies with particularly active share repurchase programs may want to consider adopting and closely monitoring blackout trading windows and utilizing Rule 10b5-1 plans executed during open trading windows.

Insider Sales

A decision not to update guidance may restrict the ability of executives and other insiders to sell shares of their company's stock. If the company learns facts causing management to conclude that prior guidance may no longer be accurate, both the underlying facts and management's conclusion could later be found to be material information. If insiders sell shares before the stale guidance is updated, regulators and plaintiffs could take the position that those transactions constituted improper insider trading. Accordingly, if events undermine the accuracy of earlier public guidance, it may be wise to suspend executive purchases and sales of stock in order to avoid allegations of insider trading.

Mergers and Acquisitions

Companies often provide guidance about the effects of significant corporate transactions — "We expect this transaction to be accretive to our earnings next year." These statements are subject to all of the concerns in this *Client Alert* generally, including the risk of liability under Rule 10b-5 and, if there is a registration statement to be filed in connection with the transaction, Sections 11 and 12. These statements also need to be considered in the context of the incremental statutory liability imposed by the proxy and tender offer rules. Regulation M-A may require documents containing these statements to be filed with the SEC. In business-combination transactions, companies must also closely monitor public statements of their financial advisors, information agents and proxy solicitors that might be attributed to the company for purposes of compliance with Regulation FD and the other issues discussed in this *Client Alert*. Statements made in the context of merger or acquisition transactions may influence voting decisions, tender decisions and purchase and sale decisions by both the company's and the target's shareholders, which increases the number of potential claimants. The many additional variables (such as the combined results of the two companies and synergies) to be taken into account when giving guidance in these circumstances make giving guidance in the context of mergers and acquisitions particularly complex.

Conclusions

Be Deliberate

The decision whether and to what extent to give guidance should be made in a deliberate manner and should be the subject of careful internal control, including discussion with counsel. Each company's situation is unique — there is no one-size-fits-all solution to earnings guidance because each decision is fact-intensive. Plan ahead about how and when guidance will be given and script the statements carefully. Make sure to explain the critical assumptions underlying projected results so investors can evaluate those projections fairly.

Get a Policy and Stick to It

Consistency can be very helpful, both from an investor relations perspective and from a liability perspective. Having a policy and following it can go a long way.[25] Companies should tell investors when guidance will be given so investors know what to expect. For example, a company should tell investors that its policy is to give guidance once a year in March concurrently with the year-end earnings release, covering expectations for the year in process. The company should then not update its guidance during the course of the year except in extraordinary circumstances, such as a securities offering or a material acquisition or disposition. This way, in between planned updates, the company can deflect investor questions by explaining that it is the company's policy not to comment on prior guidance out of cycle.

Be Vigilant With Respect to Updates

A company should not simply follow its guidance policy blindly. Particularly in the context of securities offerings, sales by insiders or share repurchase programs, companies need to be alert to market expectations. Circumstances that might cause a company to want to update guidance can occur very quickly and at inopportune times, and companies need to be able to act quickly in this era of instant information flow. All of the key players should coordinate and communicate when the need arises so that informed judgments can be made as to what to say to the market and when.

Involve Counsel

Viewed with hindsight, overly optimistic guidance can result in financial cost to the company and its directors and officers. Legal counsel should be part of the quality control and risk/reward evaluation process. It is not always true that the investor relations department wants more information projected and lawyers want less. In practice, giving good guidance can only be done by balancing the benefits to the company and the associated risks, and counsel can assist in this balancing act.

Annex A

Frequently Asked Questions

Set forth below are some frequently asked questions about how and when to give and update guidance.

Q: A company normally issues annual guidance in its year-end earnings release and updates that guidance during subsequent quarterly earnings releases. The company no longer expects to meet its previously published guidance. Should the company revise its guidance downward ahead of the next regularly scheduled quarterly earnings release?

A: It depends. The company should review what was said in the previously published guidance. Did the company say it would update its guidance between scheduled earnings releases? Did it say that it would not? Was it silent on the matter? Many companies have a general no-update policy, but companies sometimes do not make that clear in each earnings release. Updating previously published guidance between scheduled earnings releases is not common practice and the company should consider all facts and circumstances before updating guidance ahead of the next regularly scheduled earnings release. If a major corporate event has occurred, such as a material acquisition or disposition, it may be obvious that the previously published guidance is no longer operative, which may lessen the pressure for an early update.

Q: What about a similar scenario, where the company is near the end of its quarter and the midpoint of its current estimates for the year in progress is not in line with previously published guidance. Should the company revise or adjust guidance downward prior to the next earnings release?

A: The starting point of the analysis is always the same. What was said in the first instance and what does the market expect? Will the market be surprised if the company's results do not square with previously published guidance? Does the midpoint of the estimates show that the company is going to miss the bottom end of the previously announced range by a material amount? Revising or adjusting guidance downward may be an option if there is a compelling reason to provide an out-of-sequence update and the company is reasonably sure that its results will not be in line with guidance. In most cases, however, the update can wait until the next regularly scheduled earnings release. In other words, if the company's guidance policy is to give updates quarterly, then the company should follow its policy absent compelling circumstances.

Q: The company plans to attend an annual industry conference that takes place between earnings releases. Can the company pre-release a guidance update prior to the conference?

A: Yes, if there is a good reason to do so, after considering all facts and circumstances. Departing from a regular policy of giving guidance only on designated earnings releases should not be undertaken lightly, but may be necessary on occasion. For example, if there is a compelling need to update customers on expected future results — a situation that sometimes arises in the troubled-company context — then have at it. Absent a compelling reason to depart from established policy, follow the policy. As always, any updates need to occur in a manner that complies with Regulation FD.

Q: The company is near the end of its quarter and some of the analysts' estimates are higher than the results the company expects to report for the quarter and even higher than the company's previously announced guidance. Can the company meet privately with the analysts to talk them down?

A: No. This is an easy one. Regulation FD requires that when issuers disclose material information, they must make broad public disclosure of that information. Talking down an industry analyst is providing material nonpublic information to that analyst and is not allowed in any manner that does not comply with Regulation FD. Some issuers handle the rogue analyst situation by issuing a press release (or making statements on an earnings call) emphasizing the factors that the company believes will make it difficult to achieve the overly optimistic results predicted by the outlying analysts. Most companies decline to get drawn into specific public disavowals of rogue analysts' estimates.

Q: The company issued annual guidance in its year-end earnings release in March. It's now June and the company is about to launch a public offering of its common stock. The company still expects to meet (or slightly exceed) its published guidance. Can the company put a slide in the road show deck that reiterates its annual guidance?

A: This is tricky. The presence of the slide may imply that the company is confirming its annual guidance, which is effectively the same as publishing new guidance. That raises the question of whether the confirmation is itself material nonpublic information. Depending on the circumstances, there may be an argument that a reaffirmation of prior guidance is not material, but if any significant amount of time has passed between the original public guidance and the private reaffirmation, the private statement is likely to be considered material nonpublic information. If a guidance update or confirmation is material, then a public press release would be appropriate under Regulation FD.

However, an out-of-sequence guidance release, particularly where guidance is being increased, raises other issues in the context of an offering. An SEC Staff Compliance and Disclosure Interpretation (C&DI) of Regulation FD suggests that a company's reference to prior guidance will not necessarily be deemed to convey material nonpublic information as long as the company makes clear that (a) the prior guidance was issued as of the earlier date and (b) the company is not currently reaffirming the earlier guidance.[26] That C&DI could be read to support the position that a road show slide citing the earlier earnings guidance (and giving the date it was issued) is not problematic from a Regulation FD perspective. Such a slide may be an option for management teams that are able to stick tightly to the road show script and can avoid commenting on the slide in a way that would implicitly confirm the prior guidance as of the date of the road show. However, many companies elect not to venture into this tricky territory and do not comment on guidance during their road shows, except perhaps to say "We publish our annual guidance in March and it is our policy not to update guidance between earnings releases." Those companies rely on the market's understanding that it would not be appropriate to sell securities without updating outstanding guidance if the issuer felt that the prior guidance had become too high.

Q: What if the company wants to confirm or increase its guidance immediately prior to launching an offering?

A: This is another difficult scenario. The first question is whether the increased guidance is an offer under the Securities Act. Rule 168's safe harbor for regularly released factual business information or forward-looking information is available for the same type of information as previously released in the ordinary course of business. Increasing guidance between earnings releases is not in most companies' ordinary playbook, but a company that has done so at least once before (perhaps outside the context of an offering) may be able to get comfortable that it has an adequate track record for an increase in guidance to fall within the safe harbor. If a company has no such track record, the proximity of the increase in guidance to the launch of the offering would be another uncomfortable fact in the analysis of whether the communication might constitute an offer. The next question is whether the new guidance will be considered to be part of the Section 12 file associated with the upcoming offering. Depending on the new guidance's proximity to the launch of the offering, it may well be. Bottom line: Confirming or increasing guidance within days of launching an offering is potentially problematic unless part of a company's regular routine or, at least, its prior experience.

Q: The company wants to launch an offering next week but it does not expect to meet its prior guidance for the quarter in progress. Can the company revise guidance downward just before launching its offering?

A: Yes. This is good corporate citizenship. In fact, absent unusual circumstances, we would not recommend launching an offering without correcting prior guidance that has proved overly optimistic. Updating guidance to reduce the market's expectations ordinarily would not be considered to be an offer under the Securities Act. Even if it were deemed an offer, the company's Exchange Act obligation to communicate with its investors should trump any Securities Act restrictions on offers.

Q: Economic uncertainty has prevented the company from consistently meeting its guidance. Can the company discontinue providing guidance?

A: Yes. A number of companies ceased to provide guidance in 2009–2010 as a result of the financial crisis. Bear in mind, however, that there may be an adverse market reaction when a company discontinues giving guidance. One likely consequence is that the spread may widen between the highest and lowest analyst estimates.

Q: The company just announced an increase in its annual guidance and the market reacted very favorably. How long does the company need to wait before launching an offering?

A: It depends. The first question is whether the Rule 168 safe harbor is available for the announcement. Did the increase in guidance occur in a regularly scheduled earnings release or call? If not, does the company have a track record of adjusting guidance between earning calls? These would be good facts for the Rule 168 analysis. If the Rule 168 safe harbor is not available, the more prudent course would be to hold off launching the offering for a period of time sufficiently long to break the connection between the increase in guidance and the offering. How long is that? The answer will depend on the extent of the increase in guidance, the company's post-announcement trading activity compared to historical trading patterns and all other relevant facts and circumstances. The analysis under Section 12 is the same. More time between the guidance update and the launch of the offering is better than less time.

Q: The company just completed its fiscal quarter. Can it disclose preliminary financial data on that quarter in the offering memorandum?

A: Yes. This is more in the nature of "Recent Developments" disclosure than true guidance and is done all the time. For some good advice on how to provide this type of information, see our *Client Alert* "Recent Developments in Recent Developments—Using Flash Numbers in Securities Offerings," available at http://

www.lw.com/thoughtLeadership/4189-RecentDevelopmentsInRecentDevelopments-Using-Flash-NumbersinSecuritiesOfferings.

Q: The company's CFO sent an email to a group of internal personnel indicating that the company will likely miss its previously announced earnings guidance. The CFO's email inadvertently included an industry analyst as an addressee. What should the company do?

A: Time is of the essence. The company must either publicly disclose the information or obtain from the analyst an express confidentiality agreement, written or oral, within the later of 24 hours or the next trading day's opening bell. Regulation FD requires simultaneous public disclosure for any intentional disclosure of material nonpublic information and prompt public disclosure for any non-intentional disclosure that is made selectively. For this purpose, "prompt" means as soon as is reasonably practicable but in no event later than 24 hours (or before the next opening bell, if later) after a director, executive officer or investor relations official of the company learns about a non-intentional disclosure of material nonpublic information.

Q: The company has just announced its intention to publicly offer its securities, and the company's CFO wants to discuss the planned public offering during the upcoming earnings call. The CFO will also be discussing guidance and other forward-looking information during the call. Is it OK to mention the offering?

A: It would be best not to mention the planned offering during the earnings call. The CFO's desire to discuss a recently announced public offering during an earnings call is understandable — after all, investors are likely to be interested in the topic and it was just publicly announced. The rub is the Securities Act's broad (and broadly interpreted) definition of offer. Most companies rely on the press release to notify the market about the upcoming offering and refrain from discussing it during the earnings call other than to refer to the press release.

Q: The company's offering of securities will affect its previously announced guidance, either through the issuance or repayment of debt that changes interest expense or the increased dilution resulting from more outstanding shares. Should the company update its guidance during the offering?

A: The impact that the offering will have on the company's income statement and balance sheet is usually disclosed in the offering document, so most companies do not update prior guidance. Since the Rule 168 safe harbor would probably not apply, as discussed above, most companies will wait until their next regular guidance update to factor in the results of the offering.

Endnotes

[1] This *Client Alert* is an update to the *Client Alert* we published on giving good guidance on March 2, 2007.

[2] This *Client Alert* does not address the SEC's encouragement to include forward-looking information in Management's Discussion and Analysis. *See, e.g., Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8056 (Jan. 22, 2002), text at note 8 ("Disclosure is mandatory where there is a known trend or uncertainty that is reasonably likely to have a material effect on the registrant's financial condition or results of operations."). In our experience, MD&A does not typically include earnings guidance, although more and more public companies include some kind of forward-looking statements in their MD&A under a caption entitled "Outlook" or something similar.

[3] Rule 10b-5 generally requires a plaintiff to demonstrate that a defendant acted with *scienter* — that is, either intent to deceive, manipulate or defraud or recklessness (beyond mere negligence).

[4] These statements include, among other things, projections of revenues, income, earnings, capital expenditures, dividends, capital structure or other financial items, plans and objectives for future operations, products or services and related assumptions. *See* definition of "forward-looking statement" in Securities Act Section 27A(i)(1)(A) and Exchange Act Section 21E(i)(1)(A).

[5] Securities Act Section 27A(c)(1)(A)(i); Exchange Act Section 21E(c)(1)(A)(i).

[6] *See* Securities Act Section 27A(c)(1)(B) and Exchange Act Section 21E(c)(1)(B).

[7] The case law underscores the importance of providing detailed, robust and regularly customized cautionary language for each significant forward-looking statement. *See, e.g., Slayton v. American Express*, 604 F.3d 758 (2d Cir. 2010) (finding that the company's forward-looking statement was not immunized by the PSLRA safe harbor's "meaningful cautionary language" prong because the cautionary language in the company's Form 10-Q was too vague to be "meaningful"). For further information on the Slayton opinion and its implication for public companies, see our *Client Alert* "Second Circuit Wades Into the PSLRA Safe Harbor — The Lessons of *Slayton v. American Express* for Forward-Looking Statements," available at http://www.lw.com/thoughtLeadership/2nd-circuit-addresses-pslra-safe-harbor.

[8] Securities Act Section 27A(d); Exchange Act Section 21E(d).

[9] A duty to update should be distinguished from a duty to correct. The duty to correct potentially applies when a statement that was believed to be correct when made turns out to have been incorrect when made.

[10] The NYSE and Nasdaq rules for listed companies contain requirements for prompt disclosure of material information, but these requirements have not been understood to apply to internal projections or forecasts of future operating results.

[11] *See Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (U.S. 1988).

[12] *Selective Disclosure and Insider Trading,* Release No.33-7881 (Aug. 15, 2000), text following n.47.

[13] National Investor Relations Institute "Guidance Practices and Preferences, 2012 Survey Report" (Sept. 5, 2012) [hereinafter "NIRI Guidance Survey Report"] (survey results received from approximately 360 NIRI corporate members).

[14] Regulation G requires SEC-reporting companies that publicly disclose non-GAAP financial measures to provide an accompanying presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. *See* Regulation G, Rule 100(a). The GAAP reconciliation is only required for forward-looking financial measures "to the extent available without unreasonable efforts." *Id*. Rule 100(a)(2). For further information on Regulation G and the use of non-GAAP financial measures, see our *Client Alert* "Adjusted EBITDA Is Out of the Shadows as Staff Updates Non-GAAP Interpretations," available at http://www.lw.com/thoughtLeadership/non-gaap-financial-measures.

[15] Nearly half of guidance-giving companies provide non-financial guidance, such as statements about market conditions or industry information. However, the number of companies providing non-financial guidance has been decreasing over the past several years. *See* NIRI Guidance Survey Report.

[16] Section 11 only applies to guidance if it is included (or incorporated by reference) in the prospectus for a public offering, which is highly unusual. In these rare circumstances, companies should consider the SEC requirements for projections. *See* Item 10(b) of Regulation S-K.

[17] For a discussion of the information considered to be part of the Section 11 file and the Section 12 file for purposes of liability under the Securities Act, see our *Client Alert* "The Bought Deal Bible: A User's Guide to Bought Deals and Block Trades," available at http://www.lw.com/thoughtLeadership/the-bought-deal-bible.

[18] Companies should carefully consider the consequences of providing or updating guidance in road show meetings if the information provided at the road show is not made public. In addition, companies should also consider the impact on the offering of saying "no comment" in response to questions about previous guidance.

[19] Section 2(a)(3) of the Securities Act defines the term "offer" expansively to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." Given the breadth of this language, it can be difficult to say with certainty what is or is not an offer under this definition. For a thorough review of the law and the lore surrounding "offers," see our *Client Alert* "The Good, the Bad and the Offer: Law, Lore and FAQs," available at http://www.lw.com/thoughtLeadership/how-to-navigate-publicity-and-offers-of-securities.

[20] Under Rule 168, "factual business information" means: (i) factual information about the issuer, its business or financial developments, or other aspects of its business; (ii) advertisements of, or other information about, the issuer's products or services and (iii) dividend notices. "Forward-looking information" means: (i) projections of an issuer's revenues, income or loss, earnings or loss per share, capital expenditures, dividends, capital structure, or other financial items; (ii) statements about management's plans and objectives for future operations, including plans or objectives relating to the products or services of the issuer; (iii) statements about the issuer's future economic performance, including statements generally contemplated by the issuer's MD&A and (iv) assumptions underlying or relating to the foregoing.

[21] *See Securities Offering Reform*, Release No. 33-8591 (July 19, 2005) at 63 n.81.

[22] *Id*. at 64.

[23] *Id*.

[24] Compliance with Rule 10b-18 creates a limited safe harbor for share repurchase programs. However, that safe harbor only protects issuers from liability for market manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act. It does not shield against liability for materially false statements and omissions or insider trading.

[25] The SEC has stated that the "existence of an appropriate policy, and the issuer's general adherence to it, may often be relevant to determining the issuer's intent with regard to a selective disclosure." *Regulation FD Release*, n.90.

[26] *See SEC Division of Corporation Finance*, Compliance and Disclosure Interpretations, Regulation FD, Question 101.01.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Nathan Ajiashvili
+1.212.906.2916
nathan.ajiashvili@lw.com
New York

Alexander F. Cohen
+1.202.637.2284
alexander.cohen@lw.com
Washington, D.C.

Kirk A. Davenport II
+1.212.906.1284
kirk.davenport@lw.com
New York

Jeff G. Hammel
+1.212.906.1260
jeff.hammel@lw.com
New York

Steven B. Stokdyk
+1.213.891.7421
steven.stokdyk@lw.com
Los Angeles

Joel H. Trotter
+1.202.637.2165
joel.trotter@lw.com
Washington, D.C.

IM Guidance Update

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GUIDANCE ON THE TESTIMONIAL RULE AND SOCIAL MEDIA

From time to time, we have been asked questions concerning the nature, scope and application of the rule that prohibits investment advisers from using testimonials in their advertisements. In addition, in the past several years, we have been asked a number of questions concerning investment advisers' use of social media. We are now providing this guidance concerning registered investment advisers' use of social media and their publication[1] of advertisements that feature public commentary about them that appears on independent, third-party social media sites.[2]

We understand that use of social media has increased the demand by consumers for independent, third-party commentary or review of any manner of service providers, including investment advisers. We recognize that social media has facilitated consumers' ability to research and conduct their own due diligence on current or prospective service providers. Through this guidance, we seek to clarify application of the testimonial rule as it relates to the dissemination of genuine third-party commentary that could be useful to consumers.

Specifically, we seek through this guidance to assist firms in applying section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and rule 206(4)-1(a)(1) thereunder ("testimonial rule") to their use of social media.[3] The guidance, in the form of questions and answers, also seeks to assist investment advisers in developing compliance policies and procedures reasonably designed to address participation in this evolving technology, specifically with respect to the publication of any public commentary that is a testimonial.

Consistent with previous staff guidance, we believe that in certain circumstances, as described below, an investment adviser's or investment advisory representative's ("IAR's") publication of <u>all</u> of the testimonials about the investment adviser or IAR from an independent social media site on the investment adviser's or IAR's own social media site or website would not implicate the concern underlying the testimonial rule.[4]

BACKGROUND

Section 206(4) generally prohibits any investment adviser from engaging in any act, practice or course of business that the Commission, by rule, defines as fraudulent, deceptive or manipulative. In particular, rule 206(4)-1(a)(1) states that:

> *[i]t shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business . . . for any investment adviser registered or required to be registered under [the Advisers Act], directly or indirectly, to publish, circulate, or distribute any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser.*

Rule 206(4)-1(a)(1) was designed to address the nature of testimonials when used in investment advisory advertisements. When it adopted the rule, the Commission stated that, in the context of investment advisers, it found ". . . such advertisements are misleading; by their very nature they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable."[5] The staff has stated that the rule forbids the use of a testimonial by an investment adviser in advertisements "because the testimonial may give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients."[6]

Whether public commentary on a social media site is a testimonial depends upon all of the facts and circumstances relating to the statement. The term "testimonial" is not defined in the rule, but the staff has consistently interpreted that term to include a "statement of a client's experience with, or endorsement of, an investment adviser."[7] Depending on the facts and circumstances, public commentary made directly by a client about his or her own experience with, or endorsement of, an investment adviser or a statement made by a third party about a client's experience with, or endorsement of, an investment adviser may be a testimonial.[8]

The staff also has stated that an investment adviser's publication of an article by an unbiased third party regarding the adviser's investment performance is not a testimonial, unless it includes a statement of a client's experience with or endorsement of the adviser.[9] The staff also has stated that an adviser's advertisement that includes a partial client list that does no more than identify certain clients of the adviser cannot be viewed either as a statement of a client's experience with, or endorsement of, the adviser and therefore is not a testimonial.[10] Such an advertisement could nonetheless violate section 206(4) and rule 206(4)-1(a)(5) if the advertisement is false or misleading.[11]

The staff no longer takes the position, as it did a number of years ago, that an advertisement that contains non-investment related commentary regarding an IAR, such as regarding an IAR's religious affiliation or community service, may be deemed a testimonial violative of rule 206(4)-1(a)(1).[12]

The following questions and answers are intended to provide more guidance.

Third-party commentary

Q1. *May an investment adviser or IAR publish public commentary that is an explicit or implicit statement of a client's experience with or endorsement of the investment adviser or IAR on the investment adviser's or IAR's social media site?*

A1. Generally, staff believes that such public commentary would be a testimonial within the meaning of rule 206(4)-1(a)(1) and its use in an advertisement by an investment adviser or IAR would therefore be prohibited.

- For example, if an investment adviser or IAR invited clients to post such public commentary directly on the investment adviser's own internet site, blog or social media site that served as an advertisement for the investment adviser or IAR's advisory services, such testimonials would not be permissible.

Q2. *May an investment adviser or IAR publish the same public commentary on its own internet or social media site if it comes from an independent social media site?*

A2. When an investment adviser or IAR has no ability to affect which public commentary is included or how the public commentary is presented on an independent social media site; where the commentators' ability to include the public commentary is not restricted;[13] and where the independent social media site allows for the viewing of all public commentary and updating of new commentary on a real-time basis, the concerns underlying the testimonial prohibition may not be implicated.

As described in more depth below, publication of public commentary from an independent social media site would not raise any of the dangers that rule 206(4)-1(a)(1) was designed to prevent if:

- the independent social media site provides content that is independent of the investment adviser or IAR;
- there is no material connection between the independent social media site and the investment adviser or IAR that would call into question the independence of the independent social media site or commentary; and

- the investment adviser or IAR publishes all of the unedited comments appearing on the independent social media site regarding the investment adviser or IAR.[14]

Under these circumstances, an investment adviser or IAR may include such public commentary in an advertisement without implicating the concerns underlying the testimonial rule.

If, however, the investment adviser or IAR drafts or submits commentary that is included on the independent social media site, the testimonial rule generally would be implicated. Also, if the investment adviser or IAR is allowed to suppress the publication of all or a portion of the commentary, edit the commentary or is able to organize or prioritize the order in which the commentary is presented, the testimonial rule generally would be implicated.

Q3. *What content is not independent of an investment adviser or IAR and what is a material connection that would call into question the independence of a site or commentary?*

A3. Commentary would not be independent of an investment adviser or IAR if the investment adviser or IAR directly or indirectly authored the commentary on the independent social media site, whether in their own name, a third party's name, or an alias, assumed or screen name.

An investment adviser or IAR would have a material connection with a site or commentary that would call into question the independence of the site or commentary if, for example, the investment adviser or IAR: (1) compensated a social media user for authoring the commentary, including with any product or service of value; or (2) prioritized, removed or edited the commentary.[15]

- For example, an investment adviser could not have a supervised person submit testimonials about the investment adviser on an independent social media site and use such testimonials in advertisements without implicating the testimonial rule.

- An investment adviser or IAR could not compensate a client or prospective client (including with discounts or offers of free services) to post commentary on an independent social media site and use such testimonials in advertisements without implicating the testimonial rule.

Q4. *May an investment adviser or IAR publish testimonials from an independent social media site in a way that allows social media users to sort the criteria?*

A4. An investment adviser or IAR's publication of testimonials from an independent social media site that directly or indirectly emphasizes commentary favorable to the investment adviser or IAR or de-emphasizes commentary unfavorable to the investment adviser or IAR would implicate the prohibition on testimonials. The investment adviser may publish only the totality of the testimonials from an independent social media site and may not highlight or give prominence to a subset of the testimonials.

- Investment adviser or IAR sites may publish the testimonials from an independent social media site in a content-neutral manner, such as by chronological or alphabetical order, which presents positive and negative commentary with equal prominence.

- Social media users, however, are free to personally display the commentary and sort by any criteria, including by the lowest or highest rating. Investment adviser and IAR sites may facilitate a user's viewing of the commentary by providing a sorting mechanism as long as the investment adviser or IAR site does not itself sort the commentary.

Q5. *May an investment adviser or IAR publish testimonials from an independent social media site that includes a mathematical average of the public commentary?*

A5. Publication by an investment adviser or IAR of such testimonials from an independent social media site would not raise any of the dangers that rule 206(4)-1(a)(1) was designed to prevent if the independent social media site were designed to make it equally easy for the public to provide negative or positive commentary about an investment adviser or IAR.

- Investment advisers or IARs could publish testimonials from an independent social media site that include a mathematical average of the commentary provided that commenters themselves rate the investment advisers or IARs based on a ratings system that is not designed to elicit any pre-determined results that could benefit any investment adviser or IAR.

- The independent social media site, the investment adviser and the IAR may not provide a subjective analysis of the commentary.[16]

Inclusion of on Investment Adviser Advertisements on Independent Social Media Site

Q6. *May an investment adviser or IAR publish public commentary from an independent site if that site also features the investment adviser or IAR's advertising?*

A6. The existence of an investment adviser or IAR's advertisement within the architecture of an independent site that also contains independent public commentary does not, in combination, create a prohibited testimonial or otherwise make the advertisement false or misleading, provided that the investment adviser complies with the material connection and independence factors described above and provided that the advertisement is easily recognizable to the public as a sponsored statement.

- In other words, an advertisement would not cause the investment adviser or IAR's publication of the independent social media site's commentary to violate rule 206(4)-1 where (1) it would be readily apparent to a reader that the investment adviser or IAR's advertisement is separate from the public commentary featured on the independent social media site and (2) the receipt or non-receipt of advertising revenue did not in any way influence which public commentary is included or excluded from the independent social media site.

Reference to Independent Social Media Site Commentary Investment Adviser Non-Social Media Advertisements

Q7. *May an investment adviser or IAR refer to public commentary from an independent social media site on non-social media advertisements* (*e.g.*, newspaper, radio, television)*?*

A7. An investment adviser or IAR could reference the fact that public commentary regarding the investment adviser or IAR may be found on an independent social media site, and may include the logo of the independent social media site on its non-social media advertisements, without implicating the testimonial rule.

- For example, an IAR could state in its newspaper ad "see us on [independent social media site]," to signal to clients and prospective clients that they can research public commentary about the investment adviser or IAR on an independent social media site.

- In contrast, an investment adviser or IAR may not publish any testimonials from the independent social media site on the newspaper ad without implicating the testimonial rule.[17]

Client lists

Q8. Would a list or photographs of "friends" "or "contacts" on an investment adviser or IAR's social media site that is viewable by the general public be considered a testimonial or otherwise violate section 206(4) or rule 206(4)-1?

A8. It is common on social media sites to include a communal listing of contacts or friends. The staff has stated that an advertisement that contains a partial client list that does no more than identify certain clients of the adviser cannot be viewed either as a statement of a client's experience with, or endorsement of, the investment adviser, and therefore is not a testimonial.[18] Such an advertisement, however, could be false or misleading under rule 206(4)-1(a)(5) depending on the facts and circumstances.

- If the contacts or friends are not grouped or listed so as to be identified as current or past clients of an IAR, but are simply listed by the social media site as accepted contacts or friends of the IAR in the ordinary course, such a listing of contacts or friends generally would not be considered to be in violation of rule 206(4)-1(a)(1).

- However, if an IAR attempts to create the inference that the contacts or friends have experienced favorable results from the IAR's investment advisory services, the advertisement could be considered to be in violation of section 206(4) and rule 206(4)-1.

Fan/Community Pages

Q9. Individuals unconnected with a particular investment adviser or IAR may establish "community" or "fan" or other third-party sites where the public may comment on a myriad of investment topics, along with commentary regarding an investment adviser firm or individual IARs. Do such sites raise concerns under rule 206(4)-1?

A9. In the ordinary course, a third party's creation and operation of unconnected community or fan pages generally would not implicate rule 206(4)-1. We strongly caution investment advisers and supervised persons when publishing content from or driving user traffic to such sites (including through hyperlinks to such sites), particularly if the site does not meet the material connection and independence conditions described above. The Commission has stated that:

> *any SEC-registered investment adviser (or investment adviser that is required to be SEC registered) that includes, in its web site or in other electronic communications, a hyperlink to postings on third-party web sites, should carefully consider the applicability of the advertising provisions of the [Advisers Act]. Under the Advisers Act, it is a fraudulent act for an investment adviser to, among other things, refer to testimonials in its advertisements.*[19]

Endnotes

1 For purposes of this guidance, "publication" refers to any form of real-time broadcast through social media or the Internet whether by hyperlinking, posting, live-streaming, tweeting, or forwarding or any similar public dissemination and, does not relate to advertisements on non-Internet or non-social media sites, such as paper, television or radio. Social media allows for instantaneous updating of posted commentary and concurrent viewing of *all of* the comment history; in contrast, paper, television and radio are static media that reflect public commentary at a particular point in time and are limited media that would typically not reproduce all of the available public commentary simultaneously (often due to cost, space and other considerations).

2 As used herein, "independent social media sites" refers specifically to third-party social media sites that predominantly host user opinions, beliefs, findings or experiences about service providers, including investment advisory representatives or investment advisers (*e.g.*, Angie's List). An investment adviser's or IAR's own social media profile or account that is used for business purposes is not an "independent social media site."

3 This *IM Guidance Update* only addresses the use by a firm or IARs of social media sites for business purposes. This Update does not address the use by individuals of social media sites for purely personal reasons. This Update does not seek to address any obligations under state law of social media for business use. In addition, this guidance does not seek to address the use of social media sites by broker-dealers.

4 Any such advertisements also must comply with rule 206(4)-1(a)(5).

5 Investment Advisers Act Rel. No. 121 (Nov. 2, 1961) (adopting rule 206(4)-1).

6 *See* Richard Silverman, Staff No-Action Letter (pub. avail. March 27, 1985).

7 *See* Cambiar Investors, Inc., Staff No-Action Letter (pub. avail. Aug. 28, 1997) ("Cambiar").

8 *See* DALBAR, Inc., Staff No-Action letter (pub. avail. March 24, 1998) ("DALBAR").

9 *See* New York Investors Group, Inc., Staff No-Action Letter (pub. avail. Sept. 7, 1982); Stalker Advisory Services, Staff No-Action Letter (pub. avail. Feb. 14, 1994). *See also* Kurtz Capital Management, Staff No-Action Letter (pub. avail. Jan. 22, 1988).

10 *See* Cambiar, supra note 7.

11 *Id. ("*For example, the inclusion of a partial client list in an adviser's advertisement has the potential to mislead investors if the clients on the list are selected on the basis of performance and this selection bias is not adequately disclosed. A list that includes only advisory clients who have experienced above-average performance could lead an investor who contacts the clients for references to infer something about the adviser's competence or about the possibility of enjoying a similar investment experience that the investor might not have inferred if criteria unrelated to the client's performance had been used to select the clients on the list or if the selection bias was fully and fairly disclosed.").

12 *See* Dan Gallagher, Staff No-Action Letter (pub. avail. July 10, 1995). Advisers that publish advertisements regarding non-investment related commentary remain subject to the fiduciary responsibilities imposed by section 206(1) and (2) of the Advisers Act. Thus an adviser cannot use social media to perpetrate affinity frauds, which are investment scams that prey upon members of identifiable groups, such as religious or ethnic communities, the elderly, or professional groups. Affinity frauds can target any group of people who take pride in their shared characteristics, whether they are religious, ethnic, or professional. *See* http://www.sec.gov/investor/pubs/affinity.htm.

13 Some independent social media sites may have member fees or subscriptions payable by users. An investment adviser or IAR's publication of public commentary from a site that charges member or subscription fees to public users would not call into question the independence of the independent social media site for purposes of our views herein.

14 Independent social media sites may have editorial policies that edit or remove public commentary violative of the site's own published content guidelines (*e.g.*, prohibiting defamatory statements; threatening language; materials that infringe on intellectual property rights; materials that contain viruses, spam or other harmful components; racially offensive statements or profanity). An investment adviser or IAR's publication of public commentary that has been edited according to such an editorial policy would not call into question the independence of the independent social media site for purposes of the staff's views herein.

15 As explained in Q6 below, any arrangement whereby the investment adviser or IAR compensated the independent social media site, including with advertising or other revenue, in order to publish or suppress the publication of anything less than the totality of the public commentary submitted could render any use by the IAR or investment adviser on its social media site violative of the prohibition on testimonials.

16 *See* DALBAR, supra note 8.

17 *See* supra note 1.

18 *See Cambiar, supra* note *7*.

19 *See* Commission Guidance on the Use of Company Websites at note 83, Investment Company Act Rel. No. 28351 (Aug. 1, 2008). *See also SEC Interpretation: Use of Electronic Media*, Investment Company Act Rel. No. 24426 (May 4, 2000).

The Investment Management Division works to:

- protect investors
- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

If you have any questions about this IM Guidance Update, please contact:

Catherine Courtney Gordon
Chief Counsel's Office/Public Inquiry
Phone: 202.551.6825
Email: IMOCC@sec.gov

U.S. Securities and Exchange Commission

Division of Investment Management
Division of Corporation Finance
Securities and Exchange Commission

Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms

Staff Legal Bulletin No. 20 (IM/CF)

Action: Publication of IM/CF Staff Legal Bulletin

Date: June 30, 2014

Summary: The Division of Investment Management is providing guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. The Division of Corporation Finance is providing guidance on the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms.

Supplementary Information: The statements in this bulletin represent the views of the Division of Investment Management and the Division of Corporation Finance. This bulletin is not a rule, regulation or statement of the Commission. Further, the Commission has neither approved nor disapproved its content.

Contacts: For further information relating to investment advisers, please contact the Division of Investment Management's Office of Chief Counsel by calling (202) 551-6825 or by e-mailing IMOCC@sec.gov. For further information relating to the proxy rules, please contact the Division of Corporation Finance's Office of Chief Counsel by calling (202) 551-3500 or by submitting a web-based request form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive.

Question 1. As a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting.[1] Further, the Commission's rules provide that it is a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser registered or required to be registered with the Commission to exercise voting authority with respect to client securities unless the adviser, among other things, adopts and implements written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients ("Proxy Voting Rule").[2] What steps could an investment adviser take to seek to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's proxy voting procedures?

Answer. Compliance could be demonstrated by, for example, periodically sampling proxy votes to review whether they complied with the investment adviser's proxy voting policy and procedures. The investment adviser also could specifically review a sample of proxy votes that relate to certain proposals that may require more analysis. In addition, as part of an investment adviser's ongoing compliance program, it should review, no less frequently than annually, the adequacy of its proxy voting policies and procedures to make sure they have been implemented effectively, including whether these policies and procedures continue to be reasonably designed to ensure that proxies are voted in the best interests of its clients.[3]

Question 2. Is an investment adviser required to vote every proxy?

Answer. The Proxy Voting Rule does not require that investment advisers and clients agree that the investment adviser will undertake all of the proxy voting responsibilities. We understand that in most cases, clients delegate to their investment advisers the authority to vote proxies relating to equity securities.[4] We further understand that, in general, clients usually delegate this authority completely, without retaining authority to vote any of the proxies. The staff notes that investment advisers and their clients also may agree to this type of delegation, as well as other proxy voting arrangements in which the adviser would not assume all of the proxy voting authority. Some agreements between investment advisers and their clients may include the following arrangements:

- An investment adviser and its client may agree that the time and costs associated with the mechanics of voting proxies with respect to certain types of proposals or issuers may not be in the client's best interest.

- An investment adviser and its client may agree that the investment adviser should exercise voting authority as recommended by management of the company or in favor of all proposals made by a particular shareholder proponent, as applicable, absent a contrary instruction from the client or a determination by the investment adviser that a particular proposal should be voted in a different way if, for example, it would further the investment strategy being pursued by the investment adviser on behalf of the client.

- An investment adviser and its client may agree that the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself.

- An investment adviser and its client may agree that the investment adviser will focus resources on only particular types of proposals based on the client's preferences.

As these non-exclusive examples demonstrate, an investment adviser and its client have flexibility in determining the scope of the investment adviser's obligation to exercise proxy voting authority. [5] We reiterate, however, that an investment adviser that assumes proxy voting authority must do so in compliance with the Proxy Voting Rule.

Question 3. What are some of the considerations that an investment adviser may wish to take into account if it retains a proxy advisory firm to assist it in its proxy voting duties?

Answer. When considering whether to retain or continue retaining any particular proxy advisory firm to provide proxy voting recommendations, the staff believes that an investment adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues.[6] In this regard, investment advisers could consider, among other things: the adequacy and quality of the proxy advisory firm's staffing and personnel; the robustness of its policies and procedures regarding its ability to (i) ensure that its proxy voting recommendations are based on current and accurate information and (ii) identify and address any conflicts of interest and any other considerations that the investment adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm.

***Question 4*.** Does an investment adviser have an ongoing duty to oversee a proxy advisory firm that it retains?

Answer. The staff believes that an investment adviser that has retained a third party (such as a proxy advisory firm) to assist with its proxy voting responsibilities should, in order to comply with the Proxy Voting Rule, adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients. [7] In addition, the staff notes that a proxy advisory firm's business and/or policies and procedures regarding conflicts of interest could change after an investment adviser's initial assessment, and some changes could alter the effectiveness of the policies and procedures and require the investment adviser to make a subsequent assessment. Consequently, the staff has stated that investment advisers should establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis,[8] such as by requiring the proxy advisory firm to update the investment adviser of business changes the investment adviser considers relevant (i.e., with respect to the proxy advisory firm's capacity and competency to provide proxy voting advice) or conflict policies and procedures.

Question 5. What are an investment adviser's duties when it retains a proxy advisory firm with respect to the material accuracy of the facts upon which the proxy advisory firm's voting recommendations are based?

Answer. As stated above, it is the staff's position that an investment adviser that receives voting recommendations from a proxy advisory firm should ascertain that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information.[9] For example, an investment adviser may determine that a proxy advisory firm's recommendation was based on a material factual error that causes the adviser to question the process by which the proxy advisory firm develops its recommendations. In such a case, the staff believes that the investment adviser should take reasonable steps to investigate the error, taking into account, among other things, the nature of the error and the related recommendation, and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.

Question 6. When is a proxy advisory firm subject to the federal proxy rules?

Answer. A proxy advisory firm would be subject to the federal proxy rules when it engages in a "solicitation," which is defined under Exchange Act Rule 14a-1(*l*) to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." As a general matter, the Commission has stated that the furnishing of proxy voting advice constitutes a "solicitation" subject to the information and filing requirements of the federal proxy rules.[10] Providing recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy would subject a proxy advisory firm to the proxy rules. Exchange Act Rule 14a-2(b) provides exemptions from the information and filing requirements of the federal proxy rules that a proxy advisory firm may rely upon if it meets the requirements of the exemptions.

Question 7. Where a shareholder (such as an institutional investor) retains a proxy advisory firm to assist in the establishment of general proxy voting guidelines and policies and authorizes the proxy advisory firm to execute a proxy or submit voting instructions on its behalf, and permits the proxy advisory firm to use its discretion to apply the guidelines to determine how to vote on particular proposals, may the proxy advisory firm providing such services rely on the exemption from the proxy rules in Exchange Act Rule 14a-2(b)(1)?

Answer. No. Rule 14a-2(b)(1) provides an exemption from most provisions of the federal proxy rules for "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization." The exemption would not be available for a proxy advisory firm offering a service that allows the client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client.

In this instance, the proxy advisory firm would be viewed as having solicited the "power to act as a proxy" for its client. This would be the case even if the authority was revocable by the client.

Question 8. If a proxy advisory firm only distributes reports containing recommendations, would it be able to rely on the exemption in Rule 14a-2(b)(1)?

Answer. Yes. To the extent that a proxy advisory firm limits its activities to distributing reports containing recommendations and does not solicit the power to act as proxy for the client(s) receiving the recommendations, the proxy advisory firm would be able to rely on the exemption, so long as the other requirements of the exemption are met.

Question 9. To the extent that Rule 14a-2(b)(1) is not available to a proxy advisory firm, either for the reason specified in the answer to Question 7 or otherwise, is there any other exemption from the proxy rules that might apply?

Answer. Yes. Exchange Act Rule 14a-2(b)(3) exempts the furnishing of proxy voting advice by any person to another person with whom a business relationship exists, subject to certain conditions. [11] The exemption is available if the person gives financial advice in the ordinary course of business; discloses to the recipient of the advice any significant relationship with the company or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the person in such matter; receives no special commission or remuneration for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice; and does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Question 10. If a proxy advisory firm provides consulting services to a company on a matter that is the subject of a voting recommendation or provides a voting recommendation to its clients on a proposal sponsored by another client, would the proxy advisory firm be precluded from relying on Rule 14a-2(b)(3)?

Answer. In order to rely on Rule 14a-2(b)(3), a proxy advisory firm would need to first assess whether its relationship with the company or security holder proponent[12] is significant or whether it otherwise has any material interest in the matter that is the subject of the voting recommendation and disclose to the recipient of the voting recommendation any such relationship or material interest. Whether a relationship would be "significant" or what constitutes a "material interest" will depend on the facts and circumstances. In making such a determination, a proxy advisory firm would likely consider the type of service being offered to the company or security holder proponent, the amount of compensation that the proxy advisory firm receives for such service, and the extent to which the advice given to its advisory client relates to the same subject matter as the transaction giving rise to the relationship with the company or security holder proponent. A similar inquiry would be made for any interest that might be material. A relationship generally would be considered "significant" or a "material interest" would exist if knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the advisor and the advice.

Question 11. If a proxy advisory firm determines that it has a significant relationship or a material interest that requires disclosure for purposes of relying on Rule 14a-2(b)(3), what must it disclose?

Answer. The proxy advisory firm must provide the recipient of the advice with disclosure that provides notice of the presence of a significant relationship or a material interest. We do not believe that boilerplate language that such a relationship or interest may or may not exist provides such notice. In addition, we believe the disclosure should enable the recipient to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict, and provide sufficient information to allow the recipient to make an assessment about the reliability or objectivity of the recommendation.

Question 12. Does the disclosure requirement in Rule 14a-2(b)(3) permit a proxy advisory firm to state only that information about significant relationships or material interests will be provided upon request?

Answer. No. Rule 14a-2(b)(3) imposes an affirmative duty to disclose significant relationships or material interests to the recipient of the advice. We do not believe that providing the information upon request would satisfy the requirement in the rule.

Question 13. Does disclosure of a significant relationship or material interest have to be provided in a document that conveys a voting recommendation or advice, such as the proxy advisory firm's report about a company, and must it be publicly available?

Answer. Rule 14a-2(b)(3) does not specify where the required disclosure should be provided. A proxy advisory firm should provide the disclosure in such a way as to allow the client to assess both the advice provided and the nature and scope of the disclosed relationship or interest at or about the same time that the client receives the advice. This disclosure may be made publicly or between only the proxy advisory firm and the client.

* * * * *

The staff recognizes that investment advisers and proxy advisory firms may want or need to make changes to their current systems and processes in light of this guidance. The staff expects any necessary changes will be made promptly, but in any event in advance of next year's proxy season.

1 Proxy Voting by Investment Advisers, Release No. IA-2106, at n. 2 and accompanying text (Jan. 31, 2003) ("Proxy Voting Release"), citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940 ("Advisers Act")).

2 Rule 206(4)-6 under the Advisers Act.

3 See Rule 206(4)-7 under the Advisers Act (e.g., requiring investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised person, of the Advisers Act). See also Rule 38a-1 under the Investment Company Act of 1940 ("1940 Act") (e.g., requiring each registered investment company to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by the registered investment company's investment adviser, among others).

4 See Proxy Voting Release.

5 See id. at n. 19 ("The scope of an adviser's responsibilities with respect to voting proxies would ordinarily be determined by the adviser's contracts with its clients, the disclosures it has made to its clients, and the investment policies and objectives of its clients.")

6 See Egan-Jones Proxy Services, SEC Staff Letter (May 27, 2004) ("Egan-Jones") and Institutional Shareholder Services, Inc., SEC Staff Letter (Sept. 15, 2004) ("ISS").

7 See Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the 1940 Act.

8 See Egan-Jones and ISS.

9 Id.

10 See Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Release No. 34-16104 (Aug. 13, 1979).

11 In 1992, the Commission noted that "advice given with respect to matters subject to a shareholder vote by . . . proxy advisory services in the ordinary course of business is covered by the exemption provided by [Rule 14a-2(b)(3)], so long as the other requirements of that exemption are met." See Regulation of Communications Among Shareholders, Release No. 34-31326 (Oct. 16, 1992).

12 Rule 14a-8 does not require that the identity of the shareholder proponent be disclosed in the proxy statement. Therefore, there may be instances in which the proxy advisory firm has no knowledge that the proponent is a client. In such a case, we do not believe that there would be a duty to investigate who the proponent is. To the extent that the identity of the proponent is unknown, there is little concern that the relationship would affect the proxy advisory firm's recommendation regarding that proposal.

http://www.sec.gov/interps/legal/cfslb20.htm

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Modified: 06/30/2014

U.S. Chamber of Commerce Corporate Governance Update:

Public Company Initiatives in Response to the SEC Staff's Guidance on

PROXY ADVISORY FIRMS

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Executive Summary

This Corporate Governance Update is intended to alert public companies of the June 2014 Securities and Exchange Commission (SEC) Staff Guidance, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisors and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* (SEC Staff Guidance) regarding responsibilities for the development and dispensation of proxy advice. Accordingly, this update describes several approaches that public companies may use to ensure that the concepts of the SEC Staff Guidance are implemented in the best interest of public company shareholders.

The SEC Staff Guidance was issued due to concerns surrounding the increasingly outsized role and influence of proxy advisory firms on corporate governance matters in the United States and globally. Two firms—Institutional Shareholder Services (ISS) and Glass-Lewis—control a combined 97% of the proxy advisory industry, yet have been roundly criticized for operating with serious conflicts of interest, frequent adoption of "one-size-fits-all" voting recommendations, and conducting policy making that is largely done outside the public eye.

The SEC Staff Guidance provides, among other things, clarity surrounding the SEC's Proxy Voting Rule, reinforces the requirement that fiduciary duties govern all aspects of the development and receipt of proxy advice, and reaffirms that enhancing shareholder value must be the core consideration when rendering proxy-voting advice and making proxy-voting decisions.

This Corporate Governance Update highlights three main issues that public companies could focus on in light of the guidance: communication with proxy advisory firms, dealing with proxy advisory firm conflicts of interest, and communication with institutional investors.

Communication with Proxy Advisory Firms: Public companies can serve their shareholders by maintaining a continuous dialogue with proxy advisory firms in order to correct erroneous or stale information, or to address any troublesome recommendations that do not advance the best interests of the shareholders.

Dealing with Proxy Advisory Firm Conflicts of Interest: Public companies can take steps to verify proxy advisory firm conflicts identification and remediations, and bring any deficiencies to the attention of the advisory firm or, if necessary, the SEC.

Communication with Institutional Investors: Public companies should continue to engage in year-round, regular communications with institutional investors, to develop and maintain a relationship of trust and confidence, and also provide public companies with an opportunity to bring concerns about the actions (or inaction) of proxy advisory firms to the attention of investors.

The U.S. Chamber of Commerce (Chamber) is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber formed the Center for Capital Markets Competitiveness (CCMC) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. It is an important priority of the CCMC to advance an effective and transparent corporate governance system that encourages shareholder communication and participation.

The CCMC has long advocated for proxy advisory firms to be more transparent and accountable in the development and dispensation of proxy advice and to ensure that conflicts of interest are disclosed and addressed in order to prevent corporate governance failures.

In 2013, the CCMC released *Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice* (Chamber Principles).[1] The Chamber Principles focused on the proxy voting practices of proxy advisory firms, public companies, and investment portfolio management organizations; discussed core principles applicable to those activities; and recommended improvements and systems to bring about transparency and accountability for proxy advisory firms and to foster stronger corporate governance.

On June 30, 2014, the Securities and Exchange Commission's staff issued Legal Bulletin Number 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*.[2] This Corporate Governance Update alerts public companies to the SEC Staff Guidance and describes several approaches public companies may wish to consider to ensure that the concepts of the SEC Staff Guidance are implemented in connection with the retention

1 The Chamber Principles can be found at http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

2 The SEC Staff Guidance can be found at http://www.sec.gov/interps/legal/cfslb20.htm.

of proxy advisory firms and how they research, formulate, and ensure the accuracy of the proxy voting advice they render.

Background

Over the years, proxy advisory firms have played an increasingly outsized role in imposing their views of appropriate corporate governance on corporations and their shareholders. These firms purport to evaluate every issue for which corporate proxies are solicited, in the United States and globally, and their recommendations are demonstrably influential in how proxy votes are cast.[3] In the United States, two proxy advisory firms—Institutional Shareholder Services Inc. and Glass Lewis & Co. LLC (Glass Lewis)—constitute 97% of the proxy advisory industry and are the *de facto* corporate governance standard setters for public companies.[4]

Despite their disproportionate influence on corporate governance, proxy advisory firms have been criticized by U.S. and global regulators, academics, institutional investors, shareholders, and others for, among other things,

- Serious (and frequently undisclosed or inadequately disclosed) conflicts of interest—ISS, for example, offers consulting services to the same companies about which it renders proxy voting advice, while Glass Lewis,[5] for example, frequently offers recommendations that coincide with the views of its shareholder activist ownership;

3 *See*, *e.g.*, Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting* (June 2007) (GAO Report), available at http://www.gao.gov/new.items/d07765.pdf; and J. Glassman and J. Verret, *How to Fix Our Broken Proxy Advisory System* (Glassman and Verret), available at http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

4 *See* GAO Report, *supra* n. 3, at p. 13; Glassman and Verret, *supra* n. 3, at p. 8.

5 Glass Lewis is owned by two large government pension funds, one of which is an activist investor.

- "One-size-fits-all" voting advice that ignores the effect of their recommendations on the economic well-being of shareholders;[6]
- Industry concentration;
- Policy making that is largely conducted outside the public eye; and
- Errors in analysis and a lack of due diligence, in part due to the vast number of issues they purport to cover, with a relatively small staff.[7]

The Chamber Principles addressed these deficiencies, and sought to foster a collaborative effort to ameliorate them. Thus, the Chamber Principles noted that some portfolio managers make clear in their voting polices that they use proxy advice as one of several sources in formulating their own independent voting decisions—an approach that is consistent with the interests and investment objectives of their investors—while other portfolio managers were not, and are not, structured to enable voting policies that

6 Proxy advisory firms that offer "one-size-fits-all" recommendations—generic recommendations disseminated to most clients that do not vary in any significant manner to reflect the specific attributes of each client that receives these recommendations—are unlikely to render significant assistance to portfolio managers in their efforts to promote and enhance their investors' best economic interests. *See*, *e.g.*, Chamber Principles, *supra* n. 1, at p. 3; J. Glassman and H. Peirce, *How Proxy Advisory Services Became So Powerful*, Mercatus on Policy (June 2014), at p. 2, available at http://mercatus.org/sites/default/files/Peirce-Proxy-Advisory-Services-MOP.pdf ("One-size-fits-all recommendations miss the nuances of particular corporations").

7 For example, ISS states that it has a global staff of 250 individuals who analyze, research, and prepare recommendations on the 250,000 voting issues on which it offers advice. *See* ISS, *Best Practice Principles for Providers of Shareholder Voting Research & Analysis: ISS Compliance Statement*, at §1 (June 10, 2014), available at http://www.issgovernance.com/file/duediligence/BPP-ISS-ComplianceStatement-1406010.pdf. Similarly, Glass Lewis states that it has a global staff of 200 individuals who perform the same functions. *See* Glass Lewis website, *About Us*, http://www.glasslewis.com/about-glass-lewis/. If one "does the math," it is clear that, *on average*, each ISS analyst is responsible for researching and preparing reports on 1,000 issues in the truncated period of the usual "proxy season." Glass Lewis purports to analyze fewer issues, but has fewer analysts available to do so, ensuring that its analysts are equally overwhelmed with their responsibilities in a very short period of time.

would achieve the same results.[8] The Chamber Principles offered guidance on how proxy advice should be tailored to meet the objective of enhancing shareholder value and returns, and processes portfolio managers should employ to fulfill their fiduciary obligations.

Following release of the Chamber Principles, the House Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing on June 5, 2013, titled *Examining the Market Power and Impact of Proxy Advisory Firms*, at which the Chamber testified.[9] That hearing developed a detailed record that further amplified the nature of concerns about the manner in which proxy advisory firms develop and finalize their voting recommendations, and the conflicts of interest to which they are subject.

On December 5, 2013, the SEC held a Roundtable on Proxy Advisory Firms, in which the Chamber participated.[10] While the roundtable featured the participation of a broad range of investors, businesses, lawyers, and proxy advisors, all with differing perspectives about the functioning of proxy advisory firms, there was a consensus among participants—other than those representing the largest proxy advisory firms—with respect to two major concerns regarding proxy advisory firms and the performance of their activities:

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8 *See* Hon. D. Gallagher, *Outsized Power & Influence: The Role of Proxy Advisers*, Wash. L. Found. Critical Legal Issues Working Paper Series No. 187 (Aug. 2014), at pp. 10–11, available at http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf.

9 *See* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-hpitt-20130605.pdf (testimony of former SEC Chairman Harvey Pitt on behalf of the Chamber).

10 *See* Transcript of the SEC Roundtable on Proxy Advisory Firms (Dec. 5, 2013), at pp. 24–27, 158–159 (remarks of former SEC Chairman Harvey Pitt), available at http://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt. *See also*, Letter from the Chamber to SEC Chair Mary Jo White, outlining issues of importance in advance of the SEC roundtable, which can be found at http://www.centerforcapitalmarkets.com/wp-content/uploads/2014/02/2013-12-3-Chamber-SEC-Roundtable-Letter.pdf.

- First, that these firms are afflicted by significant specific conflicts of interest that are often undisclosed (or inadequately disclosed); and
- Second, that proxy advisory firms' processes, and especially how they develop their voting recommendations, are not sufficiently transparent.

SEC Staff Guidance

Six months after the proxy advisory firm roundtable, the SEC Staff Guidance was published. It addressed issues and concerns raised at the roundtable, providing clarity about the SEC's Proxy Voting Rule[11] and the availability of exemptions for proxy advisory firms from the SEC's proxy solicitation requirements.[12] The Proxy Voting Rule requires that SEC-registered portfolio managers adopt policies describing how portfolio securities are voted to further their clients' financial best interests. The exemptions for proxy advisory firms from the SEC's proxy solicitation requirements depend, among other things, on the absence (or full disclosure) of conflicts of interest to which the proxy advisory firms are (or may be) subject.

The SEC Staff Guidance structures its substantive advice as a response to specific questions. The three constituency groups affected by the SEC Staff Guidance—proxy advisory firms, portfolio managers, and public companies—must focus their attention on five overarching principles:

- Fiduciary duties permeate and govern all aspects of the development, dispensation, and receipt of proxy advice;

11 Investment Advisers Act Rule 206-4(6), 17 C.F.R. §275.206(4)-6 (2014).

12 Securities Exchange Act Rule 14a-2(b)(3), 17 C.F.R. §240.14a-2(b)(3).

- Enhancing and promoting shareholder value must be the core consideration in rendering proxy-voting advice as well as making proxy-voting decisions;
- The proper role of proxy advisory firms vis-à-vis proxy voting is to provide accurate and current information to assist those with voting power to further the economic best interests of those who entrust their assets to portfolio managers and are the beneficial shareholders of public companies. If proxy advisory firms exceed that role—for example, by effectively exercising (or being granted) a measure of discretion over how shares are voted on specific proposals, or by failing to make proper disclosure regarding specific conflicts of interest afflicting a proxy advisory firm in connection with voting recommendations it is making—proxy advisory firms so employed, and those engaging them, incur serious legal and regulatory consequences;
- Clarity is provided as to the scope of portfolio managers' obligations to exercise a vote on proxy issues, and it emphasizes the broad discretion portfolio managers have—subject to appropriate procedures and safeguards—to refrain from voting on every, or even any, proposal put before shareholders for a vote; and
- In light of the direction provided, proxy advisory firms, portfolio managers, and public companies need to reassess their current practices and procedures, and adopt appropriate changes necessitated by the SEC Staff Guidance.

To help stakeholders implement policies and practices that embody these principles, the SEC Staff Guidance suggests methodologies that can be employed in selecting, overseeing, and assessing the performance of proxy advisory firms; an articulation of the nature and manner of proper conflict disclosures required of proxy advisors; and a clarification of when portfolio managers are required to vote securities. Most significant, the guidance confirms the primacy of enhancing shareholder value that must be the basis for proxy advisory firm recommendations.

Issues Public Companies Should Focus On

Although the SEC Staff Guidance directly addresses obligations of proxy advisory firms and investment portfolio manager organizations, public companies need to understand these obligations, and should consider various approaches we outline to ensure that the concepts articulated in the SEC Staff Guidance are implemented in the best interests of public company shareholders.

Communication with Proxy Advisory Firms

The SEC Staff Guidance reiterates the fundamental principle that fiduciary duties govern all aspects of the development, dispensation, and receipt of proxy advice, and emphasizes the need for proxy advisory firms to adhere to the highest level of due diligence, accuracy, and promotion of shareholder value. Public companies can serve their shareholders and enhance the ability of proxy advisory firms and portfolio managers to fulfill their fiduciary and other duties by:

- Asking proxy advisory firms for the opportunity for input both before and after proxy advisory firms' recommendations are finalized;
- Because public companies may be unable to provide input *prior* to the issuance of adverse proxy advisory firm recommendations, public companies should certainly make their views known promptly after adverse proxy advisory firm recommendations are issued;
- Formally notifying proxy advisory firms *and* portfolio managers holding their securities if the public company does not believe that it was afforded an adequate opportunity for input *before* proxy advisory firms finalized their recommendations;

- ☐ Alerting proxy advisory firms, portfolio managers, and others (including SEC staff) about instances reflecting proxy advisory firms' reliance on inaccurate or stale data;
- ☐ Advising proxy advisory firms, portfolio managers, and others of proxy advisory firm unresponsiveness to public company indications of significant errors, misjudgments, noncurrent data, or mistaken assumptions;
- ☐ Examining recommendations about their companies, and advising proxy advisory firms and their clients if specific proxy advisory firm recommendations do not advance the economic best interests of public company shareholders, appear to reflect "one-size-fits-all" recommendations, or would foster deleterious consequences (and the reasons underlying those conclusions);
- ☐ If public companies are not satisfied that proxy advisory firms have appropriately corrected problematic recommendations brought to their attention, public companies should advise portfolio managers of their concerns; and
- ☐ Public companies should bring erroneous, stale, or non–economically beneficial proxy advisory firm recommendations to the attention of the SEC and its staff.

Given the lack of clarity regarding the ways in which proxy advisory firms establish their voting policies, and how they determine whether their recommendations enhance actual shareholder value, public companies can play an important role in determining *how* selected proxy advisory firms generate guidance recommendations, and on what bases their recommendations are predicated. In addition, the SEC Staff Guidance clarifies that a portfolio manager that effectively outsources voting responsibility to proxy advisory firms is acting inconsistently with applicable fiduciary obligations and contravening other obligations borne by portfolio managers. As a result, public companies should consider implementing the following practices:

- ☐ Preparing (in advance of proxy season) materials articulating positions vis-à-vis significant issues to be submitted to a shareholder vote, addressing major rationales supporting a view contrary to the views the public company intends to espouse;
- ☐ Consistent with SEC proxy solicitation rules, disseminating or otherwise making materials addressing shareholder voting issues available to proxy advisory firms, current investors, company social media outlets, various media outlet representatives covering the public companies, street name holders of public company securities, and SEC staff;
- ☐ Formally seeking opportunities to meet with proxy advisory firms on issues subject to shareholder votes—in advance of proxy advisory firm issuance of recommendations (if possible), and immediately after recommendations are made—to ensure that predicates for recommendations are accurate and up to date;
- ☐ Contemporaneously documenting proxy advisory firm responses to meeting requests, as well as substantive discussions at any meetings;
- ☐ Formally requesting that proxy advisory firms provide previews of recommendations they anticipate making vis-à-vis issues to be submitted to public company shareholders for a vote;
- ☐ Contemporaneously documenting proxy advisory firm responses to preview requests (and any substantive discussions about ensuing proxy advisory firm recommendations); and
- ☐ Monitoring proxy advisory firm recommendations for accuracy or reliance on outdated information.

Dealing with Proxy Advisory Firm Conflicts of Interest

At the SEC's roundtable, a consensus was reached that the two biggest problems raised by the operations of proxy advisory firms were conflicts of interest and a lack of transparency regarding their operations.

The resulting SEC Staff Guidance treats the issue of conflicts in the context of its analysis of the conditions that must be met before a proxy advisory firm will be deemed exempt from the SEC's proxy soliciting disclosure and filing requirements. The exemptive rule specifically applicable to proxy advisory firms establishes a fundamental conflict disclosure requirement, obligating proxy advisory firms to disclose to their clients three broad categories of information:

- Significant relationships the proxy advisory firm has with the proponent of the proposal on which the proxy advisory firm is rendering advice;
- Any material interest the proxy advisory firm may have in the outcome of voting on the particular matter on which it is advising; and
- Any significant relationships the proxy advisory firm has with the subject public company or any of its affiliates.

The obligation imposed on proxy advisory firms—to disclose potential conflicts *before* their clients act on those recommendations—is a crucial linchpin that may exempt proxy advisory firms from the proxy solicitation disclosure and filing requirements.

As a result, public companies may wish to consider the following important issues in this context:

- ☐ Public companies should take steps to verify the nature of proxy advisory firm conflict identification, management, remediation, and responsiveness, to assist institutional investors in making their required assessments of proxy advisory firm policies and procedures;
- ☐ To the extent evidence exists of difficulties on the part of one or more proxy advisory firms in implementing the SEC Staff Guidance, public companies should endeavor to make that information known to proxy advisory firms so they can remedy

any perceived deficiencies in their conflict policies and procedures, as well as advise portfolio managers of any shortcomings in conflict identification, disclosure, management, and remediation; and

- These issues should also be brought to the attention of the SEC.

Communication with Institutional Investors

The SEC Staff Guidance clarified that neither the Proxy Voting Rule nor an institutional investor's fiduciary duties obligates that investor to vote on *every* issue presented to the shareholders of portfolio companies. Given that the SEC Staff Guidance makes clear that institutional investors could make a determination, after securing investor agreement, as to the extent of their responsibility to vote portfolio securities, public companies should also consider adopting the following recommendations in communicating with major institutional investors:

- Putting in place a year-round, regular communication program with major institutional investors, among the goals of which should be:
  - Developing and maintaining a relationship of trust and confidence with important shareholders;
  - Consistent with SEC rules prohibiting selective disclosure of material, nonpublic information,[13] apprising portfolio managers of plans, issues likely to arise, and perspectives on current conditions affecting the public company;
  - Understanding institutional investor assessments of management as well as of past, current, and anticipated public company performance; and

13 *See* SEC Regulation FD, 17 CFR §§243.100-243.103.

- Developing strategic positions vis-à-vis likely institutional investor changes to voting policies and practices.

- Bringing to the attention of major institutional investors observed deficiencies in proxy advisory firms' conflict identification, disclosure, management, and remediation, as well as any inadequacies observed with proxy advisory firms' implementation of the SEC Staff Guidance.

Conclusion

The SEC Staff Guidance is a positive first step toward bringing more transparency and rationality to the current system of proxy voting advice. While the shareholders of public companies—whose interests the proxy advisory system is ultimately meant to serve—stand to benefit, it remains to be seen whether proxy advisory firms will take this opportunity to improve the transparency and efficacy of their business operations. Public companies therefore have a unique and important role to play in order to achieve a more desirable system of proxy voting advice. We hope that this Corporate Governance Update serves as a useful guide and stimulates further discussion for public companies so that the full potential of the SEC Staff Guidance can be achieved.

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Discussion of Current & Future Real Estate Market Lunch General Session Meeting

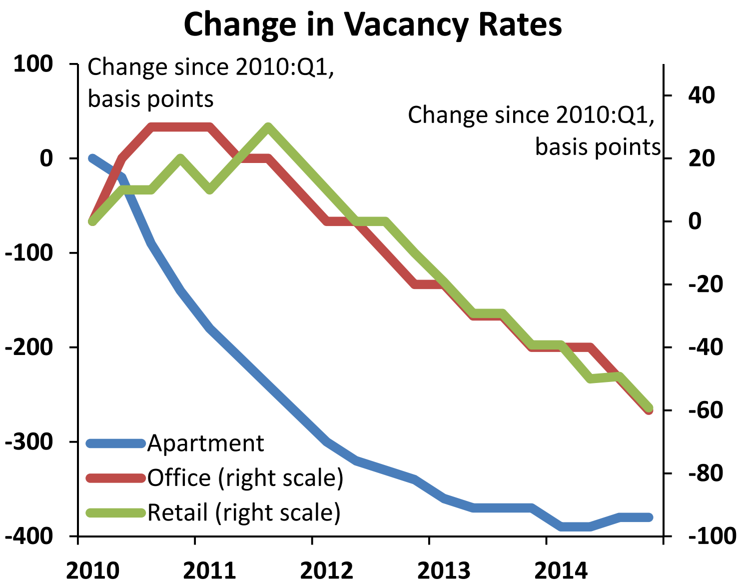
Wednesday, April 1st
12:45pm – 2:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

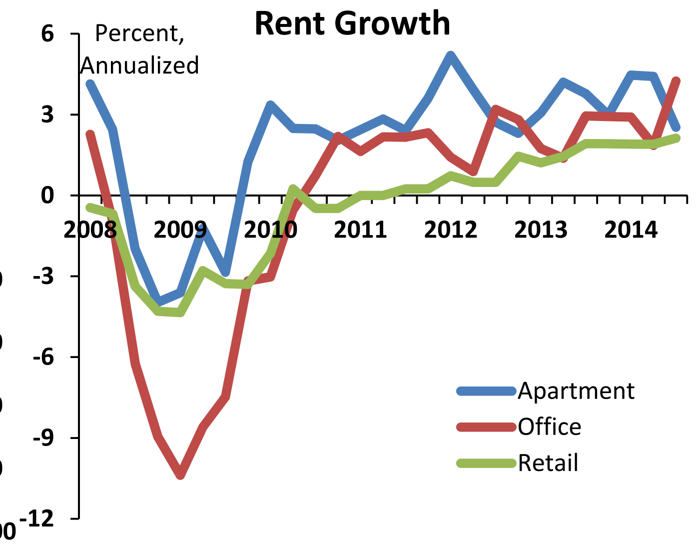
Speaker:

Kerry Vandell, Professor & Director, University of California-Irvine

National Association of Real Estate Investment Trusts®

Commercial Property Update 2014:Q4





The apartment sector remains robust. Vacancy rates continued at 4.2%, a decade-low level that indicates little (if any) excess supply. An acceleration in the national job market has spurred household formation (page 2 has more details) and continues to fuel strong rental demand. Rent growth eased to a 2.5% annual rate; this slowing may be due to seasonal demand weakness during the fall.

The office sector saw strong growth in demand, bolstered by healthy job gains over the last quarter. Rent growth accelerated to a 4.3% annual rate, the fastest pace in the recovery to date. Absorption rates moved up to a post-crisis high. Vacancy rates continue to edge downward at a slow pace, in line with the trend since 2011. The acceleration in job growth during Q4, however, could signal a more rapid recovery in office markets in 2015.

The retail sector is sluggish. Net absorption for 2014 is 17% behind the previous year, while vacancy rates edged down 10 bps. Rent growth increased ever so slightly from last quarter, to a 2.1% annualized rate – an improvement from earlier years, but barely keeping pace with inflation.

Calvin Schnure
Senior Vice President,
Research & Economic
Analysis
cschnure@nareit.com
202-739-9434

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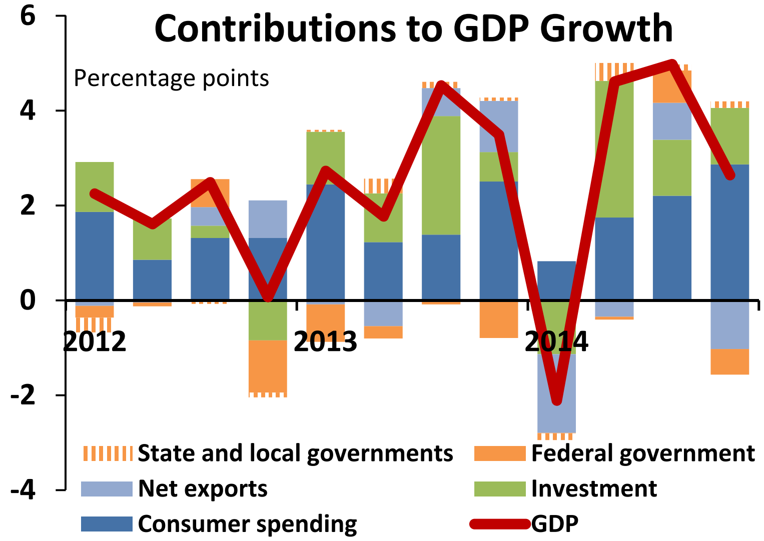
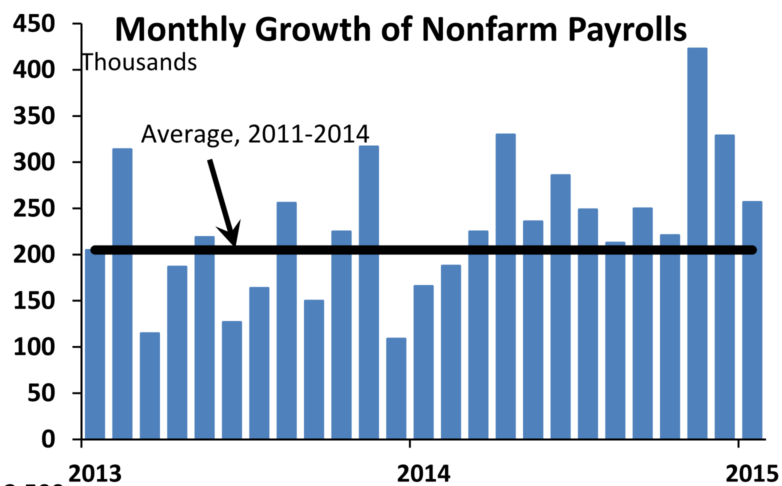
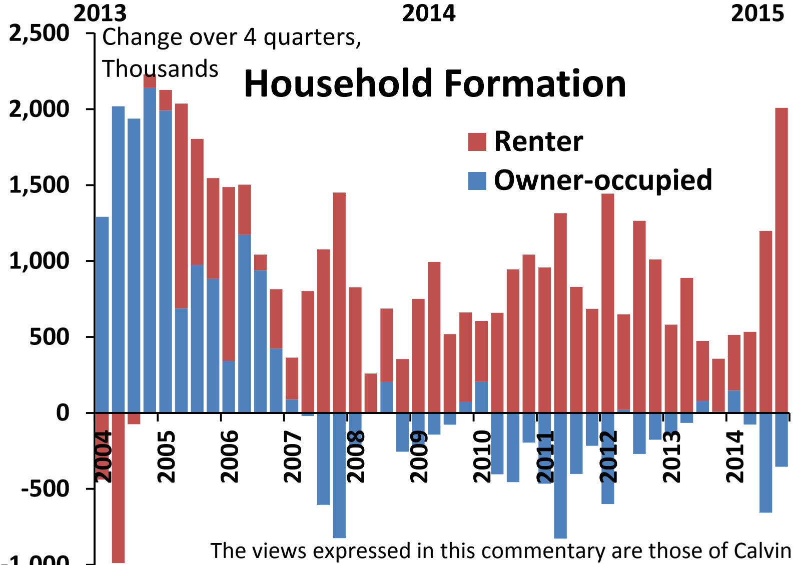
Economic Fundamentals for Commercial Real Estate







Strong domestic demand supports real estate markets, despite slower overall GDP growth. Domestic private demand grew at a 4.0% annual rate in Q4. Consumer spending accelerated to a 4.3% pace, the highest since 2006. Headline GDP growth was held down to a 2.6% pace, however, due to declining net exports and federal military spending.

Surging job growth bodes well for all types of real estate. The job market got off to a roaring start in 2015 with a 257,000 increase in payroll employment in January. This comes on the heels of 324,000 average monthly growth in Q4, the best quarterly performance since 1999.

Average hourly earnings rose 0.5%, suggesting that stronger demand for workers may finally be lifting wages.

Recent trends in hiring, wages and consumer spending indicate that a positive feedback cycle is reinforcing the economy's momentum. These trends will have broad impact on real estate markets: rising incomes fuel consumer spending (retail sector) and demand for housing (apartment REITs and single-family rentals), and, of course, more space for the workers (office REITs).

Robust demand for rental housing bolsters apartment outlook. Total occupied rental housing increased by 2 million units in 2014, a record rise, according to Census Bureau data beginning in 1965. The acceleration in job growth appears to be encouraging the millions of "doubled up" Millennials and others to move out to a place of their own. This "pent up demand" is likely to keep vacancy rates low—and rents and property prices high—even as construction ramps up.

The views expressed in this commentary are those of Calvin Schnure, PhD, of the National Association of Real Estate Investment Trusts (NAREIT®) and reflect the current views of Dr. Schnure as of February 12, 2015.

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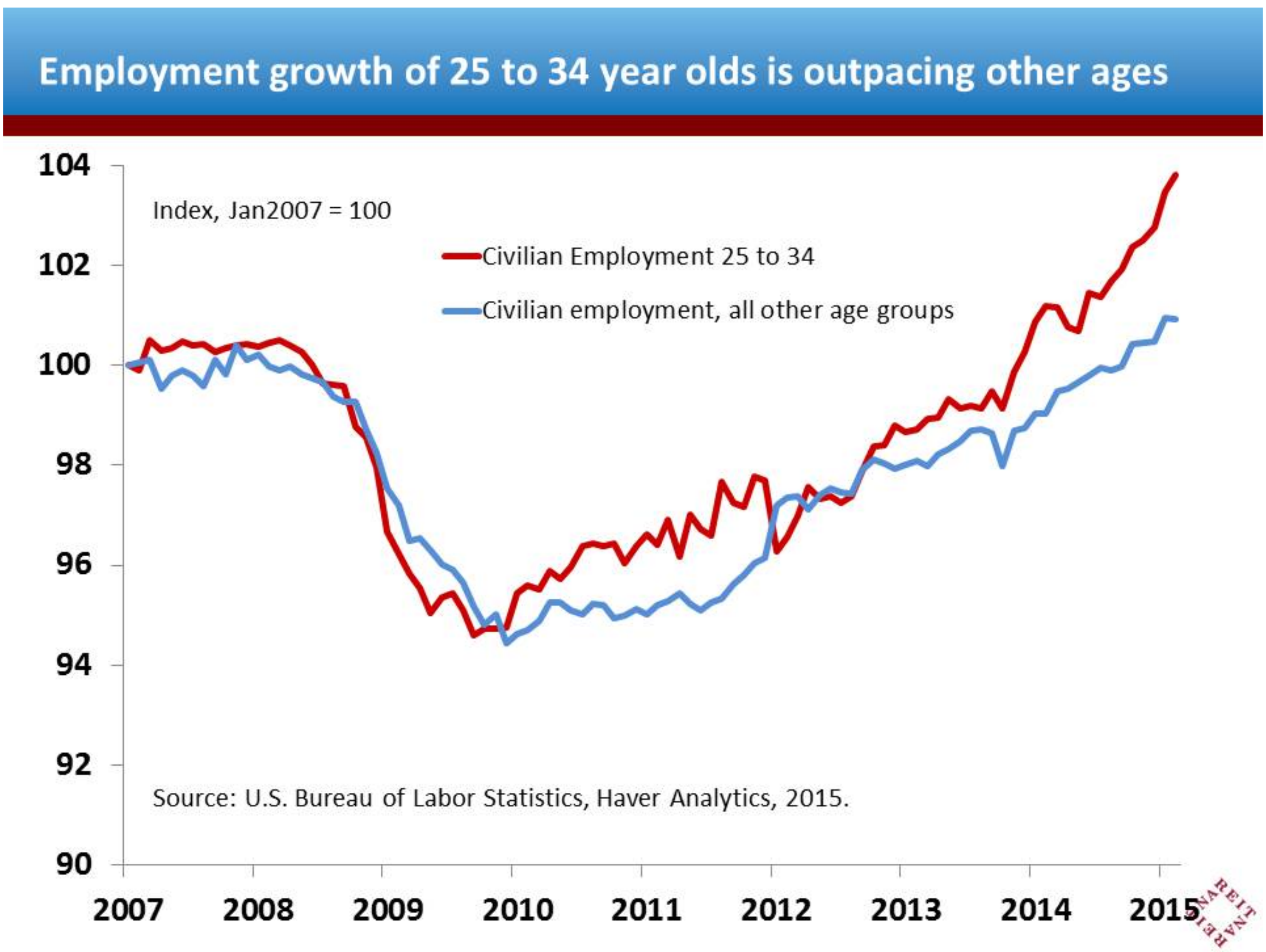
Multifamily Markets Still Have a Wind at Their Back

03/06/2015 | By Calvin Schnure

The multifamily housing market had a stellar performance in 2014, leaving everyone to wonder what comes next. Would the market take a breather, perhaps, as home sales start to pick up? And how much of a threat does the swelling construction pipeline pose to rents?

Recent news from the job market suggests that rental demand has the wind at its back. In particular, employment growth of those aged 25 to 34—the prime years for signing a new lease on an apartment—has pulled ahead of all other age groups. With rapid job growth in this age group in 2014 carrying over into early 2015, the gap in hiring patterns has continued to widen.



Stronger job prospects for this age group will help free up the "pent up demand" for apartment rentals, as those who are currently living with family or roommates will become more likely to move out on their own. With 3 million or more currently "doubled up", rental demand seems likely to keep pace with supply in the months ahead.

Category: Real Estate Fundamentals
Keywords: multifamily, apartment rental, vacancy, rent

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Discussion of the Current and Future Real Estate Markets

March 31-April 2, 2015

Addressing the Hot Button Questions: What Is keeping REIT Professionals up at Night?

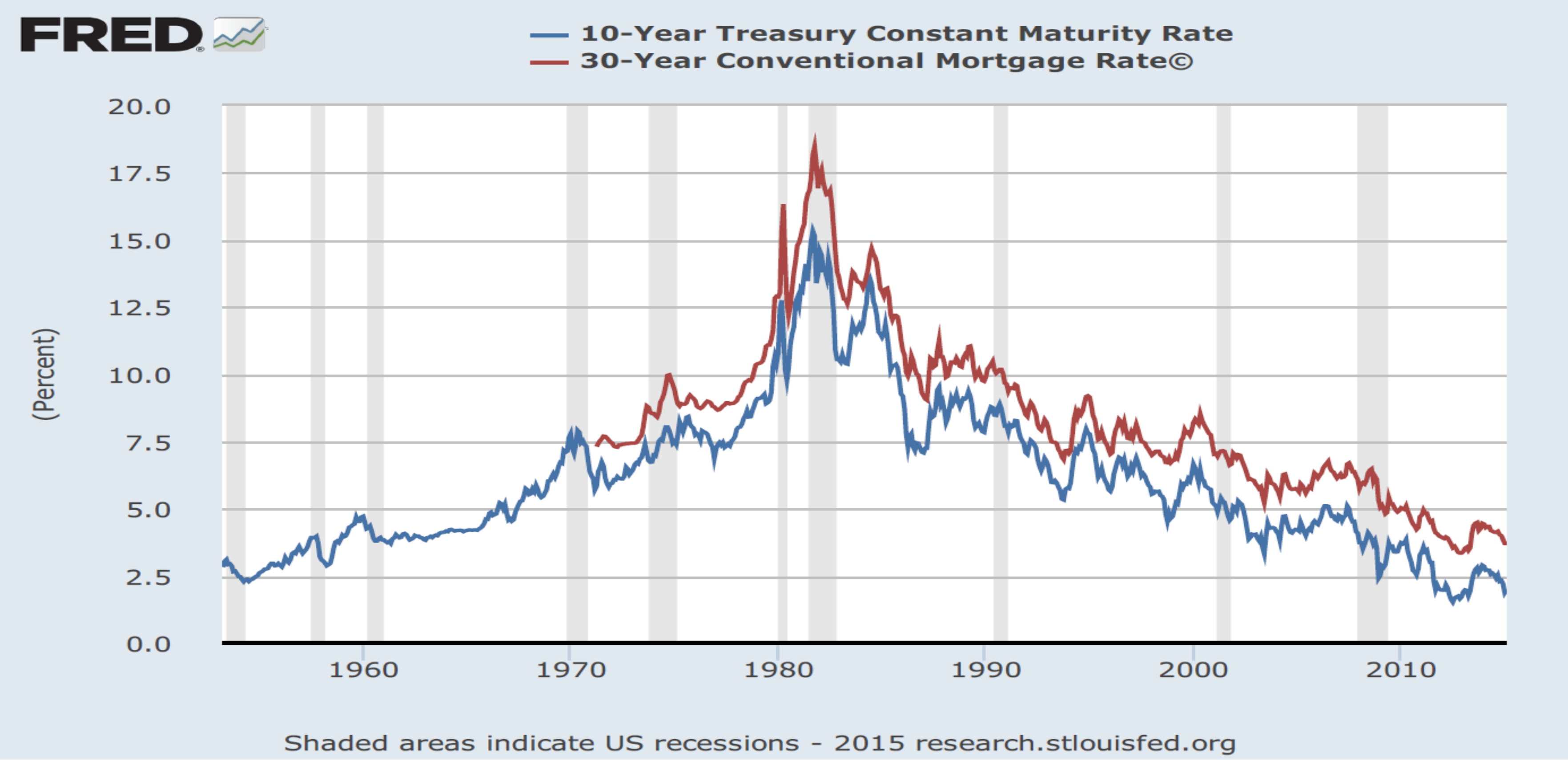
- Economic Keynote address: REITWise – 2015
- Kerry Vandell
- University of California - Irvine

The burning questions: survey results

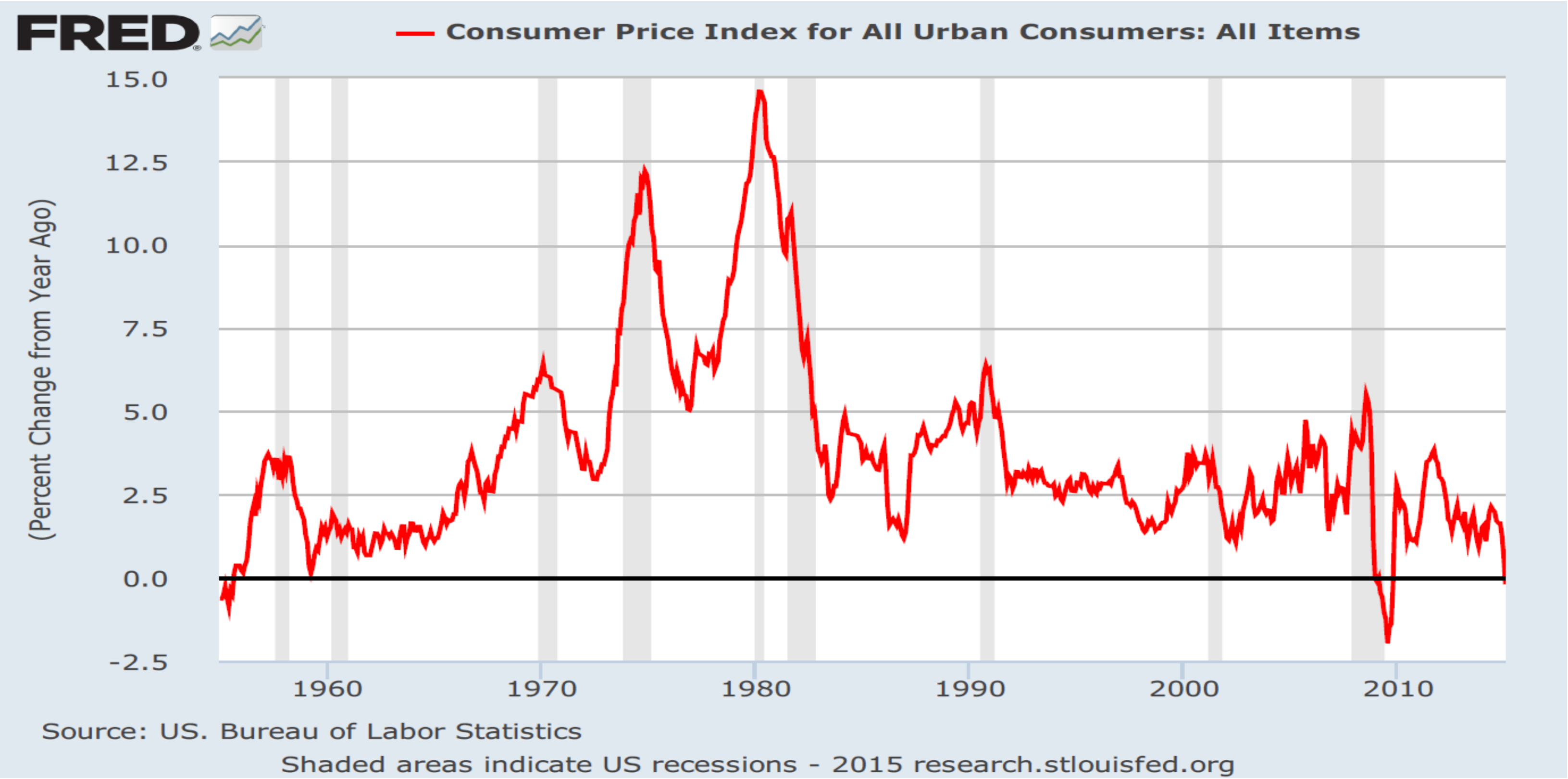
1. What will happen to interest rates, and how will they affect my business?
2. Where are we in "The Cycle"?
3. How will the price of oil affect REIT share prices?
4. How will global economic forces affect my business?
5. Will US REITs be able to increase market share? How can we grow? The life cycle of REITs
6. Will e-commerce cause the demise of retail REITs?
7. The multifamily sector: Fortune or fade?

1. What will happen to interest rates, and how will they affect my business?

Treasury and mortgage rate trends



…closely correlated with inflation



Goldman Sachs

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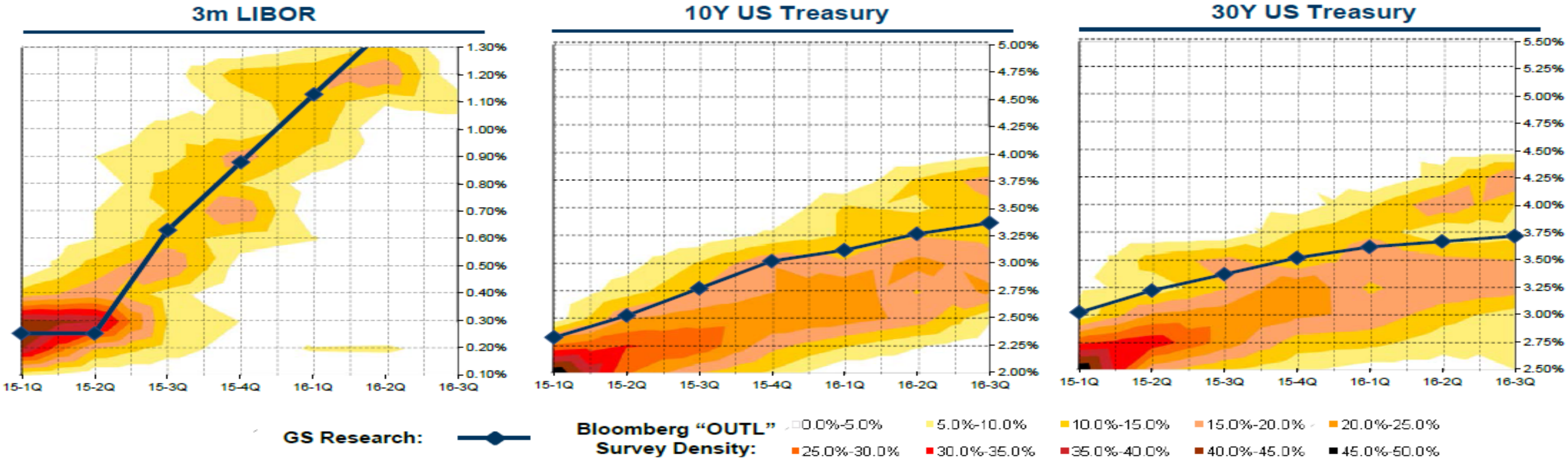
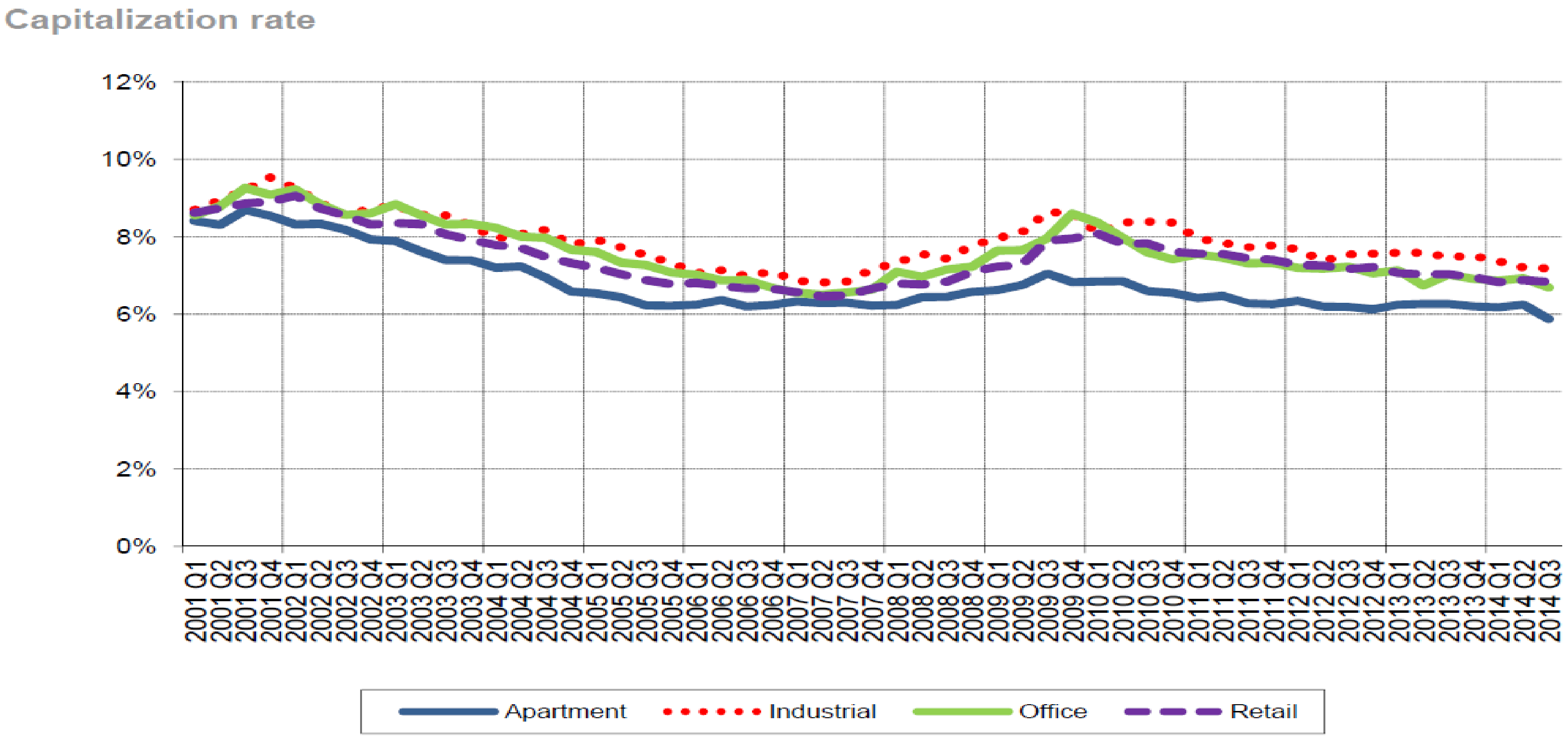
GS Research vs. Bloomberg Rate Forecasts

GS Long-Term Forecasts Above Consensus

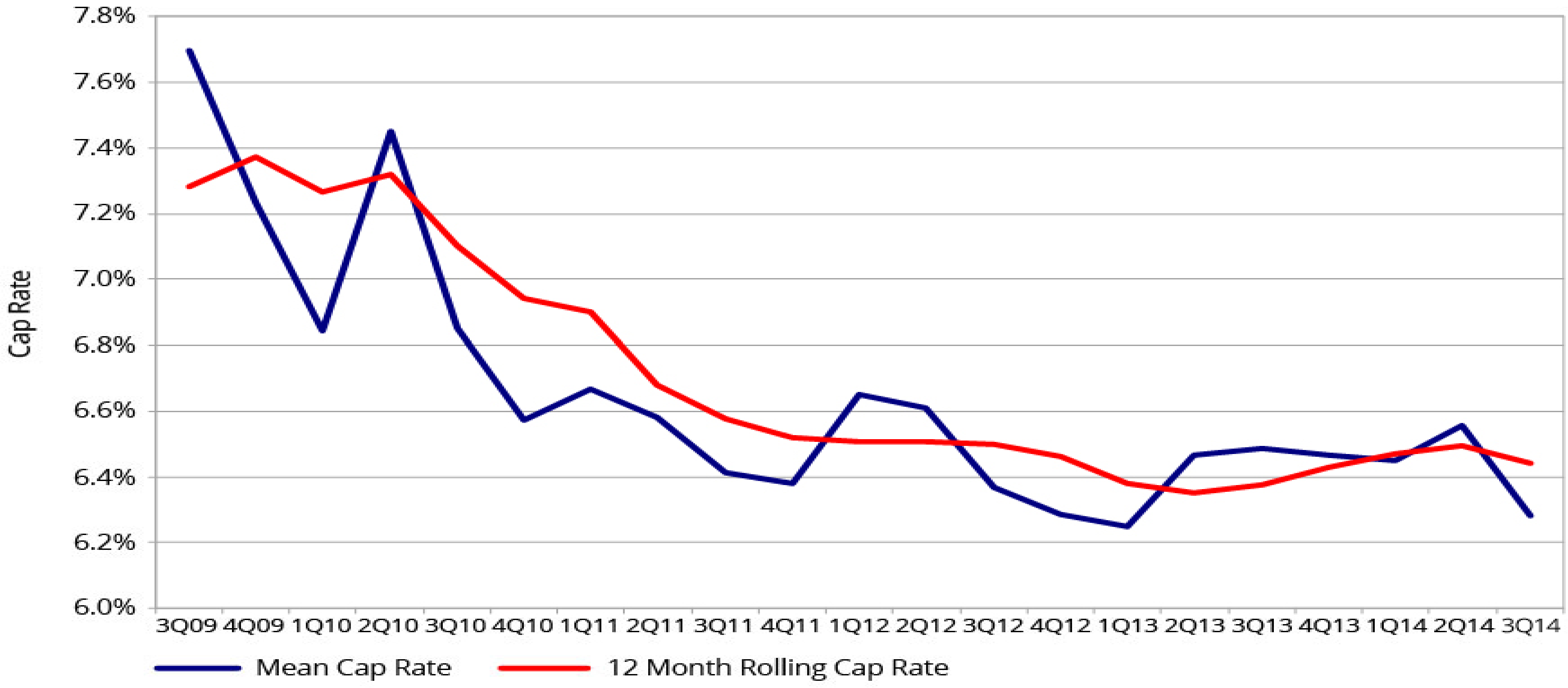


Cap rate trends

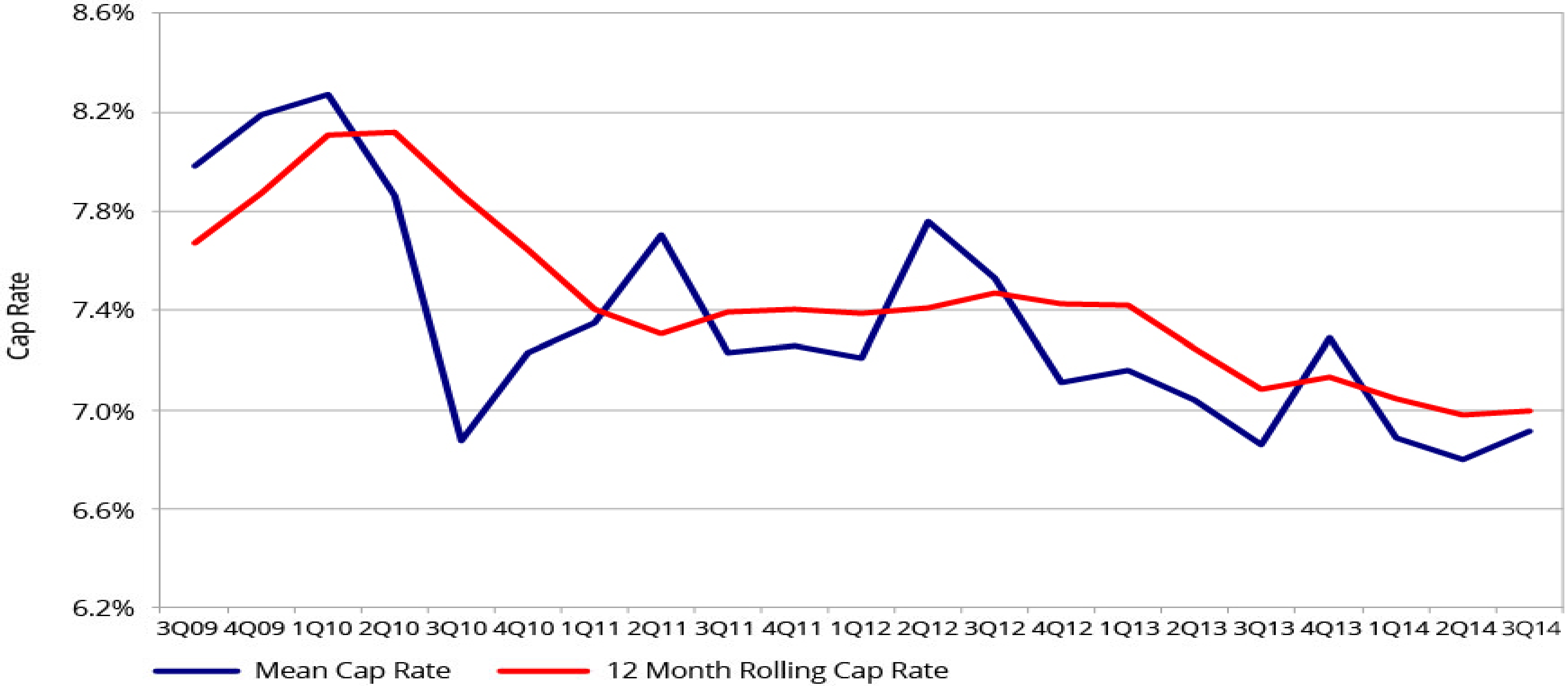


Source: Real Capital Analytics.

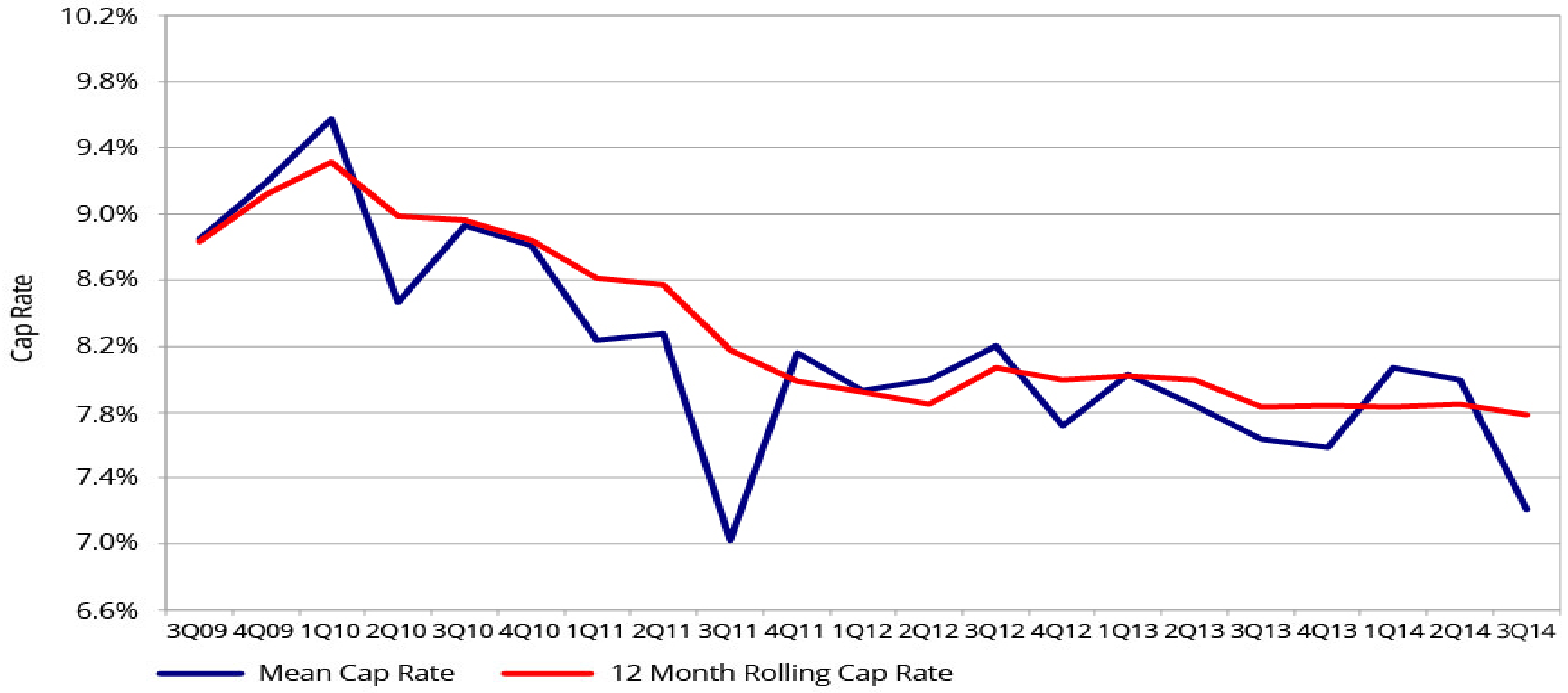
Multifamily cap rates



Office cap rates



Retail cap rates



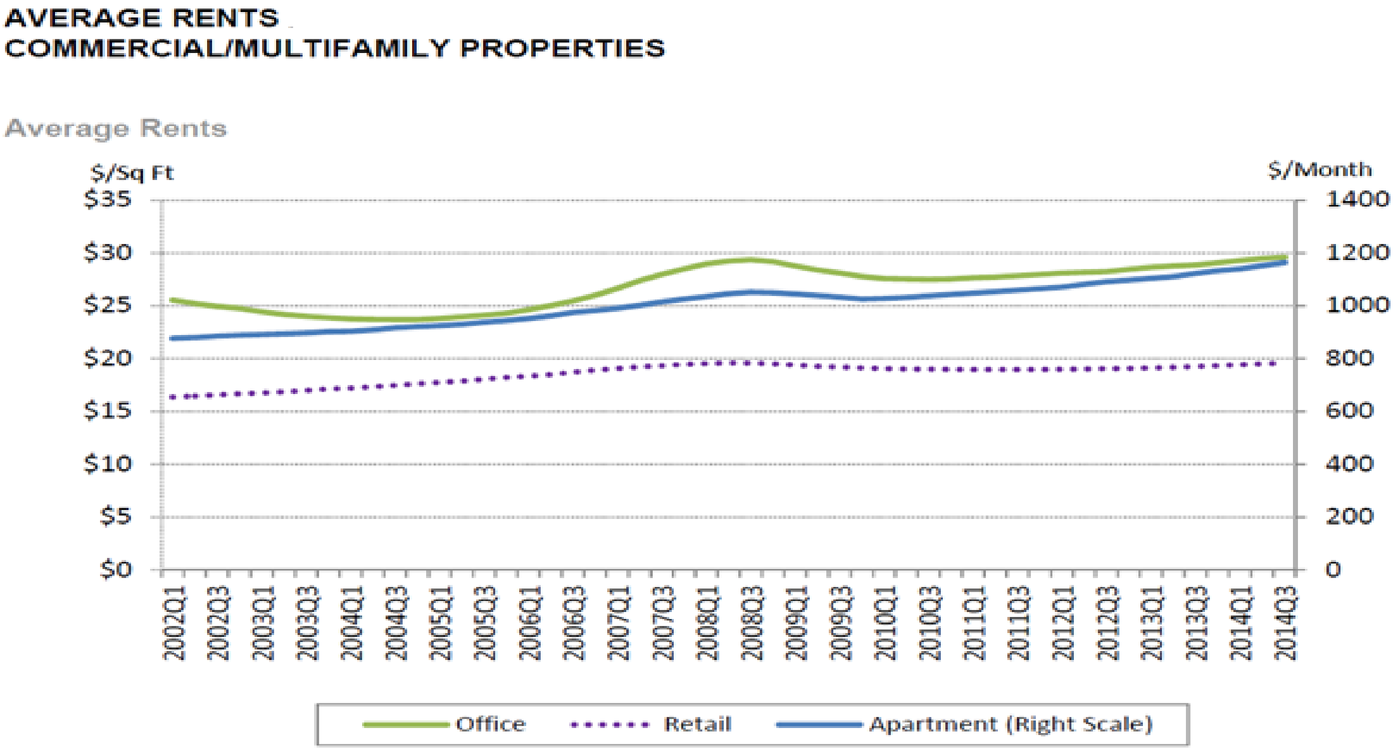
Leverage by property type: Equity REITs

This table presents main summary statistics for leverage and coverage ratio variables separated by the main property types of REITs in the sample. The first column contains the total number of observations in each property type. We report means, standard deviations, minimum, and maximum values. *Leverage* is the ratio of total debt to total REIT value, *Coverage Ratio* is the value of EBITDA divided by total interest expenses for the REIT.

		Leverage				**Coverage Ratio**			
Property Type	Obs.	Mean	Std	Min	Max	Mean	Std	Min	Max
Diversified	253	0.47	0.21	0.01	0.96	7.45	17.47	-4.75	111.10
Health Care	193	0.38	0.19	0.01	0.89	4.64	4.25	-1.98	26.69
Hotel	219	0.51	0.21	0.03	0.97	5.71	12.75	-3.68	111.10
Industrial	177	0.52	0.18	0.23	0.97	2.86	1.54	-1.27	11.25
Manufactured Homes	62	0.44	0.14	0.19	0.75	3.66	2.90	0.77	24.45
Multi-Family	392	0.52	0.16	0.07	0.92	3.30	3.27	-3.55	60.05
Office	346	0.49	0.14	0.10	0.99	3.35	1.74	-4.75	12.36
Regional Mall	151	0.60	0.14	0.05	0.99	2.86	1.81	-1.76	14.12
Retail: Other	131	0.44	0.22	0.00	0.99	8.26	17.91	-0.03	111.1
Self-Storage	81	0.33	0.26	0.02	0.99	20.30	34.14	-4.75	111.1
Shopping Center	337	0.48	0.17	0.02	0.97	3.59	3.85	-4.75	37.65
Specialty	67	0.49	0.16	0.02	0.90	4.91	6.83	-4.75	36.23
Total	2,409	0.48	0.19	0.00	0.99	4.95	11.01	-4.75	111.10

Source: Harrison, Panasian, Seiler, "Further Evidence on the Capital Structure of REITs," *Real Estate Economics*, 2011

Commercial/multifamily rent fluctuations over the cycle



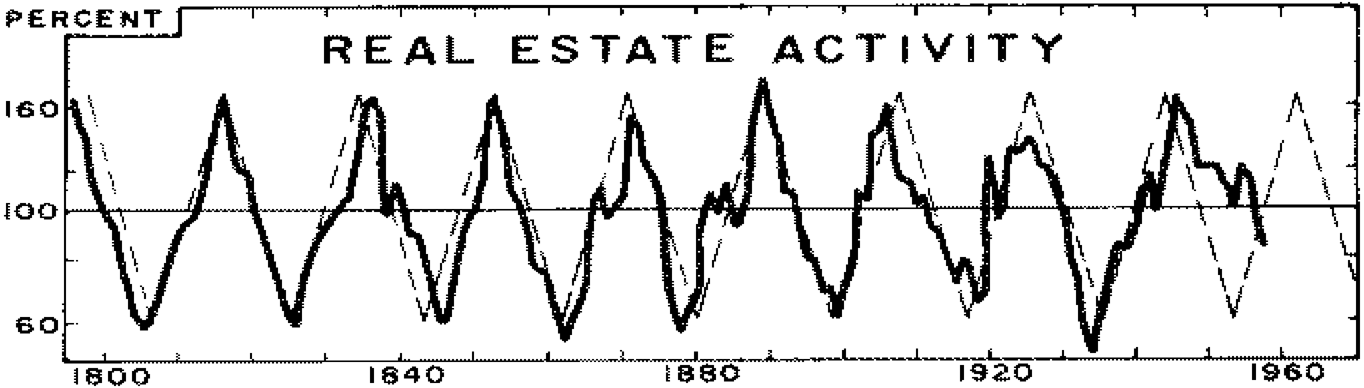
The takeaway:

- Impact on values depends upon complex relationships among changes in:
  - Interest rates (mortgage rates)
  - Rents
  - Inflation
  - Leverage
- If interest rates driven primarily by inflation, rent increases will offset (more than offset?) mortgage rate increases, hence keeping cap rates low and values high

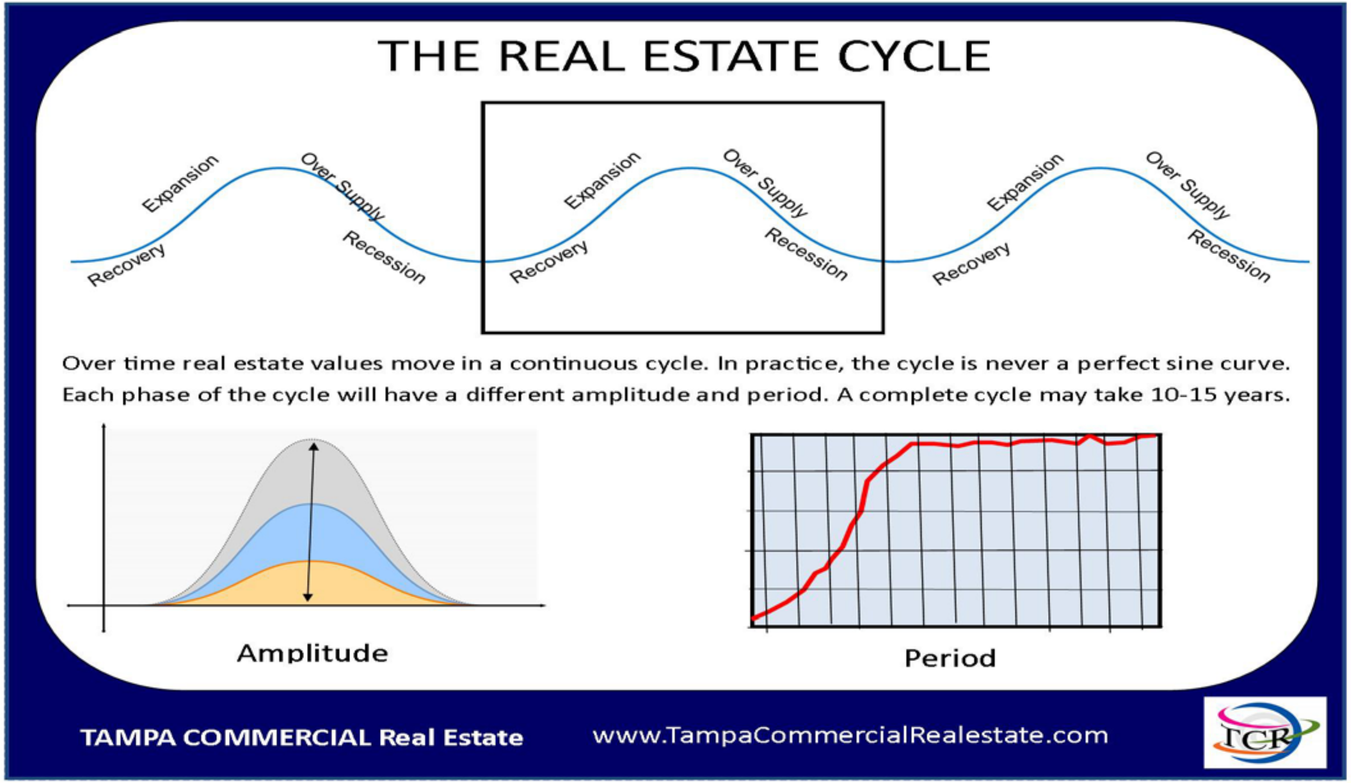
Where are we in "The Cycle"?

"In the beginning"…there emerged the Father of cycle theory

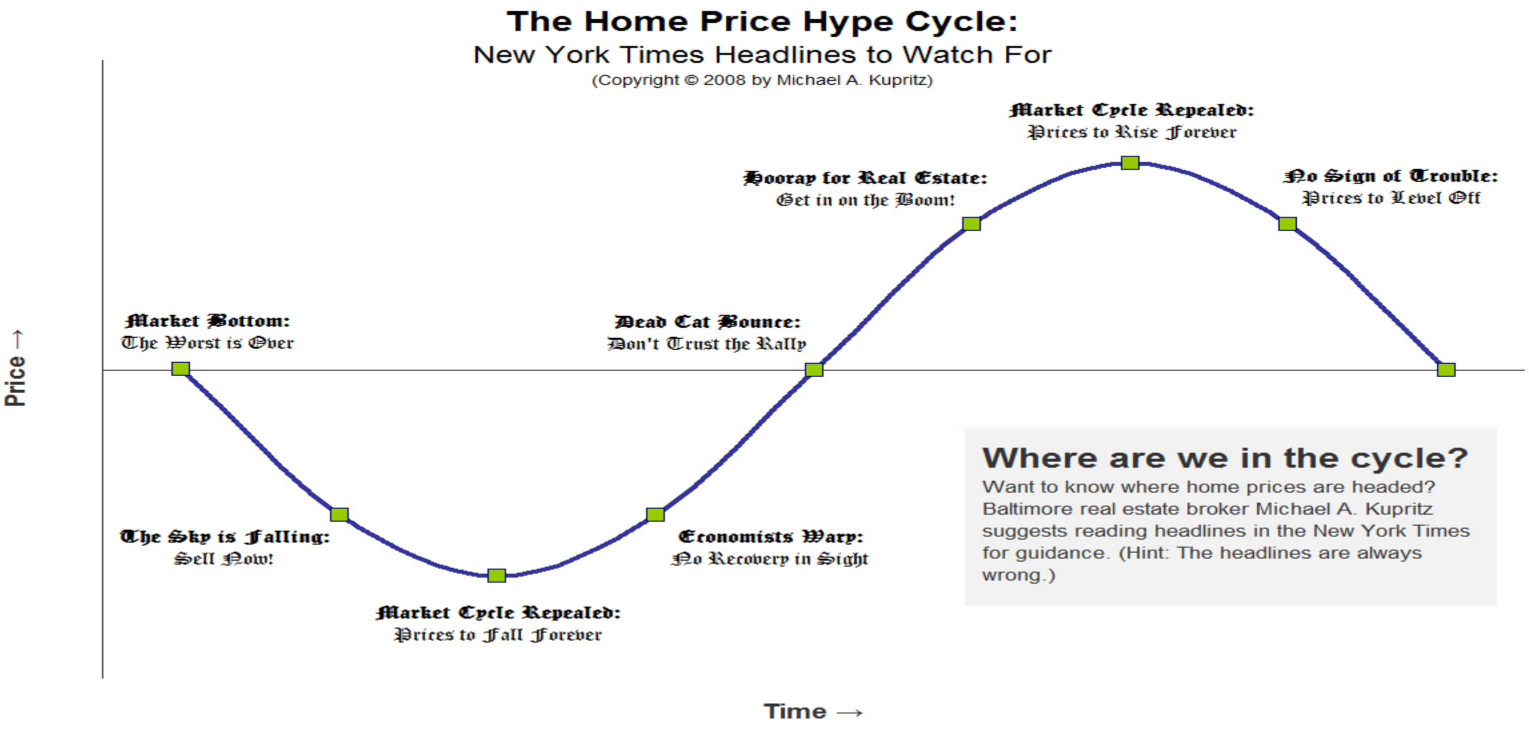
Dewey and Cycles Edward R Dewey (1895-1978) formed the Foundation for the Study of Cycles in 1940.



Evolving into "conventional wisdom"



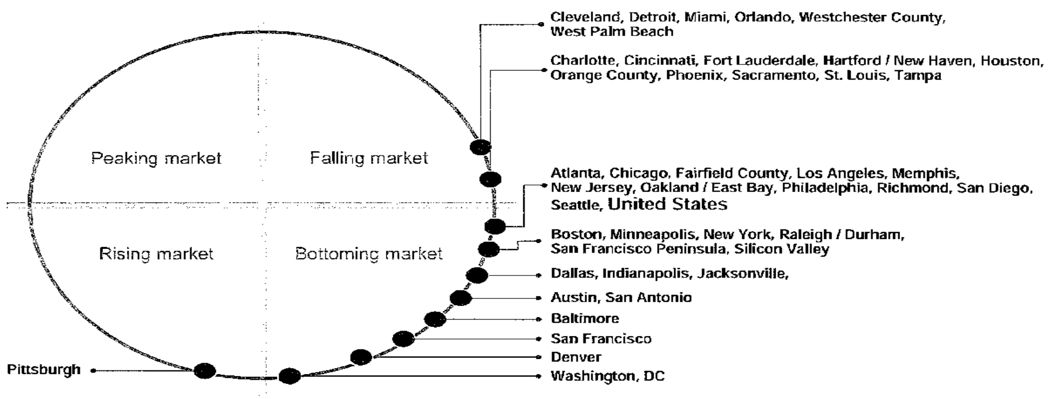
…then into "rules for action"



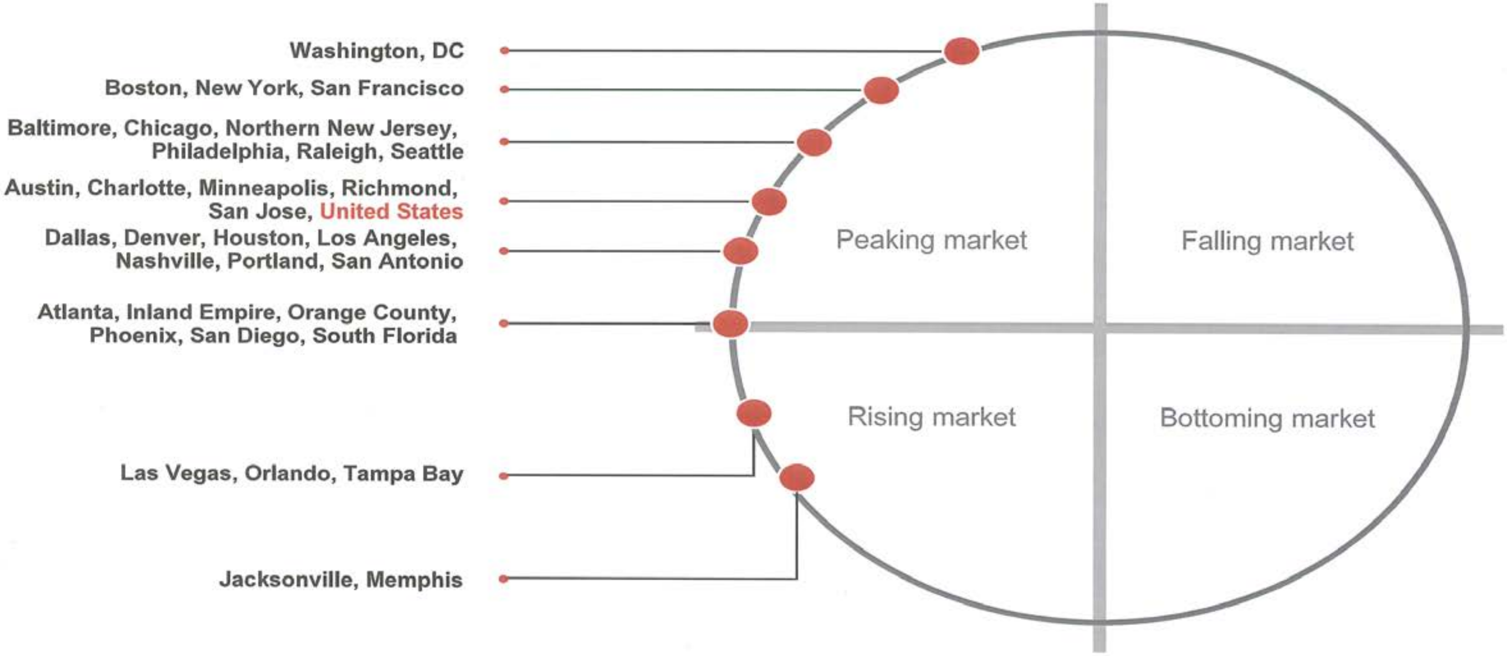
…then into psychological "stages of grief" and the "double-dip'

…and finally the "Property Clock"

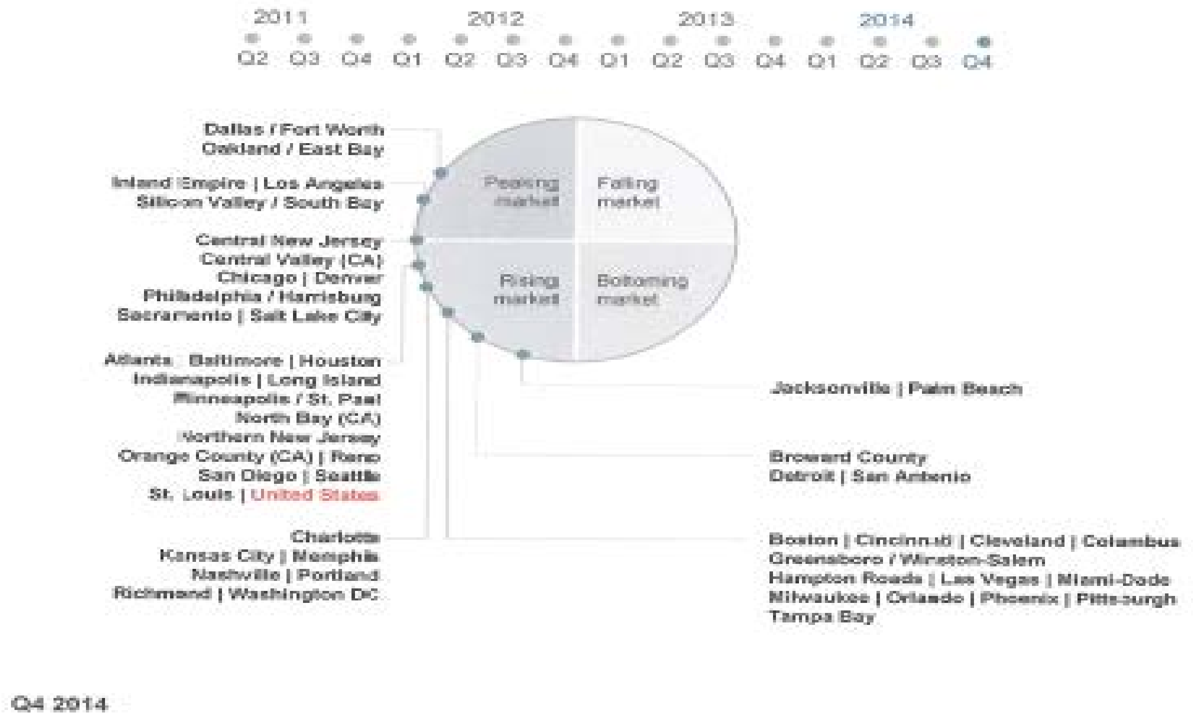
United States office clock



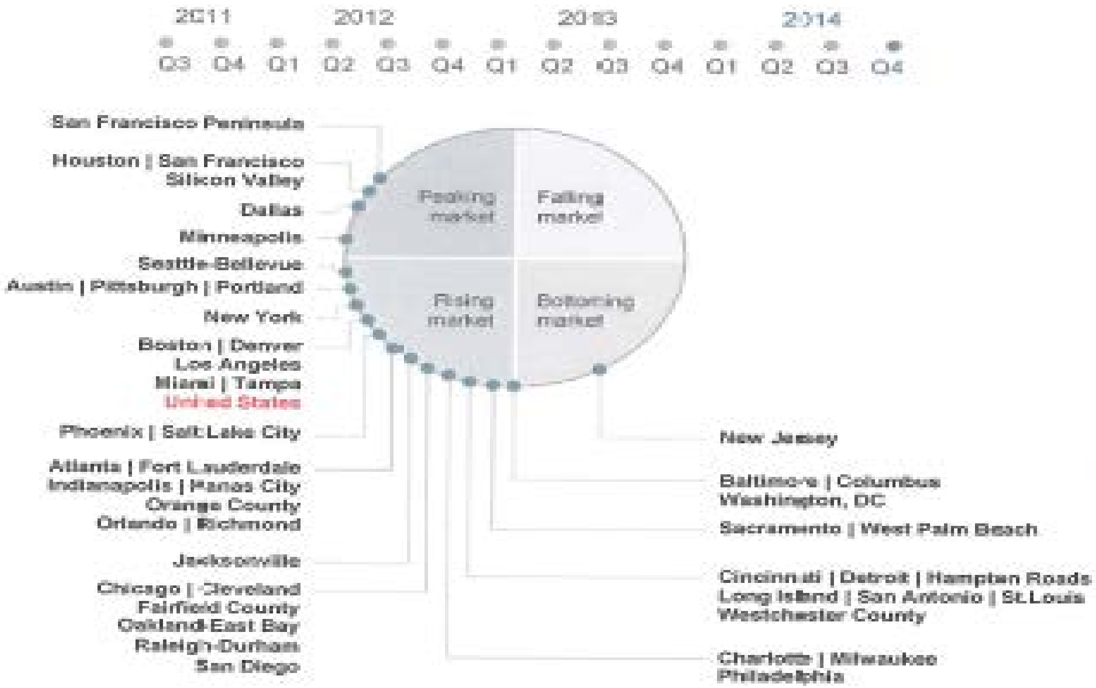
United States – Multifamily clock



The industrial property clock

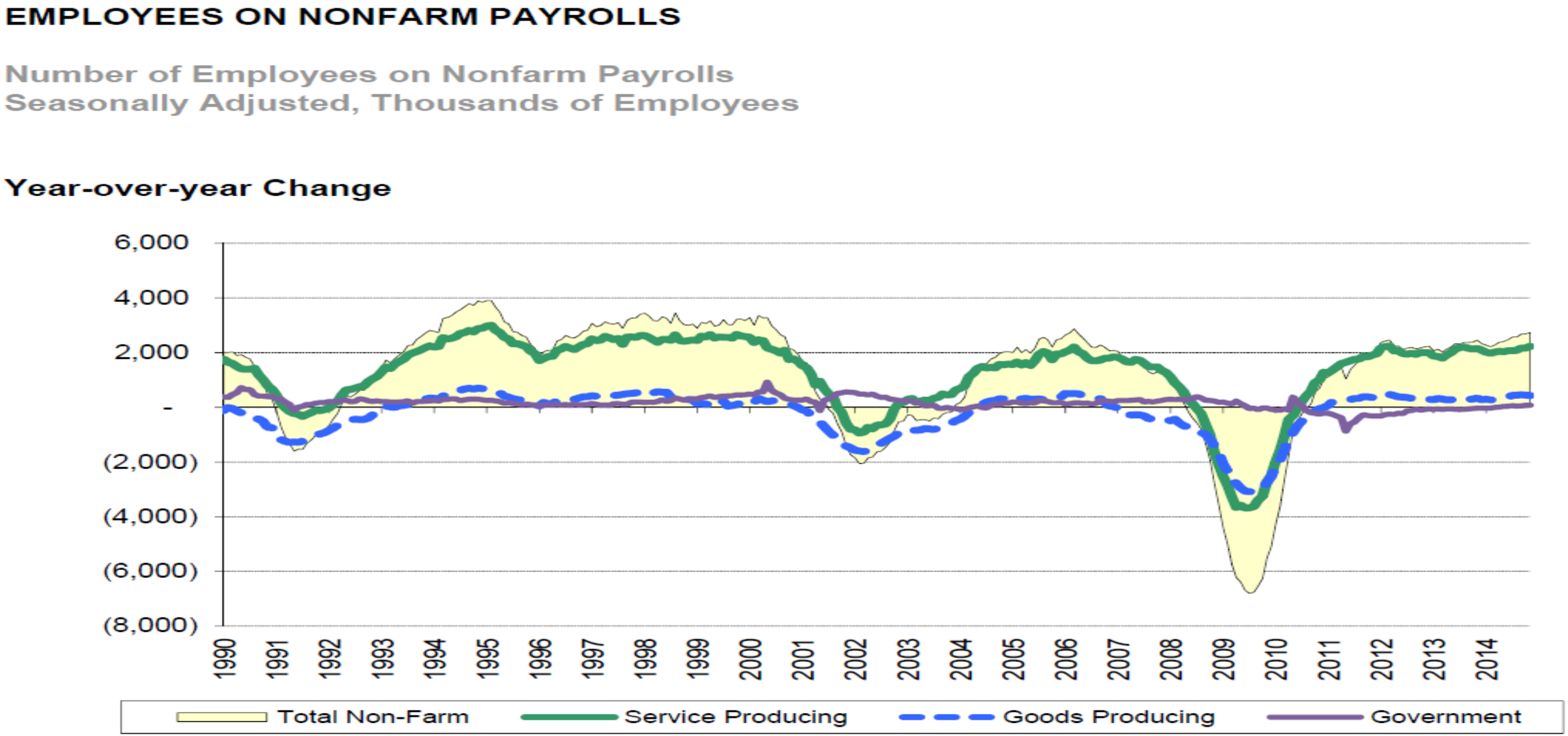


The office property clock



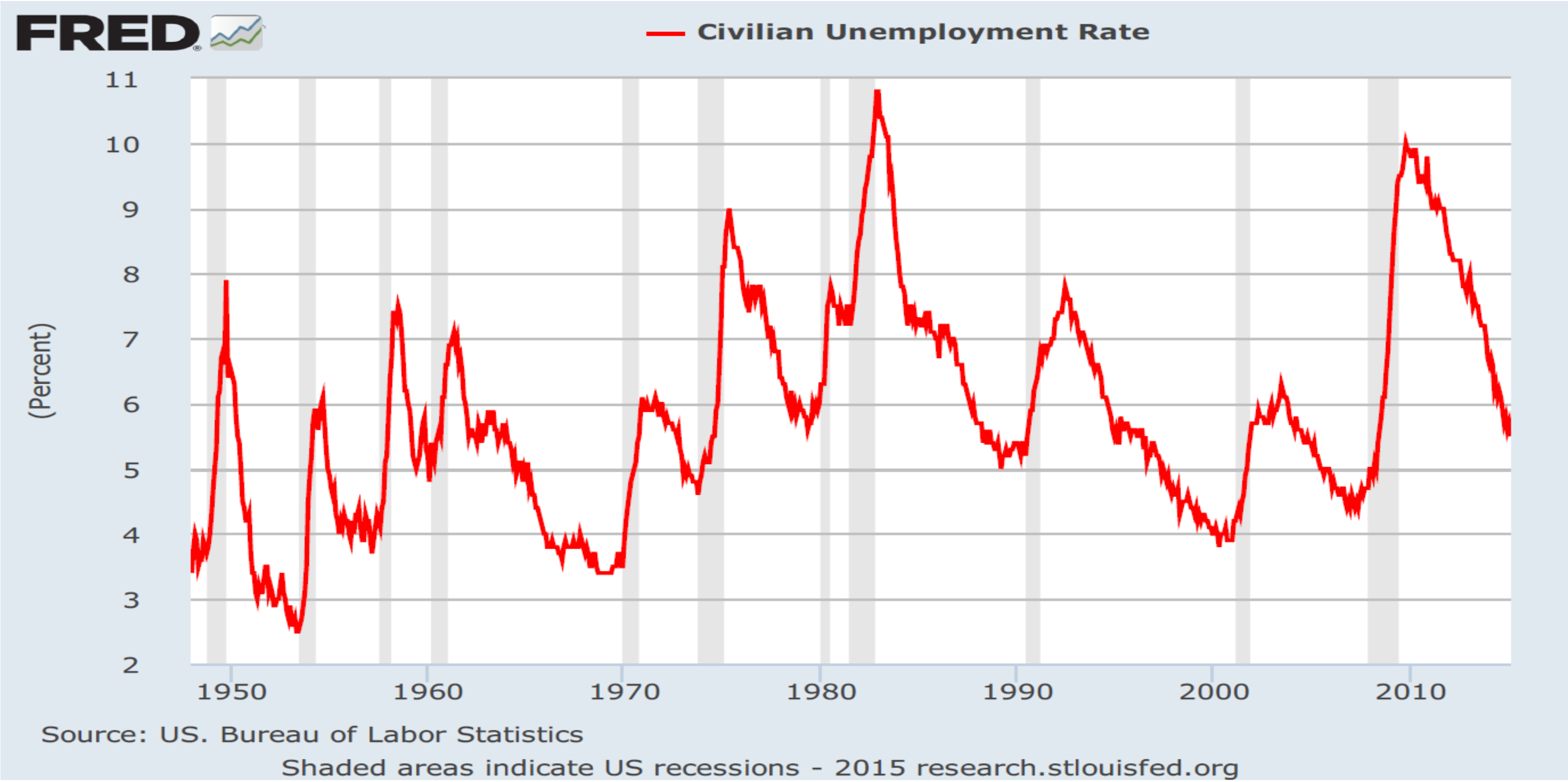
The retail property clock

What about fundamentals? Employment growth has resumed

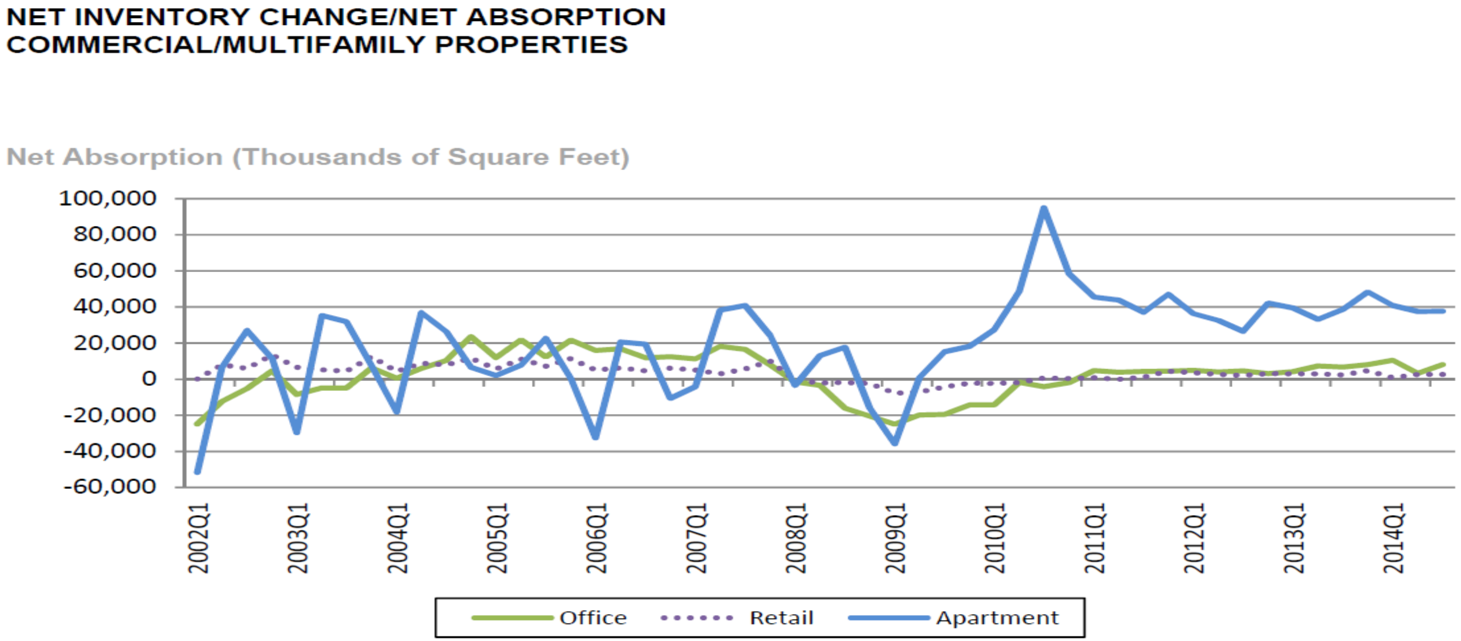


Source: Bureau of Labor Statistics

…and unemployment is continuing its decline



The supply side (except multifamily) has remained muted



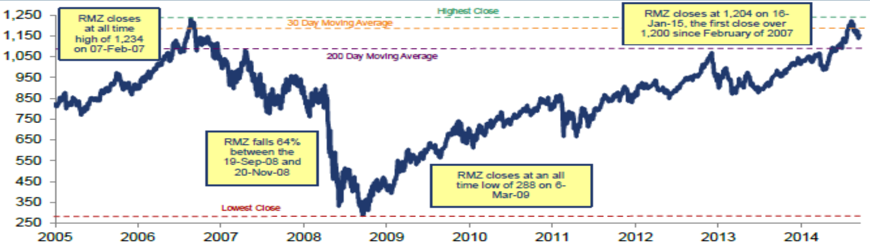
Source: REIS

REIT capital flows and indices have been buoyant (till now?)

Real Estate Index Performance & Fund Flows

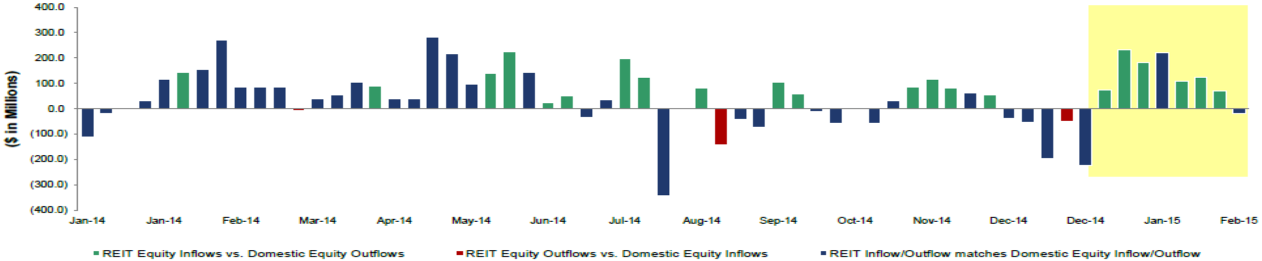
INVESTMENT BANKING DIVISION

The RMZ has tested all-time highs in 2015 and remains significantly higher than long term moving averages



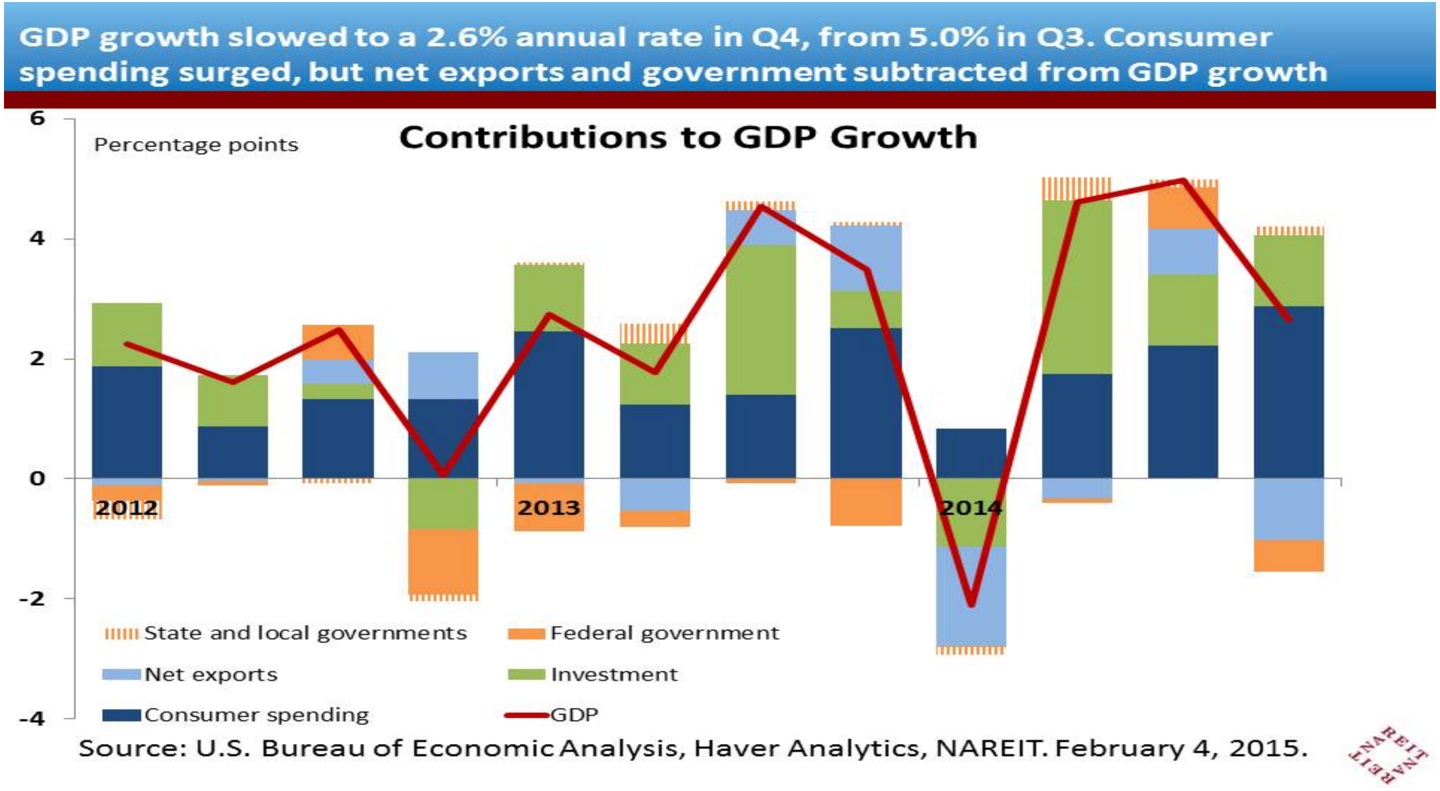
Key Value	Value	Current vs.[1]
Highest Close	1,234	(6.7)%
30 Day Moving Avg	1,180	(2.5)%
200 Day Moving Avg	1,079	+6.6%
Lowest Close	288	+299.8%

REITs remain one of the few sectors where cash is being actively deployed as broad market volatility has caused a flight to safety



Source: Bloomberg, AMG Data Services
[1]RMZ value as of 3-Mar-2015 is 1,150.88

Consumer spending is driving growth, but investment is moderate and the strong dollar is driving down exports

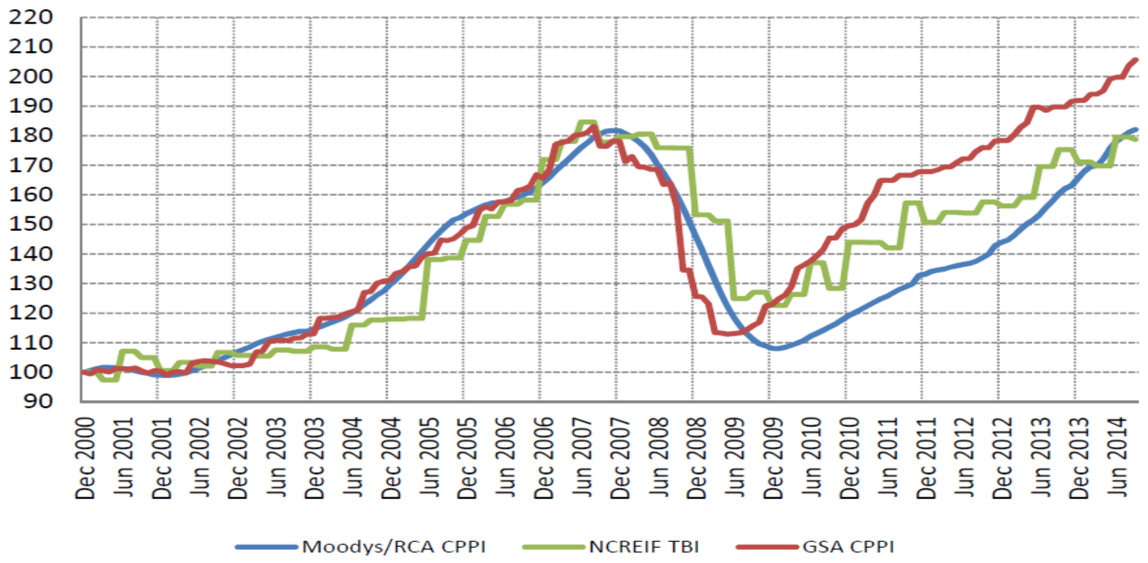


But property prices continue to head higher

COMMERCIAL/MULTIFAMILY PROPERTY PRICES AS REFLECTED IN SELECTED INDICES

Re-Indexed Values of the Moody's/RCA CPPI,
NCREIF Transaction Based Index, and Green Street Advisors CPPI

December 2000 = 100



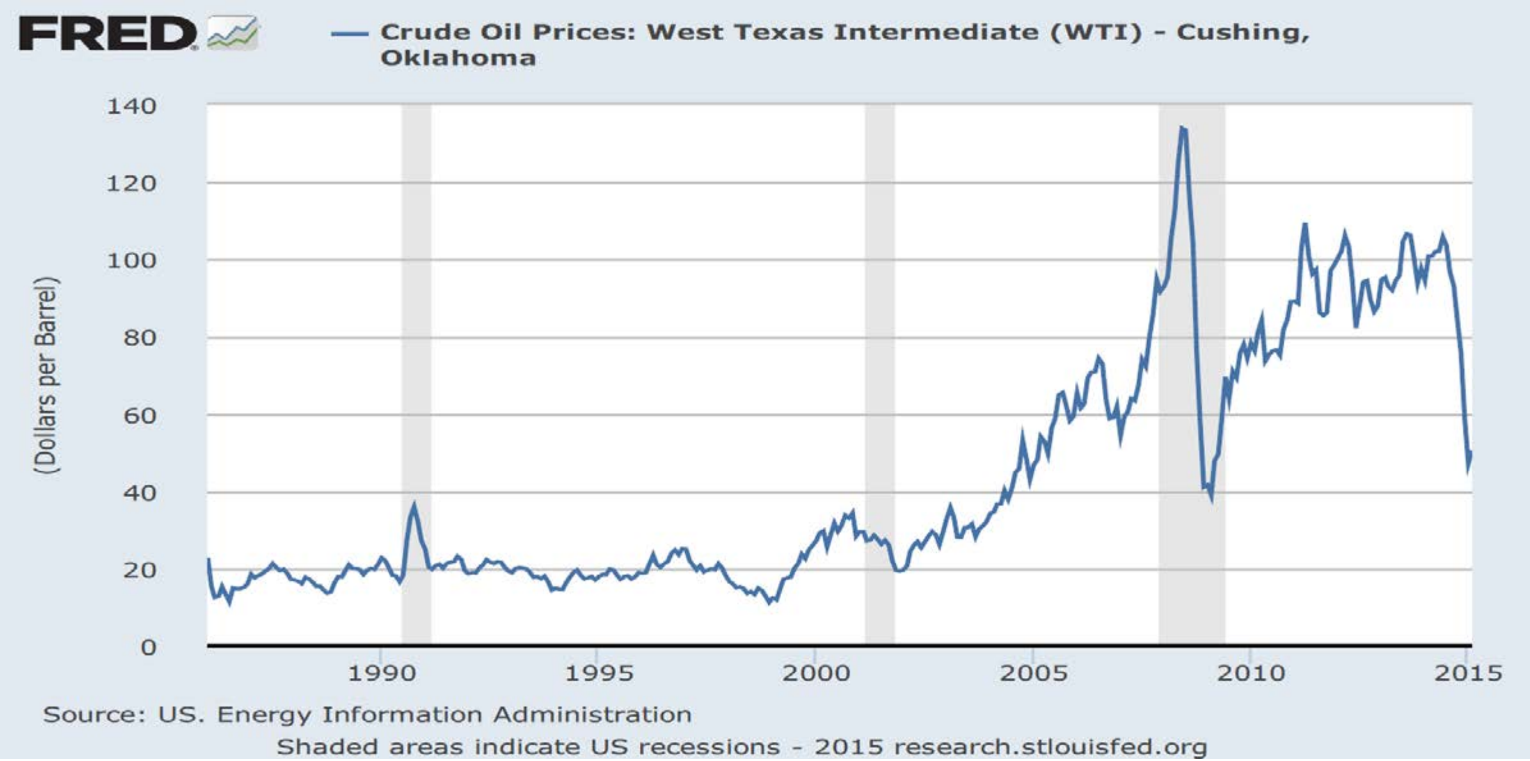
Source: Mortgage Bankers Association, Real Capital Analytics, Moody's Investors Services, National Council of Real Estate Investment Fiduciaries, and Green Street Advisors

The takeaway:

- If we believe the property clocks and the permanency of "The Cycle", we still have room to run, from 6:00 to 11:00, depending on the market
- If we look at the economic fundamentals, there are signs of re-establishment of equilibrium in several sectors
- There are more questions on the supply side than on the demand side in the short run

3. How will the price of oil affect REIT share prices?

Oil prices clearly are in a funk…but for how long?



Some opinions from the street

"Multifamily and office sectors … would suffer first from a sharp uptick in unemployment or corporate downsizing in an oil price collapse. Multifamily, moreover, would presumably feel pressure for lower rents sooner, because of its shorter lease durations. But ***of all oil-sensitive states to be exposed to, Texas may be among the safest, in part because of its relatively well-diversified economy***. Moreover, while the Dallas and Houston markets are tied directly to oil production, the exposure in Austin is indirect, with the impact of an oil crash likely to come by way of state government cutbacks."

Standard & Poor's, January 7, 2015

"It is best to assume oil prices stay range bound for some time and work from there. ***This assumption likely translates into a positive impact on the U.S. economy in the short run, an unknown impact in the long run, and negative short- and long-run impacts to energy-driven MSAs such as Houston***."

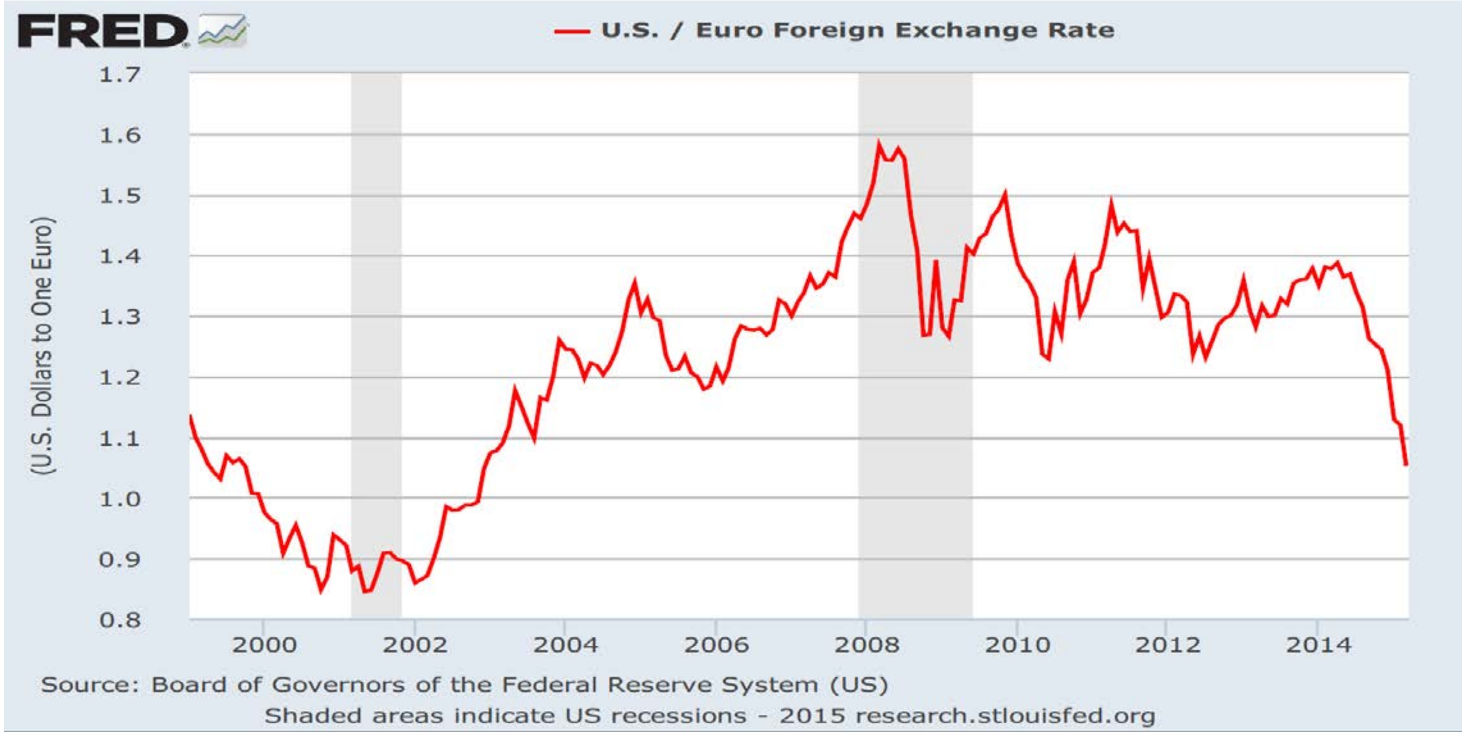
Green Street Advisors , January 6, 2015

The takeaway:

- Don’t count cheap oil as the “new normal”
- Prices reflect geopolitical factors at least as much as they reflect underlying economic fundamentals, especially in the short run
- Technology (e.g., fracking and alternative energy) are also wild cards

4. How will global economic forces affect my business?

The sinking of the Euro (and other foreign currencies) against the Dollar is having a major effect on trade balances and international capital flows



Nonetheless, REITs continue to expand globally

As of June 30, 2012. Source: UBS and Cohen & Steers.

Countries with Listed REITs (Year Adopted)				REIT Legislation in Progress		REITs Under Consideration
United States (1960) **Netherlands (1969)** **Australia (1971)** **Canada (1994)** **Ghana (1994)** **Belgium (1995)** **Brazil (1995)** **Greece (1999)** **Turkey (1999)** **Japan (2000)** **South Korea (2001)** **Singapore (2002)** **France (2003)** **Hong Kong (2003)** **Taiwan (2003)** **Bulgaria (2005)**		Malaysia (2005) Israel (2006) Germany (2007) United Kingdom (2007) Italy (2007) New Zealand (2007) Nigeria (2010) Mexico (2011) Thailand (2012) Finland (2013) Ireland (2013) Pakistan (2013) South Africa (2013 Dubai (2014) Spain (2014)		Chile Costa Rica Hungary Indonesia Lithuania Luxembourg Philippines Puerto Rico		China India

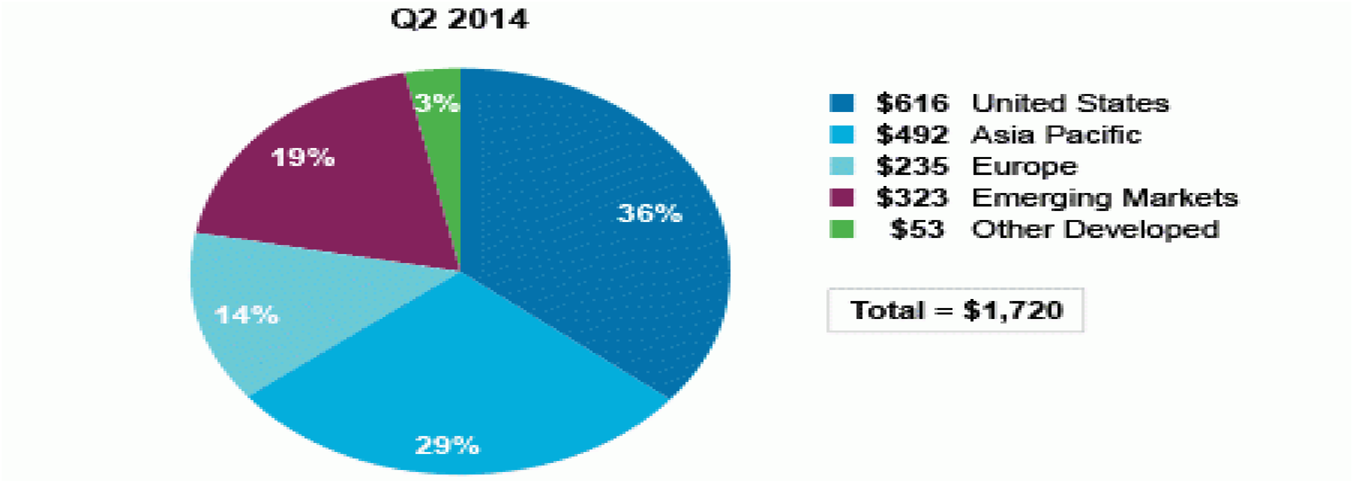
…and more of them have become very large

FTSE EPRA/NAREIT Developed Index Series - Top 20 Constituents		
Company	**Country**	**Symbol/Code**
Simon Property Group	U.S.	SPG
Mitsubishi Estate	Japan	8802
Public Storage	U.S.	PSA
Mitsui Fudosan	Japan	8801
Equity Residential	U.S.	EQR
Unibail-Rodamco	Netherlands	UL
Health Care REIT	U.S.	HCN
Sun Hung Kai Properties	Hong Kong	16
Prologis	U.S.	PLD
AvalonBay Communities	U.S.	AVB
Ventas	U.S.	VTR
HCP	U.S.	HCP
Vornado Realty Trust	U.S.	VNO
Boston Properties	U.S.	BXP
Host Hotels & Resorts	U.S.	HST
Sumitomo Realty & Development	Japan	8830
Scentre Group	Australia	SCG
Link REIT	Hong Kong	823
Westfield Group	Australia	WDC
Land Securities	U.K.	LAND
Source: FTSE EPRA/NAREIT	*Version: December 2014*	

What is the size of the global real estate securities market?

- The global real estate securities market has a total market capitalization of approximately $1.7 trillion, spread across 456 companies (as of 6/30/2014).
- The U.S. accounts for 35% of the current market, with 28% represented by Asia Pacific and a **relatively smaller portion from Europe** and other regions.
- Emerging markets saw the largest growth in listed real estate, now comprising 19% of the global market, up from 2% in 2000.
- More than three quarters of companies in the global real estate securities universe are REITs or REIT-like structures, with the rest consisting of real estate development companies and non-REIT owner/operators.
- Is this big?

Distribution of market cap of real estate securities globally



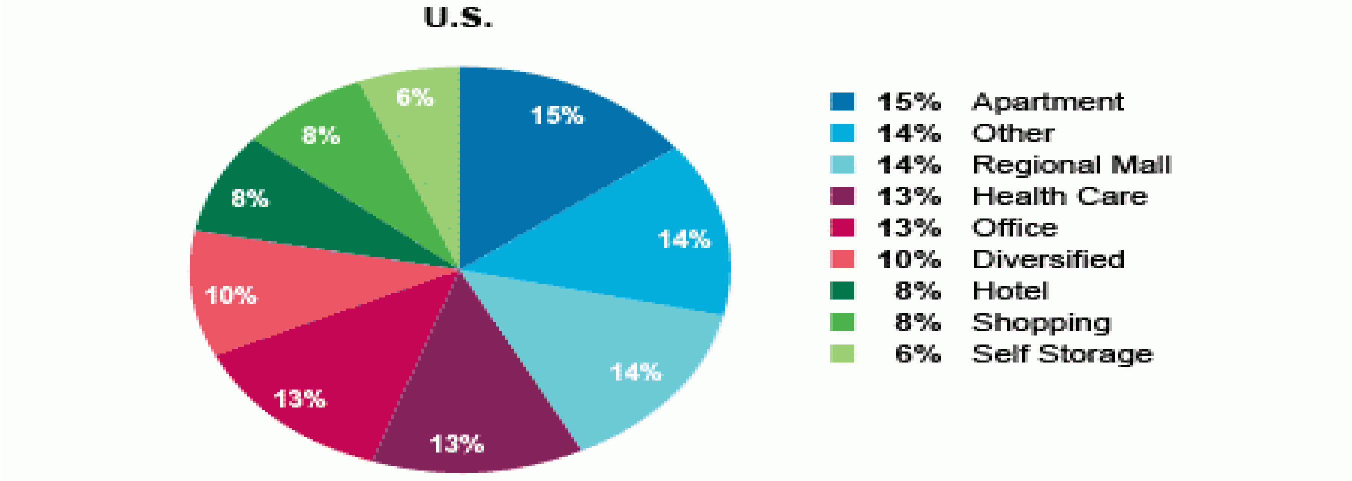
At June 30, 2014. Source: FTSE, FactSet and Standard & Poor's. Real estate securities represented by the FTSE EPRA/NAREIT Global Real Estate Index. Percentages may not sum to 100% due to rounding error. See important disclosures and index definitions related to this chart below.

The takeaway:

- Globally, REITs have plenty of “room to grow”
- The entrance of India and China will be BIG!!
- REITs in the U.S. have not grown as rapidly as offshore REITs as a percent of total commercial property value
- Currency valuations and politics are having great impact on cross-border investments and the balance of trade – Thus far, has had major positive impact on US real estate and capital available for investment (but drop in exports could slow growth, especially in goods producing sector)
- Share of this cross-border capital flow that is going into the US REIT sector is not that great

5. Will US REITs be able to increase market share? How can we grow? The life cycle of REITs

What is the current composition of the US REIT market by sector?



At June 30, 2014. Source: Cohen & Steers and FTSE. U.S. REITs represented by the FTSE NAREIT Equity REIT Index (property sector breakdown provided by the index). Percentages may not add to 100% due to rounding error. See important disclosures and index definitions related to this chart below.

REIT Industry Fact Sheet

Industry Size

- FTSE NAREIT All REITs equity market capitalization = $907 billion
- FTSE NAREIT All Equity REITs equity market capitalization = $833 billion
- REITs own approximately $1 trillion of commercial real estate assets, including stock exchange-listed and public, non-listed REITs
- 216 REITs are in the FTSE NAREIT All REITs Index
- 188 REITs trade on the New York Stock Exchange
- NYSE listed REITs equity market capitalization = $875 billion

Dividends
Yield Comparison

- FTSE NAREIT All REITs: 4.00%
- FTSE NAREIT All Equity REITs: 3.56%
- S&P 500: 2.00%
- REITs paid out approximately $34 billion in dividends in 2013.
- On average, 68 percent of the annual dividends paid by REITs qualify as ordinary taxable income, 13 percent qualify as return of capital and 19 percent qualify as long-term capital gains.

Leverage and Coverage Ratios

(Balance sheet data as of Q3 2014)

- Equity REITs
  - Debt Ratio: 31.6%
  - Coverage Ratio: 4.0x
  - Fixed Charge Ratio: 3.6x
  - 46 Equity REITs are rated investment grade, 68 percent by equity market capitalization.
- All REITs
  - Debt Ratio: 42.7%
  - Coverage Ratio: 3.4x
  - Fixed Charge Ratio: 3.1x
  - 46 REITs are rated investment grade, 62 percent by equity market capitalization.

Coverage ratio equals EBITDA divided by interest expense.
Fixed charge ratio equals EBITDA divided by interest expense plus preferred dividends.

Average Daily Dollar Trading Volume

- December 2014: $6.1 billion
- December 2009: $3.1 billion
- December 2004: $1.4 billion

Data as of December 31, 2014, except where noted. All data are derived from, and apply only to, publicly traded US REITs.

Growth in absolute nominal terms is not an issue: Equity market capitalization outstanding ($MM at year end)

	All REITs		Equity		Mortgage		Hybrid	
End of Year	# of REITs	Market Capitalization	# of REITs	Market Capitalization	# of REITs	Market Capitalization	# of REITs	Market Capitalization
1971	34	1,494.3	12	332.0	12	570.8	10	591.6
1972	46	1,880.9	17	377.3	18	774.7	11	728.9
1973	53	1,393.5	20	336.0	22	517.3	11	540.2
1974	53	712.4	19	241.9	22	238.8	12	231.7
1975	46	899.7	12	275.7	22	312.0	12	312.0
1976	62	1,308.0	27	409.6	22	415.6	13	482.8
1977	69	1,528.1	32	538.1	19	398.3	18	591.6
1978	71	1,412.4	33	575.7	19	340.3	19	496.4
1979	71	1,754.0	32	743.6	19	377.1	20	633.3
1980	75	2,298.6	35	942.2	21	509.5	19	846.8
1981	76	2,438.9	36	977.5	21	541.3	19	920.1
1982	66	3,298.6	30	1,071.4	20	1,133.4	16	1,093.8
1983	59	4,257.2	26	1,468.6	19	1,460.0	14	1,328.7
1984	59	5,085.3	25	1,794.5	20	1,801.3	14	1,489.4
1985	82	7,674.0	37	3,270.3	32	3,162.4	13	1,241.2
1986	96	9,923.6	45	4,336.1	35	3,625.8	16	1,961.7
1987	110	9,702.4	53	4,758.5	38	3,161.4	19	1,782.4
1988	117	11,435.2	56	6,141.7	40	3,620.8	21	1,672.6
1989	120	11,662.2	56	6,769.6	43	3,536.3	21	1,356.3
1990	119	8,737.1	58	5,551.6	43	2,549.2	18	636.3
1991	138	12,968.2	86	8,785.5	28	2,586.3	24	1,596.4
1992	142	15,912.0	89	11,171.1	30	2,772.8	23	1,968.1
1993	189	32,158.7	135	26,081.9	32	3,398.5	22	2,678.2
1994	226	44,306.0	175	38,812.0	29	2,502.7	22	2,991.3
1995	219	57,541.3	178	49,913.0	24	3,395.4	17	4,232.9
1996	199	88,776.3	166	78,302.0	20	4,778.6	13	5,695.8
1997	211	140,533.8	176	127,825.3	26	7,370.3	9	5,338.2
1998	210	138,301.4	173	126,904.5	28	6,480.7	9	4,916.2
1999	203	124,261.9	167	118,232.7	26	4,441.7	10	1,587.5
2000	189	138,715.4	158	134,431.0	22	1,632.0	9	2,652.4
2001	182	154,898.6	151	147,092.1	22	3,990.5	9	3,816.0
2002	176	161,937.3	149	151,271.5	20	7,146.4	7	3,519.4
2003	171	224,211.9	144	204,800.4	20	14,186.5	7	5,225.0
2004	193	307,894.7	153	275,291.0	33	25,964.3	7	6,639.4
2005	197	330,691.3	152	301,491.0	37	23,393.7	8	5,806.6
2006	183	438,071.1	138	400,741.4	38	29,195.3	7	8,134.3
2007	152	312,009.0	118	288,694.6	29	19,054.1	5	4,260.3
2008	136	191,651.0	113	176,237.7	20	14,280.5	3	1,132.9
2009	142	271,199.2	115	248,355.2	23	22,103.2	4	740.8
2010	153	389,295.4	126	358,908.2	27	30,387.2	–	–
2011	160	450,500.6	130	407,528.9	30	42,971.7	–	–
2012	172	603,415.3	139	544,414.9	33	59,000.3	–	–
2013	202	670,334.1	161	608,276.6	41	62,057.4	–	–
2014	216	907,425.5	177	846,410.3	39	61,017.2	–	–

The top ten US REITs by market cap: Diversity is the name of the game

1. Simon Property Group (NYSE: SPG)
2. Public Storage (NYSE: PSA)
3. HCP Inc. (NYSE: HCP)
4. Ventas Inc. (NYSE: VTR)
5. Equity Residential (NYSE: EQR)
6. Boston Properties, Inc. (NYSE: BXP)
7. ProLogis, Inc. (NYSE: PLD)
8. Vornado Realty Trust (NYSE: VNO)
9. AvalonBay Communities, Inc. (NYSE: AVB)
10. Health Care REIT, Inc. (NYSE: HCN)

…and REITs, now a distinct market sector, are joining the “big boys” with index funds and ETFs

Symbol	Name	Price	Change	Assets * ▼	Avg Vol	YTD
VNQ	Vanguard REIT ETF	$82.43	+1.74%	$27,393,949	4,855,023	+1.77%
IYR	iShares Dow Jones US Real Estate Index Fund	$78.10	+1.65%	$5,155,964	10,872,014	+1.64%
ICF	iShares Cohen & Steers Realty Majors Index Fund	$98.96	+1.69%	$3,512,891	379,653	+2.19%
RWR	SPDR Dow Jones REIT ETF	$92.22	+1.77%	$3,175,264	339,335	+1.45%
SCHH	Schwab U.S. REIT ETF	$39.57	+1.75%	$1,245,784	334,560	+1.59%
REM	iShares FTSE NAREIT Mortgage REITs Index Fund	$11.66	+0.78%	$1,177,248	1,037,026	-0.43%
FRI	First Trust S&P REIT Index Fund	$22.60	+1.71%	$338,855	260,129	+1.48%
REZ	iShares FTSE NAREIT Residential Index Fund	$60.65	+1.83%	$315,668	50,318	+2.95%
KBWY	PowerShares KBW Premium Yield Equity REIT Portfolio	$34.97	+1.95%	$128,588	28,135	-0.03%
MORT	Market Vectors Mortgage REIT Income ETF	$23.54	+0.90%	$114,268	39,466	-0.68%
ROOF	IQ US Real Estate Small Cap ETF	$27.34	+1.71%	$90,082	27,605	-0.55%
FTY	iShares FTSE NAREIT Real Estate 50 Index Fund	$47.56	+1.23%	$86,932	8,078	+0.61%
PSR	PowerShares Active U.S. Real Estate Fund	$73.77	+1.72%	$50,652	3,726	-0.89%
IFNA	iShares FTSE EPRA/NAREIT North America Index Fund	$57.51	+0.09%	$24,832	2,730	-1.69%
FREL	MSCI Real Estate Index ETF	$23.50	+1.47%	$21,964	25,336	n/a
WREI	Wilshire US REIT ETF	$46.09	+1.41%	$20,417	2,300	-0.50%

*** Assets in thousands of U.S. Dollars. Assets and Average Volume as of 2015-03-11 20:22:03 UTC**

Zell expects REIT consolidation in next 20 years

Billionaire investor Sam Zell says REITs with less than a “couple of billion” dollars of value aren’t relevant because they lack scale and don’t provide capital to the property market. (Bloomberg News file photo)

Billionaire investor Sam Zell, who helped to expand the industry of U.S. real estate investment trusts in the 1990s, said there are too many of the publicly traded property companies in the market.

REITs will consolidate over the next 20 years, Zell said in an interview Monday on Bloomberg Television’s “In the Loop” with Betty Liu. Those companies with less than a “couple of billion” dollars of value aren’t relevant because they lack scale and don’t provide capital to the property market, he said.

“If you don’t have that size you don’t have liquidity,” Zell said, adding that only about 30 REITs have the “size and scale” to have an impact on the market. Those larger REITs will lead real estate growth in the future, he said.

There are more than 200 publicly traded REITs in the U.S., according to data compiled by Bloomberg. Zell, 72, created companies including Equity Residential, now the largest publicly traded apartment landlord, and Equity Office Properties Trust, an office owner that was sold to Blackstone Group LP near the peak of the buyout boom in 2007 for about $39 billion.

Zell, who remains chairman of Chicago-based Equity Residential and Equity LifeStyle Properties Inc., another REIT he created, said he isn’t concerned that rising interest rates would hurt commercial or residential real estate.

“Interest rates going up will have a slight negative effect, not a catastrophic effect,” he said.

Zell said that stock markets are rebalancing after a 30 percent gain in the Standard & Poor’s 500 Index last year. The benchmark gauge has fallen 5 percent this year through Wednesday and about $3 trillion has been erased from the value of equities worldwide as China’s growth slows, the Federal Reserve scales back debt purchases and anti-government protests spread in emerging markets from Thailand to Ukraine.

“I don’t think declines are ever healthy, but balance is what keeps us in place and when we get out of balance, with subprime loans or whatever, it’s pretty disastrous,” Zell said.

But what is the US REIT market share? Is it increasing?

- US Equity REIT market cap = $833 billion
- At 48% average leverage, this implies asset values of ≈ $1.6 trillion
- Total value of all commercial real estate in the US as of beginning of 2010 ≈ $ 11.5 trillion
- Thus, REITs control approximately 1.6/11.5 or 14% of total US commercial real estate
- This has grown from approximately 5% 20 years ago

The takeaway:

- Although small relative to many other sectors and to the commercial real estate market today, REITs are growing at a more rapid rate than the market overall and are exploring new vehicles for growth
- Consolidation will continue to occur, but there are also new entrants. I have always disputed the notion of a purely “Big REIT World”

6. Will e-commerce cause the demise of retail REITs?

How much is e-retailing cutting into traditional space-based retailing? The view from Forrester Research

Forrester expects online retail sales in the US to reach $294 billion in 2014, or approximately **9% of all sales in the US**. We're forecasting a strong compound annual growth rate (CAGR) of 9.5% between 2013 and 2018 for US eCommerce, yielding approximately $414 billion in online sales by 2018. **By 2018, Forrester expects that online sales will account for 11% of total US retail sales**. The key drivers of growth in the online channel? The increased penetration of mobile devices, including tablets, and greater wallet share shift to the web channel from online buyers, all driven by rich web offers from online merchants.

Online retailing globally and by product sector

Online retail sales category breakdown for select countries

Region	Country	Consumer electronics and appliances	Apparel	Media, toys, and games	Food and drink	Furniture and homeware	Beauty and personal care	Home improvement and home care	Other[1]
World	World	25%	19%	12%	5%	4%	3%	2%	30%
North America	United States	21%	18%	13%	3%	4%	2%	1%	39%
Asia	China	52%	27%	3%	1%	1%	6%	0%	10%
	Japan	21%	18%	13%	12%	6%	6%	2%	22%
	South Korea	13%	12%	6%	3%	2%	3%	1%	59%
Western Europe	France	22%	16%	13%	11%	2%	4%	1%	31%
	Germany	27%	32%	16%	2%	7%	2%	2%	11%
	United Kingdom	10%	18%	20%	14%	4%	2%	2%	30%
Latin America	Argentina	31%	3%	4%	15%	2%	2%	1%	42%
	Brazil	50%	6%	10%	3%	2%	4%	1%	23%
	Chile	28%	1%	1%	9%	1%	2%	3%	54%
Eastern Europe	Russia	31%	21%	10%	3%	7%	3%	9%	16%
	Slovakia	35%	13%	3%	3%	1%	1%	0%	43%
	Turkey	22%	2%	9%	1%	3%	2%	2%	60%
Middle East	United Arab Emirates	83%	2%	3%	0%	0%	0%	0%	12%

[1]Other includes consumer healthcare products, tobacco products, pet food and pet care products, tissue and hygiene products, prescription drugs, sports equipment, watches, sunglasses, handbags, jewelry, antiques, souvenirs, collectibles, bicycles, candles, vases, picture frames, and pictures. Sales of services, subscriptions, travel and tourism, and tickets are excluded.

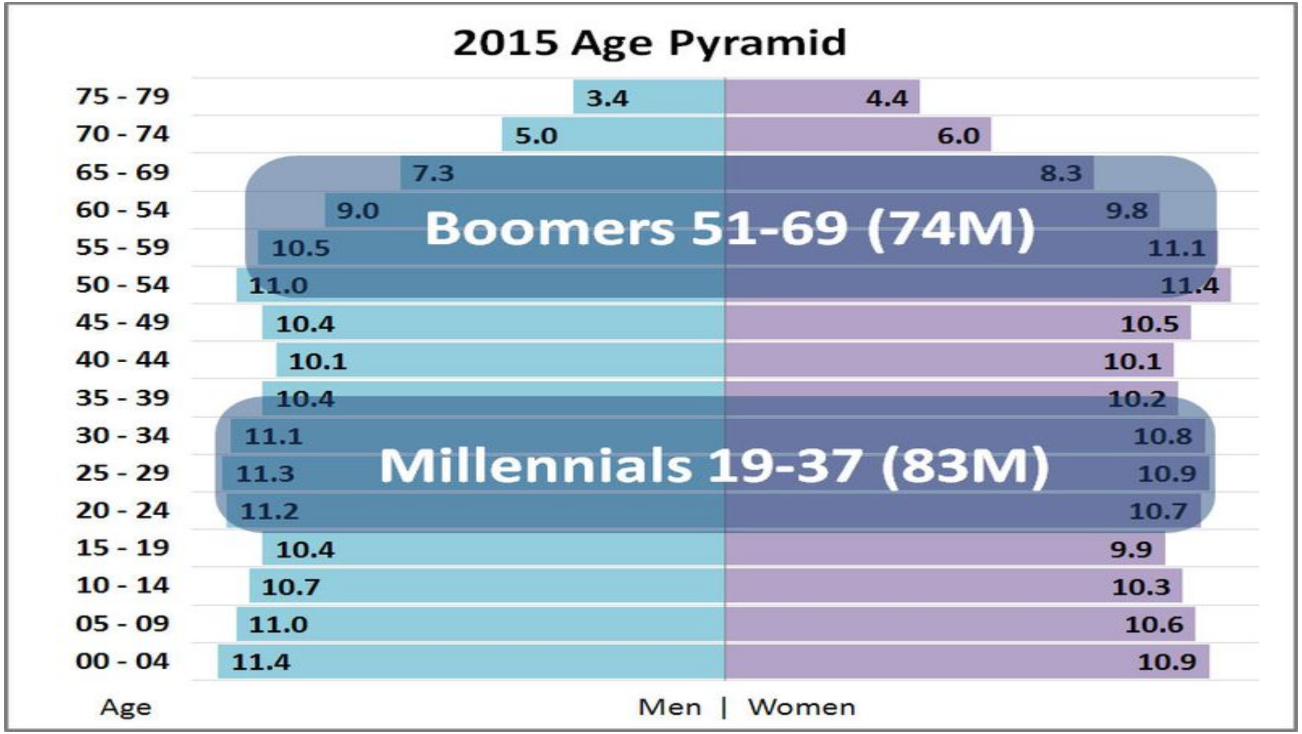
Source: Euromonitor

The takeaway:

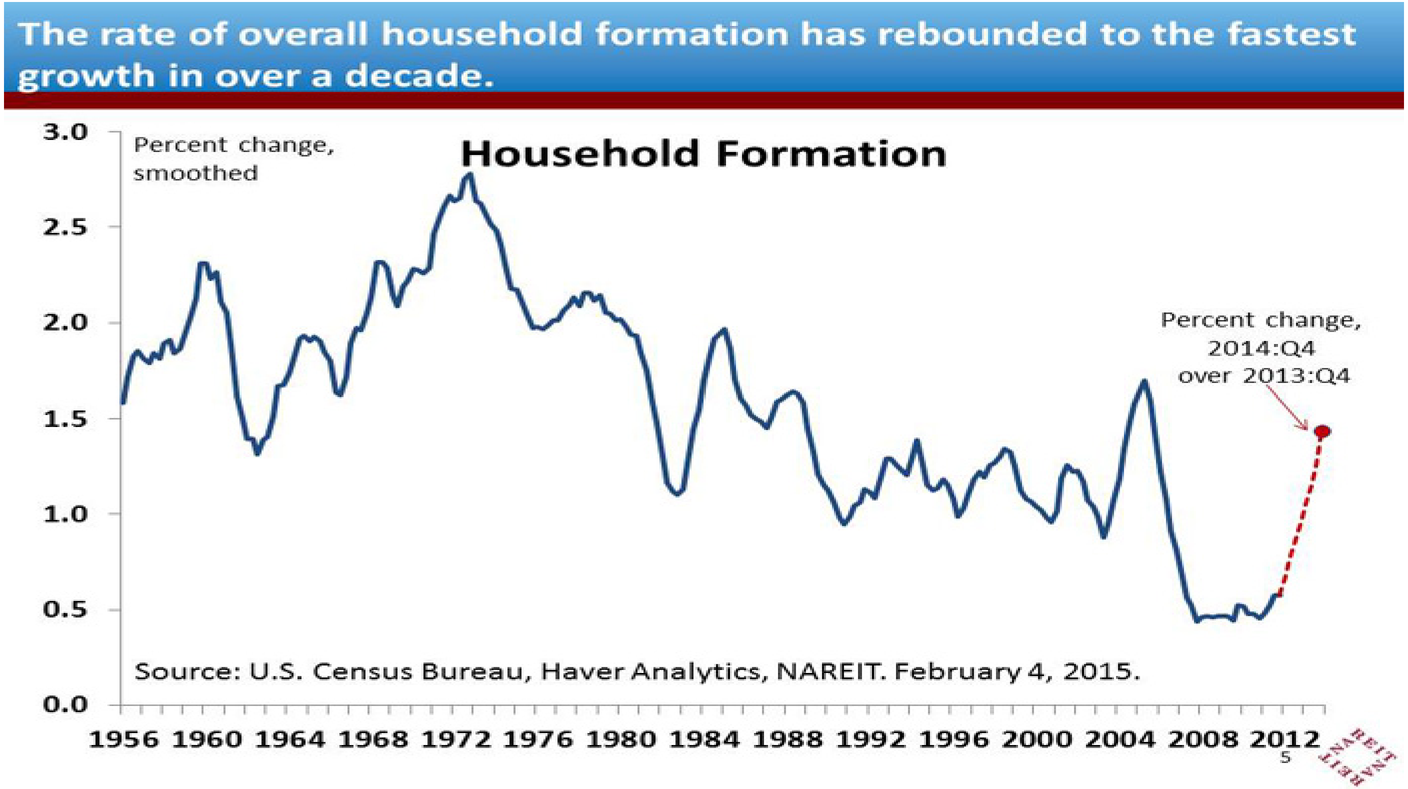
- E-commerce will continue to penetrate an increased share of retail sales, but this depends upon the product category
- Certain categories (e.g. music) will eventually reach 100% but others, like groceries, may have topped out
- My rough guest is eventual penetration of about 15-20%
- Incremental economic growth created by e-commerce will more than make up for lost space-based sales

7. The multifamily sector: Fortune or fade?

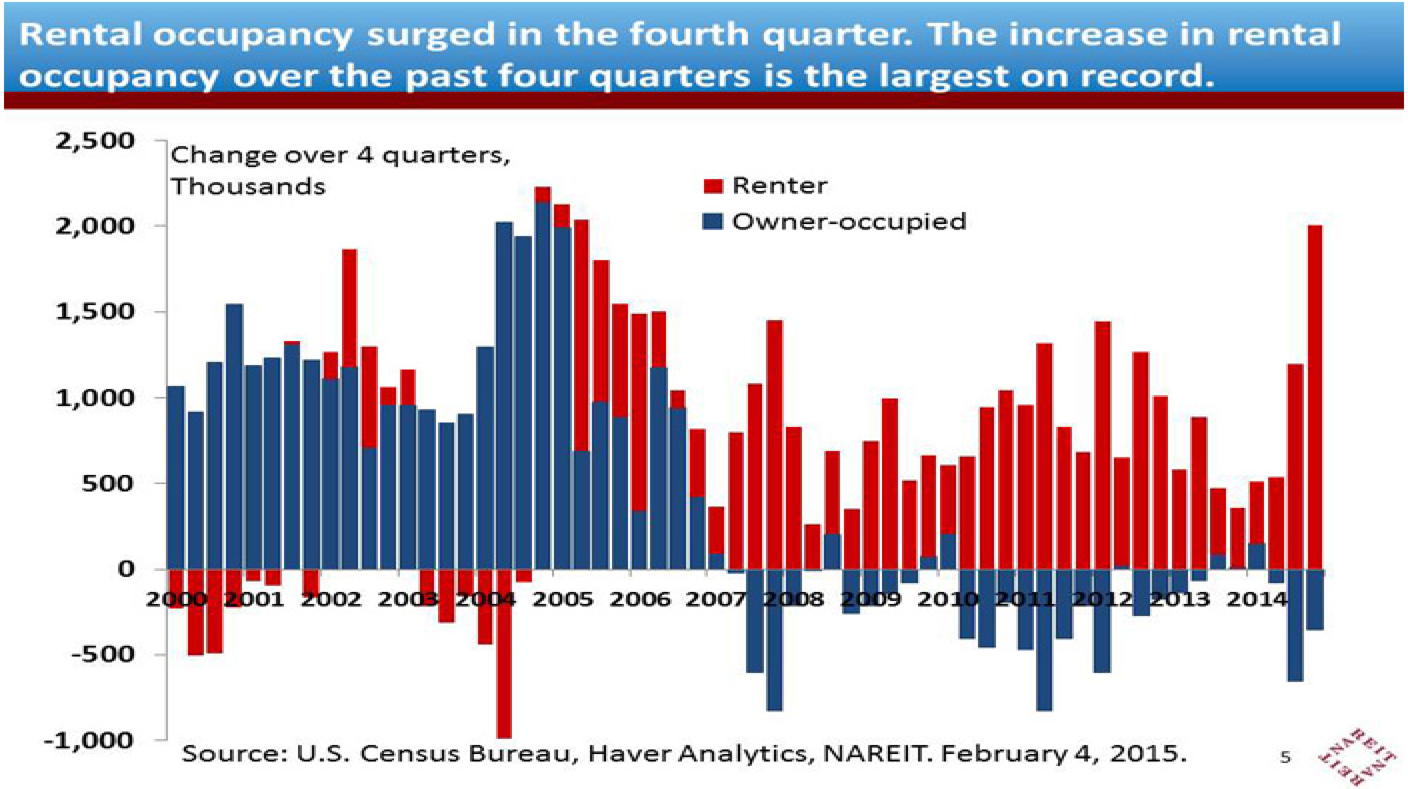
The demographics are certainly with multifamily



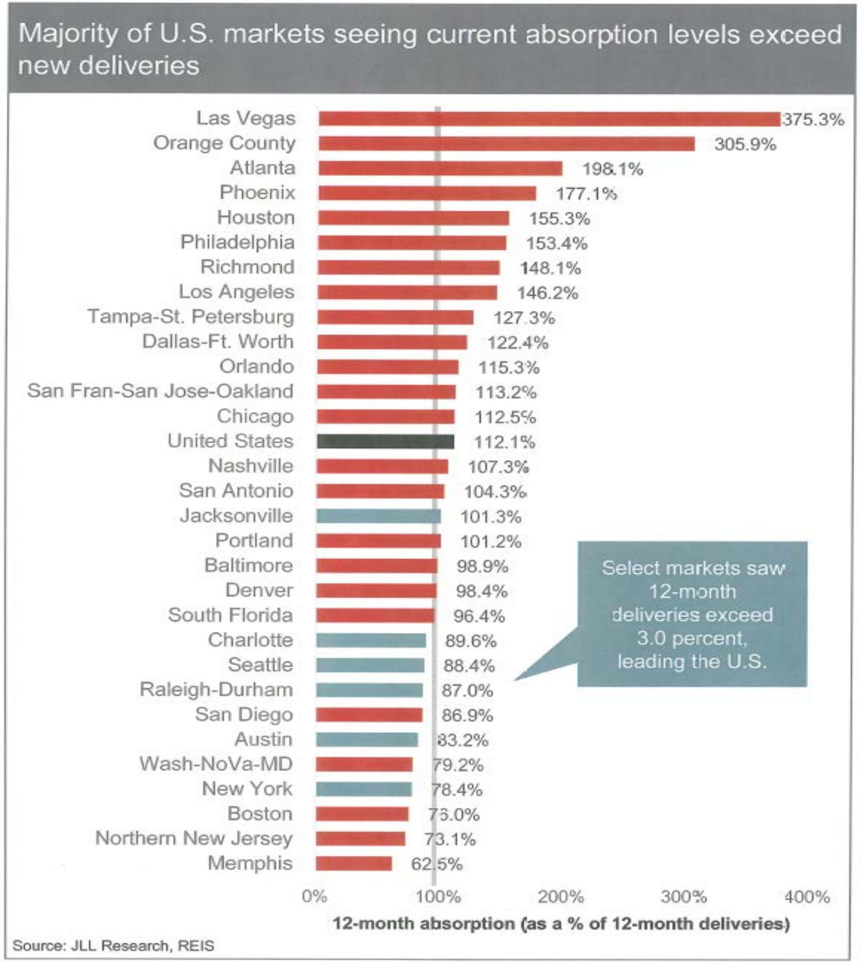
New household formation has suddenly taken off



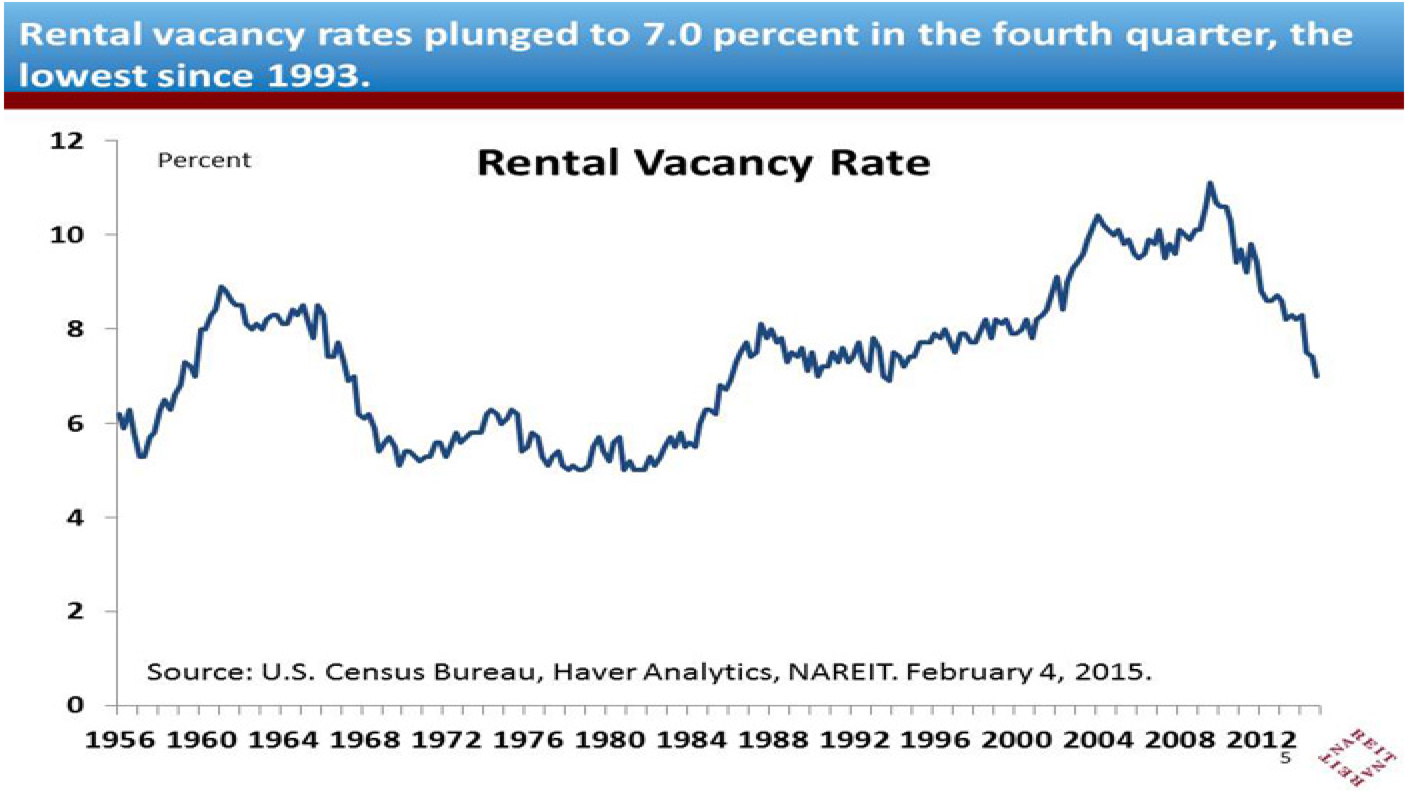
Rental occupancy is continuing to surge (while the number of homeowners declines)



Demand remains greater than new supply in most markets



…and vacancy rates continue to fall



…and are tightest in the bi-coastal markets (and Chicago and Denver)

Multifamily vacancy across the U.S.

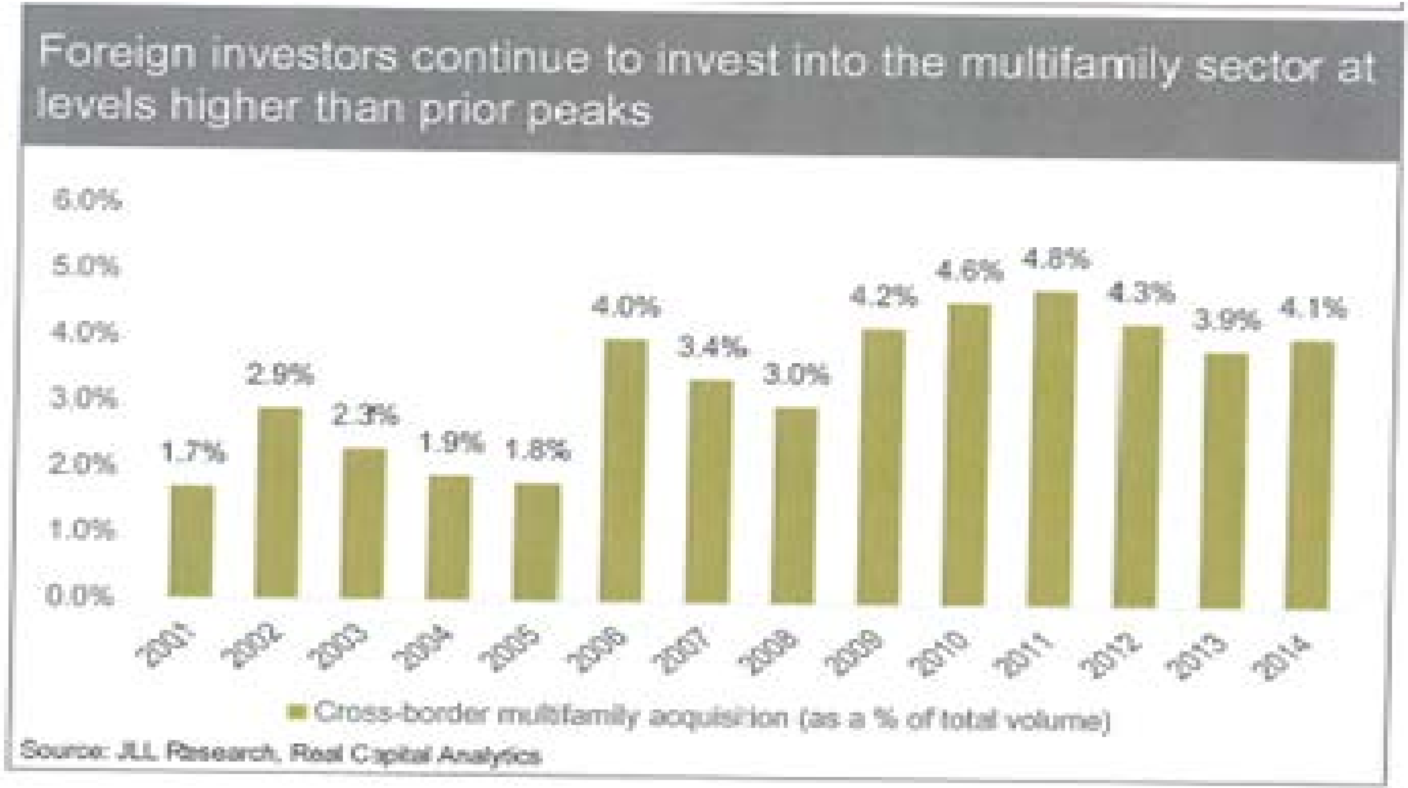
Vacancy meter
7.0% +
6.0% to 6.9%
4.0% to 5.9%
3.0% to 3.9%
< 3.0%

Top YOY rent growth	
San Fran-San Jose-Oakland	6.4%
Seattle	6.3%
Nashville	4.8%
Denver	4.7%
Houston	4.6%
South Florida	4.1%
Atlanta	4.1%
Boston	4.0%
Dallas-Ft. Worth	3.8%
New York	3.8%

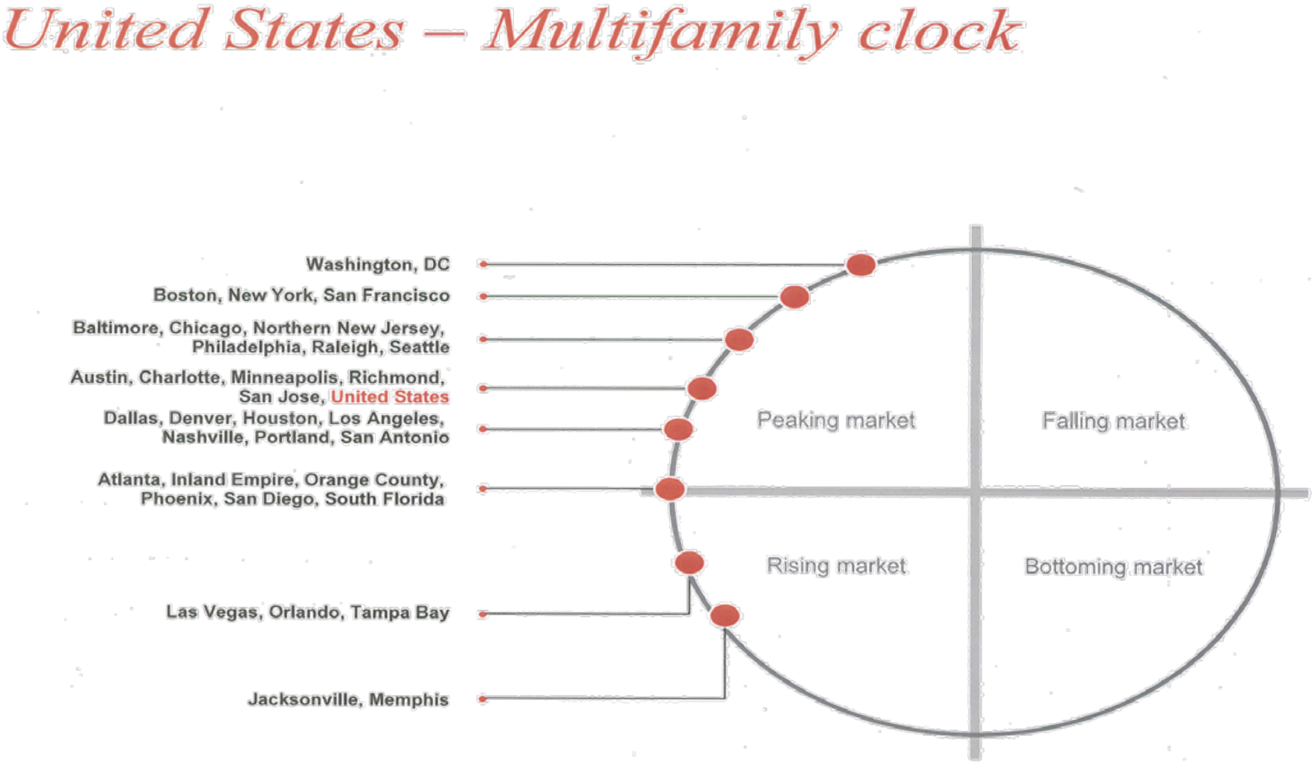
Top YOY occupancy growth	
Raleigh-Durham	3.3%
Austin	3.2%
Seattle	3.1%
Jacksonville	3.0%
San Antonio	3.0%
Charlotte	2.9%
Houston	2.9%
New York	2.6%
South Florida	2.3%
Dallas-Ft. Worth	2.3%

Source: REIS, JLL Research

Even foreign investors are getting into the act



The property clock says "things are looking good"…BUT



Financial Instruments Developments Meeting

Wednesday, April 1st
2:45pm – 4pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Andrew Corsini, Partner, KPMG LLP

Panelists:
Steven Broadwater, SVP & CAO, Simon Property Group, Inc.
Daniel Gentzel, Managing Director, Chatham Financial
Serena Wolfe, Partner, Ernst & Young
Stephen Yarad, CFO, MFA Financial, Inc.

No. 2014-08
13 March 2014

To the Point

FASB — proposed guidance

FASB sets path on changes to accounting for financial instruments

The FASB scaled back its proposal to overhaul the classification and measurement of financial instruments.

What you need to know

- The FASB tentatively decided to retain key elements of the current US GAAP approach to classifying and measuring debt securities and loans. Equity securities would be measured at fair value with changes in fair value recognized in net income, as the FASB proposed.
- The FASB confirmed that its proposed "current expected credit loss" model would be applied to financial assets that are debt instruments measured at amortized cost. Impairments on financial assets measured at fair value with changes in fair value recognized in other comprehensive income would follow a slightly different approach.
- In making these decisions, the FASB signaled that the US GAAP guidance on these topics will continue to differ from the guidance in IFRS.
- The FASB expects to issue a final standard in the second half of 2014.

Overview

The Financial Accounting Standards Board (FASB or Board) tentatively decided to retain the separate models in current US GAAP for classifying and measuring loans and debt securities, rather than overhaul its guidance in this area, as it had proposed in 2013. Equity securities would be measured at fair value with changes in fair value recognized directly in net income (FV-NI), as the FASB had proposed.

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The FASB also confirmed that companies would apply the current expected credit loss (CECL) model it has developed to financial assets measured at amortized cost. Financial assets measured at fair value with changes in fair value recognized in other comprehensive income (FV-OCI) would follow a slightly different approach. The FASB had proposed applying the CECL model to all debt instruments.

The decisions capped several months of redeliberations in which the FASB has moved away from its earlier effort to converge certain parts of financial instrument accounting between US GAAP and IFRS. Meanwhile, the International Accounting Standards Board is moving ahead with its proposals and expects to issue final guidance in the coming months.

This publication summarizes this week's FASB decisions and other key decisions the FASB has made in redeliberations.

Key decisions

Classification and measurement

The FASB tentatively decided to retain the current US GAAP classification and measurement models for loans and debt securities rather than require all financial assets to be classified and measured based on their contractual cash flow characteristics and an entity's business model for managing them, as it had proposed.

In doing so, the FASB acknowledged that concerns raised by preparers about the differences in how they manage portfolios of debt securities and loans could not be reconciled in a single model. For example, it would not be practical to restrict sales of loans measured at amortized cost in the same way as held-to-maturity debt securities because certain financial institutions need more flexibility to manage credit concentrations and exposures. The FASB also considered providing flexibility for sales of both debt securities and loans measured at amortized cost but decided against that approach.

Instead, the FASB decided that there would be no change to how companies classify and measure debt securities. Equity securities would be measured at FV-NI.

Companies would continue to measure loans at amortized cost if the loans are held for investment. There would be no change to the accounting for loans held for sale.

The FASB asked the staff to research how to resolve certain practice issues that arise in determining whether a debt instrument is a loan or a security for accounting purposes.

How we see it

While the FASB tentatively decided to require equity investments to be measured at FV-NI, we expect it will discuss at a future meeting whether to keep its proposals on the practicability exception for equity investments without readily determinable fair values and equity method investments held for sale.

Credit losses

Under the FASB's CECL model, a company's allowance for credit losses would represent its current estimate of contractual cash flows it does not expect to collect over the life of the debt instrument, taking into consideration the time value of money, the risk of loss, and reasonable and supportable forecasts.

While the FASB made a distinction between loans and debt securities in its latest decisions on classification and measurement, the Board decided that it was not necessary to make that distinction for credit losses. As such, the FASB confirmed that the CECL model would apply to all financial assets that are debt instruments measured at amortized cost (e.g., loans held for investment, held-to-maturity debt securities). The Board hasn't yet addressed whether the CECL model should be applied to trade and lease receivables and commitments to extend credit, as it had proposed.

The FASB also agreed that the CECL approach should be applied to financial assets measured at FV-OCI (i.e., available-for-sale debt securities) when the fair value of the debt security is below amortized cost. However, the allowance for credit losses would be limited to the difference between fair value and amortized cost (i.e., the net carrying value of the asset would not be less than fair value).

No expected credit losses would be recognized when the fair value of a debt instrument measured at FV-OCI is greater than or equal to amortized cost.

The FASB asked the staff to consider whether unit-of-account guidance for measuring expected credit losses (i.e., individual versus pooled assets) might be needed in light of the decision on financial assets measured at FV-OCI.

The FASB is moving ahead with its plan to have entities record lifetime expected credit losses.

How we see it

The Board's decisions don't resolve concerns raised by constituents about the recognition and measurement of credit losses for highly rated debt instruments. We believe the Board will discuss this issue at a future meeting.

Other recent decisions

Classification and measurement

The FASB previously decided:

- To retain existing guidance for bifurcating embedded derivative features from hybrid financial instruments
- Not to require a separate evaluation of the cash flow characteristics of (1) a host instrument from which an embedded derivative is bifurcated and (2) other financial assets that do not require bifurcation
- To allow an irrevocable fair value option for both hybrid financial assets and liabilities with embedded derivative features that require bifurcation

Credit losses

The FASB previously made the following decisions to clarify aspects of its CECL model:

- When considering how to incorporate forecasts into the estimate of cash flows not expected to be collected, a company would use historical average loss experience for future periods beyond which it can reasonably forecast.
- When estimating credit losses, a company would consider expected prepayments but would not consider expected extensions, renewals and modifications unless a troubled debt restructuring (TDR) with a borrower is reasonably expected.

- A company would not be able to apply the proposal's approach for purchased credit impaired debt instruments to purchased assets that are not credit impaired on the purchase date.
- The FASB rejected preparer feedback that the TDR classification would no longer be relevant. The FASB decided to require that if the basis adjustment resulting from a TDR causes an increase in the cost basis of the financial asset, then an equal and offsetting increase in the entity's allowance for credit losses would be recognized.

The Board also indicated it will provide implementation guidance that describes the factors that should be considered when adjusting historical loss experience for current conditions and reasonable and supportable forecasts.

What's next

We expect the FASB will redeliberate several other classification and measurement topics, including:

- Fair value option
- Practicability exception for equity investments without readily determinable fair values
- Equity method investments held for sale
- Nonrecourse financial liabilities
- Valuation allowances on deferred tax assets related to financial assets measured at FV-OCI

We also expect the Board to discuss several topics related to credit losses, including the recognition, measurement and presentation of market and/or credit losses when (1) an entity identifies a financial asset for sale or (2) it is more likely than not that the entity will be required to sell a financial asset before recovering its amortized cost basis.

The FASB expects to finish redeliberations in the coming months and issue a final standard in the second half of 2014.

No. 2015-04
22 January 2015

To the Point

FASB — proposed guidance

New guidance on classifying and measuring financial instruments is coming soon

The FASB has decided to retain the existing classification and measurement guidance for investments in debt securities and loans.

What you need to know

- The FASB has concluded redeliberations of its targeted amendments to the guidance for classifying and measuring financial instruments.
- Investments in equity securities would be measured at fair value through net income, unless they qualify for the proposed practicability exception.
- Changes in instrument-specific credit risk for financial liabilities that are measured under the fair value option would be recognized in other comprehensive income.
- Disclosure of the fair value of financial instruments measured at amortized cost would no longer be required for entities that are not public business entities.
- A final standard is expected to be issued in the second quarter of 2015. The FASB has not yet decided on an effective date.

Overview

The Financial Accounting Standards Board (FASB) has concluded redeliberations on its 2013 proposal[1] on classification and measurement of financial instruments and has tentatively decided to retain the existing guidance for financial assets and financial liabilities, except for investments in equity securities and financial liabilities that are measured under the fair value option. The FASB also decided to make other targeted amendments to certain disclosure requirements and other aspects of current US GAAP.

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The FASB's approach is a significant departure from the joint model it developed with the International Accounting Standards Board (IASB) and the final version of IFRS 9, *Financial Instruments*, which the IASB issued in July 2014. The FASB is expected to issue a final standard in the second quarter of 2015.

This publication summarizes the FASB's tentative decisions to date. The proposed disclosure requirements are summarized in the appendix.

Background

The FASB has been considering how to reduce complexity in the accounting for financial instruments since 2008. In May 2010, in response to the financial crisis, the FASB proposed[2] requiring greater use of fair value measurements. But the FASB backed away from that idea when many constituents objected. After jointly deliberating some issues with the IASB, the FASB issued the 2013 proposal that would have required all financial assets (regardless of legal form) to be accounted for based on their cash flow characteristics and the business model for managing them. The FASB abandoned that approach after constituents said it didn't achieve the FASB's objective of reducing complexity, choosing instead to make only targeted amendments to existing US GAAP.

Summary of proposed amendments

Investments in equity securities

Investments in equity securities that do not result in consolidation and are not accounted for under the equity method would be measured at fair value at the end of each reporting period, with the changes in fair value recognized directly in net income (FV-NI). Under existing US GAAP, the changes in fair value for equity securities that are designated as available-for-sale (AFS) are recorded in other comprehensive income (OCI). Eliminating the AFS classification for equity securities may make earnings more volatile for certain entities.

The FASB's guidance will differ significantly from IFRS.

A practicability exception would be available for investments in equity securities that don't have readily determinable fair values (i.e., cost method investments under current US GAAP). Entities would measure these investments at cost less impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for an identical investment or a similar investment of the same issuer.

The practicability exception would not apply to the following:

- A broker and dealer in securities that is subject to the guidance in Accounting Standards Codification (ASC) 940, *Financial Services — Brokers and Dealers*
- An investment company that is subject to the guidance in ASC 946, *Financial Services — Investment Companies*
- An investment in an equity security that qualifies for the practical expedient to estimate fair value in accordance with the ASC 820-10-35-59 (i.e., the net asset value practical expedient)

How we see it

We don't believe that entities will be required to perform exhaustive searches for observable price changes.

The FASB is expected to provide implementation guidance to help entities determine what constitutes a similar investment issued by the same issuer. It's not clear how much judgment will be required. Without any additional guidance, judgment would be required to determine whether the price of a preferred share (with a liquidation preference) should be considered an "observable price" when evaluating common shares (without a liquidation preference) issued by the same issuer, for example.

At each reporting period, an entity that uses the practicability exception to measure an investment in an equity security would be required to make a qualitative assessment of whether the investment is impaired.

If there is an indication that the investment is impaired (without considering whether the decline is other-than-temporary, as is the case under current US GAAP), the entity would be required to estimate the investment's fair value in accordance with ASC 820, *Fair Value Measurement*, and recognize an impairment loss in net income equal to the difference between the investment's carrying value and its fair value. The final standard will include impairment indicators that an entity should consider. This single-step model for assessing impairments is expected to accelerate recognition of losses in investments without readily determinable fair values.

Financial liabilities measured under the fair value option

For financial liabilities that are measured using the fair value option (FVO) election in ASC 825, *Financial Instruments*, the portion of the total fair value change caused by a change in instrument-specific credit risk would be presented separately in OCI. An entity may consider the portion of the total change in fair value that exceeds the amount resulting from a change in a base market rate (e.g., a risk-free interest rate) to be the result of a change in instrument-specific credit risk. This would be a significant change from current US GAAP, which requires the entire instrument's change in fair value to be recognized through earnings.

The proposal is expected to accelerate recognition of impairment losses in equity investments without readily determinable fair values.

The proposed guidance would allow entities to use other methods that they believe result in a more faithful measurement of the fair value change attributable to instrument-specific credit risk. Consistent application and disclosure of the alternative method used would be required.

Upon derecognition of the financial liability, the accumulated gains and losses due to changes in the instrument-specific credit risk would be reclassified from OCI to net income.

How we see it

For financial liabilities (including derivatives) that are required to be measured at FV-NI, the effect of an entity's own credit risk would continue to be reported in net income, resulting in continued earnings volatility resulting from changes in an entity's nonperformance risk.

Deferred tax assets

The remeasurement of a financial instrument at fair value generally creates a temporary difference between the reporting basis and the tax basis of the instrument under ASC 740, *Income Taxes*, because the tax basis generally remains unchanged. This difference requires recognition of deferred taxes. Unrealized losses can give rise to deferred tax assets (DTAs), which must be assessed for realizability. The FASB has tentatively decided that entities would make the assessment of the realizability of a DTA related to an AFS debt security in combination with the entity's other DTAs.

Currently, there are two acceptable methods for assessing the realizability of DTAs related to unrealized losses on AFS debt securities recognized in OCI. The FASB is proposing to eliminate the method that allows an entity to consider its intent and ability to hold debt securities with unrealized losses until maturity, akin to a tax planning strategy. Under that method, a valuation allowance wouldn't be necessary for DTAs on unrealized losses, even when significant negative evidence (e.g., recent cumulative losses) exists related to the realizability of other DTAs because the specific DTAs are expected to reverse as time passes.

Presentation and disclosure

The proposed guidance would change the disclosure requirements for financial instruments but would retain current US GAAP balance sheet presentation requirements. Entities would disclose all financial assets and liabilities grouped by both measurement category and form. Public business entities would continue to be required to disclose the fair value of financial assets and liabilities measured at amortized cost (except for current trade receivables and payables and demand deposit liabilities). In a significant change from current practice, nonpublic entities would no longer be required to disclose the fair value of financial instruments measured at amortized cost.

Transition and effective date

An entity would apply the guidance to all outstanding instruments and record a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which it becomes effective (i.e., a modified-retrospective approach), with two exceptions. The FASB tentatively decided that the new disclosure requirements and the practical expedient for recognizing and measuring nonmarketable equity securities would be effective prospectively. The FASB has yet to decide on an effective date for the proposed amendments.

Endnotes:

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[1] FASB Proposed Accounting Standards Update (ASU), *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, February 2013.

[2] FASB Proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, May 2010.

Appendix: Summary of proposed disclosure requirements

<table>
<tr><th>Instruments and features affected</th><th>Proposed disclosure requirements</th></tr>
<tr><td>Financial assets and financial liabilities</td><td>Entities would disclose in the notes to the financial statements all financial assets and financial liabilities grouped by measurement category (e.g., amortized cost, FV-NI) and form of financial assets (i.e., securities versus loans/receivables).</td></tr>
<tr><td>Financial assets and financial liabilities measured at amortized cost (except for receivables and payables due within one year and demand deposit liabilities)</td><td>A public business entity (PBE) would be required to disclose the fair value of financial assets and financial liabilities measured at amortized cost either parenthetically on the face of the balance sheet or in the notes to the financial statements.

A PBE would also be required to disclose the level of the fair value hierarchy (i.e., level 1, 2 or 3) within which the fair value measurement of financial instruments measured at amortized cost is categorized in their entirety.
Disclosure about the fair value of financial assets measured at amortized cost would be disaggregated into major categories (i.e., securities and loans/receivables) of those assets.
A PBE wouldn't be required to disclose the following information:
The method(s) and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of paragraph ASC 820-10-50-2(bbb).
A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period.

Non-PBEs would be exempt from disclosing the fair value of financial instruments measured at amortized cost.</td></tr>
<tr><td>Fair value measurements only for disclosure purposes</td><td>The exception in ASC 825 that allows entities to calculate fair values of certain financial instruments using an entry price notion rather than the exit price notion of ASC 820 would no longer be allowed.</td></tr>
<tr><td>Investments in equity securities without readily determinable fair values measured using the practicability exception</td><td>An entity would disclose the carrying amount of investments in equity securities measured using the practicability exception and the amount of adjustments made to the carrying amount due to observable changes and impairment charges during the reporting period.
An entity would not have to disclose the information that it considered in reaching the carrying amount and upward or downward adjustments resulting from observable price changes.</td></tr>
</table>

No. 2015-16
12 March 2015

To the Point

FASB — proposed guidance

FASB poised to make significant changes to credit impairment model

Entities would be required to recognize lifetime expected credit losses rather than incurred losses.

What you need to know

- The FASB substantially completed redeliberations on credit impairment and plans to issue a final standard that would apply to all entities, not just those in financial services.
- An entity would recognize an allowance for management's current estimate of lifetime expected credit losses for loans, trade receivables, held-to-maturity debt securities and certain other financial assets measured at amortized cost.
- Today's other-than-temporary impairment model for available-for-sale debt securities would be modified to require an allowance for credit impairment rather than a direct write-down, among other things.
- Entities would be required to make disclosures about the credit quality of certain financing receivables by year of origination (i.e., vintage). This would significantly expand the volume of disclosures.
- The Board will decide on an effective date after the staff prepares a draft of the final standard. We expect the FASB to issue a final standard in the second half of 2015.

Overview

The Financial Accounting Standards Board (FASB or the Board) has substantially completed redeliberations on new guidance that would significantly change how entities measure and recognize credit impairment for certain financial assets. Today's incurred loss model would be replaced with one that requires management to estimate all contractual cash flows that it does not expect to collect over the lives of loans and other debt instruments measured at amortized cost.

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The FASB also decided to change today's other-than-temporary impairment (OTTI) model[1] for available-for-sale (AFS) debt securities. Entities would no longer be required to consider certain factors when determining whether an impairment should be recognized. They also would be required to recognize an allowance for credit impairment rather than a direct reduction of a security's cost basis. As a result, entities could reverse credit impairments.

The FASB has been working on ways to improve the accounting for credit impairment since the financial crisis in 2008. Today's guidance was criticized for delaying recognition of credit impairments of financial assets and for providing multiple models that were too complex. The FASB initially worked with the International Accounting Standards Board (IASB) to develop new guidance but the Boards ultimately were unable reach a converged solution. The FASB's decisions on credit impairment differ significantly from the three-stage impairment model the IASB finalized as part of IFRS 9.[2]

This publication summarizes the FASB's tentative decisions to date. We expect the FASB to issue a final standard in the second half of 2015. The FASB hasn't yet decided on an effective date.

Summary of proposed amendments

Financial assets measured at amortized cost

An entity would apply what the FASB calls the "current expected credit loss" (CECL) model to most financial assets measured at amortized cost as well as certain other items.

Illustration 1 — Scope of FASB's CECL model

Items in scope	Items out of scope
‣ Loans, including those made to meet a not-for-profit entity's mission (e.g., programmatic loans) ‣ Held-to-maturity (HTM) debt securities ‣ Trade, lease and reinsurance receivables ‣ Loan commitments ‣ Financial guarantees that are not accounted for as insurance or at fair value through net income	‣ Related party loans and receivables between entities under common control ‣ Loans made to participants by defined contribution employee benefit plans ‣ Policy loan receivables of an insurance entity ‣ A not-for-profit entity's pledges receivable (i.e., promises donors have made)

Under the CECL model, an entity would reserve for all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit. The estimate of expected credit losses would consider all contractual cash flows over the life of the asset. The estimate would be developed based on historical loss experience for similar assets as well as management's assessment of current conditions and reasonable and supportable forecasts about the future.

Further, the FASB tentatively decided that an entity's estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. As a result, there would only be limited circumstances in which a reserve of zero would be appropriate.

The final standard would also eliminate the guidance in Accounting Standards Codification (ASC) 310-30[3] that applies to purchased credit-impaired (PCI) financial assets. Under the new model, an entity would recognize a CECL allowance for expected credit losses on a PCI asset it acquires (based on an estimate of expected contractual shortfalls, as described above), and the initial cost basis of the asset would equal the sum of (1) the purchase price and (2) the estimate of expected credit losses as of the date of acquisition. The subsequent accounting for PCI assets would be the same as for originated loans.

The final standard is also expected to include guidance addressing:

- Information that management would consider in determining expected credit losses
- How expected prepayments, extensions, renewals and modifications should be considered
- Estimation on a collective (pool) basis and estimation on an individual basis
- Reversion to historical averages for periods beyond which management is able to make or obtain a reasonable and supportable forecast about the future
- Collateral-based practical expedients for estimating expected credit losses
- Cost-basis adjustments resulting from troubled debt restructurings

How we see it

While the concept of the CECL model is relatively simple, entities may face significant implementation challenges, including:

- Obtaining historical lifetime credit loss data and developing appropriate models and methodologies to aggregate and analyze such information
- Developing reasonable and supportable forecasts about the future and determining how to adjust historical data to reflect this information

Once a final standard is issued, we would expect the FASB, the American Institute of Certified Public Accountants, US banking regulators and industry associations to be involved with efforts to try to help entities, particularly smaller ones, manage the complexity of implementation. We believe it is critical that broad consensus be reached about reasonable ways of implementing the standard before entities spend time and resources designing and implementing new methods and models.

Entities may face significant implementation challenges.

Available-for-sale debt securities

The FASB tentatively decided not to apply the CECL model to AFS debt securities. Instead, the FASB decided to modify the existing OTTI model in ASC 320-10. Under today's guidance, an entity first determines whether a security is impaired (i.e., whether its fair value is less than its amortized cost basis). An entity then evaluates whether an impairment is other- than-temporary based on whether (1) the entity intends to sell the security, (2) it is more likely than not that the entity will be required to sell the security before recovering its cost basis or (3) the entity does not expect to recover the entire amortized cost basis of the security by collecting all contractual cash flows (i.e., whether a credit loss exists).

Under the new guidance, an entity evaluating whether a credit loss exists would no longer be required to consider (1) the length of time that the fair value of the security has been less than its amortized cost or (2) recoveries or additional declines in the fair value after the balance sheet date.

How we see it

It's unclear whether the FASB intends to preclude an entity from considering either of these two factors when evaluating whether a credit loss exists or whether an entity would still be permitted to consider them. We expect the final standard to provide clarity on this point.

Further, the FASB decided that entities would recognize an allowance for OTTI credit losses rather than reduce their cost basis as they do today. The new approach would allow an entity to recognize reversals of OTTI credit losses, which would immediately reduce the provision for credit losses. Today, a recovery of an OTTI credit loss is recognized as interest income over time.

Disclosures

For AFS debt securities, the existing OTTI disclosure requirements would be retained, but they would be updated to reflect the Board's other decisions about AFS debt securities (e.g., the change to an allowance approach that permits reversals).

For financial assets measured at amortized cost, an entity would disclose information about its method for developing its allowance as well as changes in the factors that influenced management's estimate of expected credit losses and the reasons for those changes (e.g., change in loss severity). This would be consistent with what the FASB proposed in December 2012.[4]

For financing receivables[5] measured at amortized cost (excluding revolving lines of credit such as credit cards), disclosures about credit risk would be expanded significantly. Specifically, an entity would be required to disaggregate each credit quality indicator by year of the asset's origination (i.e., vintage) for as many as five annual periods. The FASB has directed its staff to perform outreach on the operability and usefulness of the vintage disclosures while the staff prepares a draft of the final standard. The FASB may reconsider the requirement based on this feedback.

Transition and effective date

An entity would apply the guidance by recording a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. The final standard would also include transition provisions for PCI assets and debt securities. The Board hasn't decided on an effective date but plans to do so after the staff prepares a draft of the final standard and addresses any issues that arise as a result.

Endnotes:

1 ASC 320-10, *Investments — Debt and Equity Securities.*

2 IFRS 9, *Financial Instruments,* July 2014.

3 ASC 310-30, *Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality*.

4 FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses (Subtopic 825-15),* issued 20 December 2012.

5 ASC 310-10, *Receivables*, defines a financing receivable generally as a financing arrangement that is both a contractual right to receive money (on demand or on fixed or determinable dates) and is recognized as an asset on the balance sheet, with certain exceptions.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 15, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2013-220, Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*

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 or the Board) on Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

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 U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

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1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT recommends that the FASB continue with its approach in the Proposal to provide companies with the ability to recognize and measure financial assets and financial liabilities based on a business model assessment. NAREIT commends the Board for working with the International Accounting Standards Board (IASB) (collectively, the Boards) in developing a mixed attribute model for the recognition and measurement of financial assets (*i.e.*, amortized cost, fair value through other comprehensive income, and fair value through net income) and financial liabilities (*i.e.*, amortized cost and fair value through net income). NAREIT has supported a mixed attribute model for financial instruments previously. For example, NAREIT recommended that the Board develop a mixed attribute model in its September 30, 2010 submission[2] regarding the FASB's Proposal on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

In NAREIT's view, a mixed attribute model would be consistent with the business models of companies that own and operate real estate, as well as companies that finance transactions involving real estate. These companies typically hold or issue financial assets and financial liabilities for collection or payment of contractual cash flows for principal and interest. We believe that the amortized cost method more accurately reflects this business strategy, rather than measuring these financial instruments at fair value implying that the intention is to trade financial instruments. In addition, for companies that hold mortgage backed securities for collection or payment of contractual cash flows for principal and interest or for sale, we believe that the fair value through other comprehensive income method appropriately reflects this business strategy. For financial instruments held for trading purposes, we agree with the Board that fair value through net income is a more appropriate method.

While NAREIT supports the FASB's mixed attribute model, we recommend the following enhancements to the Proposal:

- **Synchronize embedded derivatives guidance for financial assets with financial liabilities**
- **Eliminate the assessment for cash flows based solely on principal and interest**
- **Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models in allowing for the reversal of previously recorded impairment charges**

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[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.
[2] http://www.reit.com/~/media/Files/Policy/NAREITFinancialInstrumentsLetter1810-100.ashx

- **Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Synchronize embedded derivatives guidance for financial assets with financial liabilities

NAREIT contends that the Proposal, as written, creates asymmetry between financial assets and financial liabilities. While financial liabilities would continue to be evaluated for bifurcation of embedded derivatives, the corresponding embedded derivative guidance for financial assets would no longer exist. As a result, the *mere existence* of an embedded derivative in a financial asset, even if of quite limited magnitude, would cause the entire financial instrument to be subject to the cash flow characteristics and business model assessment to determine its classification and measurement. In NAREIT's view, this could result in different accounting treatment for economically similar arrangements.

Common investments amongst NAREIT's membership are debt investments, which may have embedded derivatives designed to remove uncertainty about future cash flows. NAREIT believes that to the extent that an embedded derivative *exists* in debt instruments, these instruments would fail the proposed cash flow characteristics test. Consequently, these investments would be measured at fair value with changes in value recognized in net income. Thus, NAREIT believes that it is not the existence of the derivative, but the function of the derivative that should matter. An instrument with an embedded derivative that is economically similar to an instrument that qualifies for amortized cost should be accounted for at amortized cost (*i.e.*, a single instrument). If an embedded derivative is not clearly and closely related to the host contract, it should be bifurcated and accounted for separately.

NAREIT recommends that the FASB retain existing embedded derivatives guidance for financial assets, which would create symmetry with financial liabilities. NAREIT does not believe that the current embedded derivative guidance for financial assets is broken. Currently, an embedded derivative is bifurcated and accounted for separately if it is not clearly and closely related to the host contract. Preparers account for the host contract separately from the embedded derivative, which is measured at fair value with changes in value recognized in net income. In this manner, changes in fair value are isolated to the embedded derivative only, as opposed to the entire financial asset as required by the Proposal.

Eliminate the assessment for cash flows based solely on principal and interest

NAREIT believes that the criteria to classify financial instruments at amortized cost are too restrictive. For example, many financial instruments that currently are held for the collection of cash flows and are therefore measured at amortized cost would be precluded from such classification under the Proposal. Additionally, financial assets with early redemption features could fail the assessment of cash flows based solely on principal and interest when acquired at a premium or discount. Another example is an investment in subordinated tranches of a mortgage securitization. In NAREIT's view, current U.S. GAAP that requires an embedded derivatives assessment more faithfully presents the underlying economics of the transaction. Therefore, NAREIT recommends that the FASB eliminate the assessment for cash flows based solely on principal and interest from the Proposal, and maintain existing embedded derivatives guidance for financial assets.

NAREIT also notes that the proposed cash flow test would *add* to complexity because the embedded derivative bifurcation rules would still be needed for financial liabilities. And no doubt, the proposed new test would lead to more questions and interpretation.

Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models that allow for the reversal of previously recorded impairment charges

NAREIT understands that the Proposal would eliminate current impairment guidance on other-than-temporary-impairments (OTTI) for equity investments not measured at fair value through net income. The new impairment model would be based on a qualitative assessment (*i.e.,* more likely than not) as to whether the carrying amount of the investment exceeds fair value.

While we welcome the simplified approach to recording impairment charges, we are concerned that the Proposal would only allow preparers to record downward adjustments and not reverse those losses in situations where the fair value of investments subsequently increases. With the benefit of hindsight, we could observe whether market downturns are sustained. To the extent that markets stabilize, we believe that an accounting model that allows for reversals of previously recorded impairment write-downs would more accurately reflect the financial position of a company. In our view, this symmetric accounting model would provide the best information to users of financial statements.

Further, NAREIT observes that the proposed impairment model is divergent from the models proposed by the FASB and the IASB in their respective Credit Impairment models. NAREIT notes that both the FASB and IASB Credit Impairment proposals allow for the reversal of previously recorded allowance for credit losses. In our view, providing companies with the ability to reverse previously recorded impairment write-downs would serve as an opportunity for the FASB to synthesize impairment guidance within U.S. GAAP with respect to financial instruments and achieve convergence with the IASB at the same time.

Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category

NAREIT understands that the Proposal would eliminate the concept of "tainting" from U.S. GAAP that occurs when a company sells financial instruments that are classified as held to maturity. Under the Proposal, the FASB indicates that such sales should be rare and infrequent. However, the Proposal does not articulate how many times such sales could occur. Nor does the Proposal indicate what the consequences are of executing sales from the amortized cost category. In order to reduce the possibility for improper sales from the amortized cost category, and work towards reducing situations whereby some companies might try to "game the system," NAREIT recommends that the FASB clearly articulate a threshold for sales (and the consequence of selling beyond this threshold) of financial assets that are classified in the amortized cost category.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[3] on the FASB's *Disclosure Framework* discussion paper, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.,* 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[4]) when compared with annual SEC financial reporting deadlines (*i.e.,* 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[5]). According to APB 28: *Interim Financial Reporting*, each interim period is an integral part (as opposed to a discrete part) of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

Other Comments

NAREIT notes that in the FASB's consequential amendments document, hedge accounting for interest rate risk is not permitted for debt securities measured at amortized cost, but apparently is permitted for loans measured at amortized cost. NAREIT found this difficult to understand given that the Proposal overall treats securities and loans in the same manner. NAREIT believes hedge accounting should be permitted for both loans and securities which would be consistent with good treasury risk management practices (*e.g.,* see paragraph 825-10-55-73 in the Proposal).

NAREIT observes that the proposed held-for-sale criteria for equity method investments may be interpreted very broadly. We are concerned that this may result in certain investments being inappropriately reported at fair value through net income, which may be contrary to the Board's intention. For example, investments reported under the equity method of accounting (*e.g.,* investments in joint ventures, partnerships and limited liability companies) might be considered held-for-sale investments simply because (1) the underlying arrangements may contain explicit or implied end/termination dates or (2) management often considers a wide range of exit plans depending on future developments over a long time horizon. NAREIT does not believe this result would represent the most useful financial reporting and questions whether or not the Board intended this result.

[3] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[4] http://www.sec.gov/answers/form10q.htm

[5] http://www.sec.gov/answers/form10k.htm

In summary, we urge the FASB and the IASB to remain committed on their convergence efforts. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

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 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

REIT Wise®

March 31- April 2
2015

NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Concurrent Session 1:
Financial Instruments Developments

April 1, 2014 2:45pm – 4:00pm

Presenters

Moderator:
Andrew Corsini, Partner, KPMG LLP

Panelists:
Steven Broadwater, SVP & CAO, Simon Property Group, Inc.
Daniel Gentzel, Managing Director, Chatham Financial
Serena Wolfe, Partner, EY
Stephen Yarad, CFO, MFA Financial, Inc.

FASB’s Financial Instruments project

Classification and Measurement

Building a better
working world

Classification and measurement

Background

- FASB issued a revised ED on classification and measurement in February 2013
  - FASB and IASB jointly deliberated selected aspects of their classification and measurement models
  - FASB's proposal and IASB's amendments to IFRS 9 would require entities to classify and measure their financial assets by applying a cash flow characteristics test and a business model test
- Redeliberations
  - FASB decided not to pursue the February 2013 proposed model and instead make only targeted amendments to existing US GAAP
- The FASB has not yet decided on an effective date
- Final standard is expected by the end of Q2 2015

Classification and measurement

Proposed changes to existing US GAAP

- Investments in equity securities (not accounted for under the equity method) would be measured at FV-NI
  - Practicability exception for investments in equity securities without readily determinable fair values
    - Measurement would be at cost less impairment, adjusted for observable price changes for an identical or similar investment of the same issuer
- Changes in instrument-specific credit risk for financial liabilities (that are measured under the fair value option) would be recognized in OCI
- Valuation allowances on deferred tax assets related to debt securities classified and measured at FV-OCI would be evaluated in combination with an entity's other deferred tax assets

Classification and measurement

Proposed changes to existing US GAAP (cont'd)

- Disclosure of the fair value of financial instruments measured at amortized cost would no longer be required for entities that are not public business entities
- Exception to measure the fair value of loans receivable for disclosure purposes on an entry price notion would be eliminated
- Transition
  - Modified-retrospective approach, with two exceptions. The FASB tentatively decided that the new disclosure requirements and the practical expedient for recognizing and measuring nonmarketable equity securities would be effective prospectively.

Classification and measurement

Existing US GAAP would be retained

- Classification and measurement models for loans and debt securities
- Accounting for equity method investments
- Guidance for bifurcating embedded derivatives from hybrid financial instruments
- Guidance for financial liabilities not measured under the FVO
- Unconditional fair value option
- Classification and measurement of lender loan commitments
- Accounting for unrealized foreign currency gains and losses on available-for-sale debt securities
- Balance sheet presentation

What does this mean for REITs?

- Proposed model is substantially consistent with current US GAAP
- REITs with large equity security holdings will experience increased income (and FFO) volatility
- REITs that have elected FVO for assets and liabilities will no longer have ‘symmetry’ in the income statement

Financial Instruments - Hedging

Topics for discussion

- Project background
- Potential changes and the impact on REITs
- Timing

Financial Instruments - Hedging

Project background

- 2008 Exposure Draft
- 2010 Proposed ASU
- IFRS 9
- Current project

Financial Instruments - Hedging

Potential changes and the impact on REITs

- FASB conducting research in certain areas
  - Risks permitted to be hedged
  - Effectiveness threshold
  - Effectiveness assessment
  - Ineffectiveness measurement
  - Presentation and disclosure
  - Hedge relationship documentation
  - Voluntary dedesignation

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Risks permitted to be hedged
  - Currently permitted risks
    - Benchmark interest rate (i.e. US Treasury, LIBOR, & Fed Funds)
    - Foreign currency
    - Credit
    - Overall changes

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Risks permitted to be hedged (continued)
  - Potential changes to permitted risks
    - Financial and non-financial component hedging
    - Changes to benchmark interest rate definition
    - Introduction of “contractually specified” concept
    - Separately identifiable & reliably measureable unlikely to be included
  - Impact
    - Expansion of risks permitted to be hedged
    - Not quite as expansive as the IASB model in IFRS 9
    - Easier to hedge SIFMA, Prime, and commodity exposures

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Effectiveness threshold
  - Current threshold – highly effective (80%-125% offset)
  - Potential changes to threshold
    - Non-financial risk – may become reasonably effective or stay at highly effective (depending on outcome of component hedging decision)
    - Financial risk – may continue to be highly effective
  - Impact
    - Minor impact on interest rate hedging
    - Commodity hedging relationships become more likely to qualify
      - Significant ineffectiveness could still exist depending on nonfinancial risk exposure permitted to be hedged

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Effectiveness assessment
  - Currently perform at inception and ongoing basis (at least quarterly)
  - Potential changes
    - Short-cut and critical terms match methods may go away
    - Quantitative assessment at inception & qualitative assessment thereafter
    - Quantitative assessment necessary if changes to critical terms of hedging relationship occur
  - Impact
    - Effectiveness assessments should become easier to administer over time, except in situations where critical terms are likely to change (e.g. forward hedging of debt issuances)
    - Ineffectiveness still needs to be measured in each hedging relationship

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Ineffectiveness measurement
  - Currently
    - Fair value hedges – all ineffectiveness recognized
    - Cash flow hedges – cumulative overhedged amount recognized
  - Potential changes
    - Fair value hedges – no changes expected
    - Cash flow hedges – over and under hedged amounts recognized
  - Impact
    - Recognize ineffectiveness on <u>over and under</u> hedged amounts

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Presentation and disclosure
  - Expanded disclosure
  - Rollforward of hedging activity
  - Impact
    - Greater transparency of where hedging related amounts are presented in financial statements

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Hedging relationship documentation
  - Considering simplified/relaxed requirements
  - Could be less punitive than current practice
  - Impact
    - Possibly more time to complete documentation
    - Goal to “get it right” rather than “receive the death penalty”

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Voluntary dedesignation
  - Voluntary dedesignation is currently permitted
  - Proposal could prohibit voluntary dedesignation
  - Impact
    - Less flexibility to manage hedge portfolio

Financial Instruments - Hedging

Timing

- Next steps in the current project
    - Continue research efforts
    - Prepare and expose amendments
    - Issue ASU
    - Effective ASU

FASB's Financial Instruments project

Credit loss model

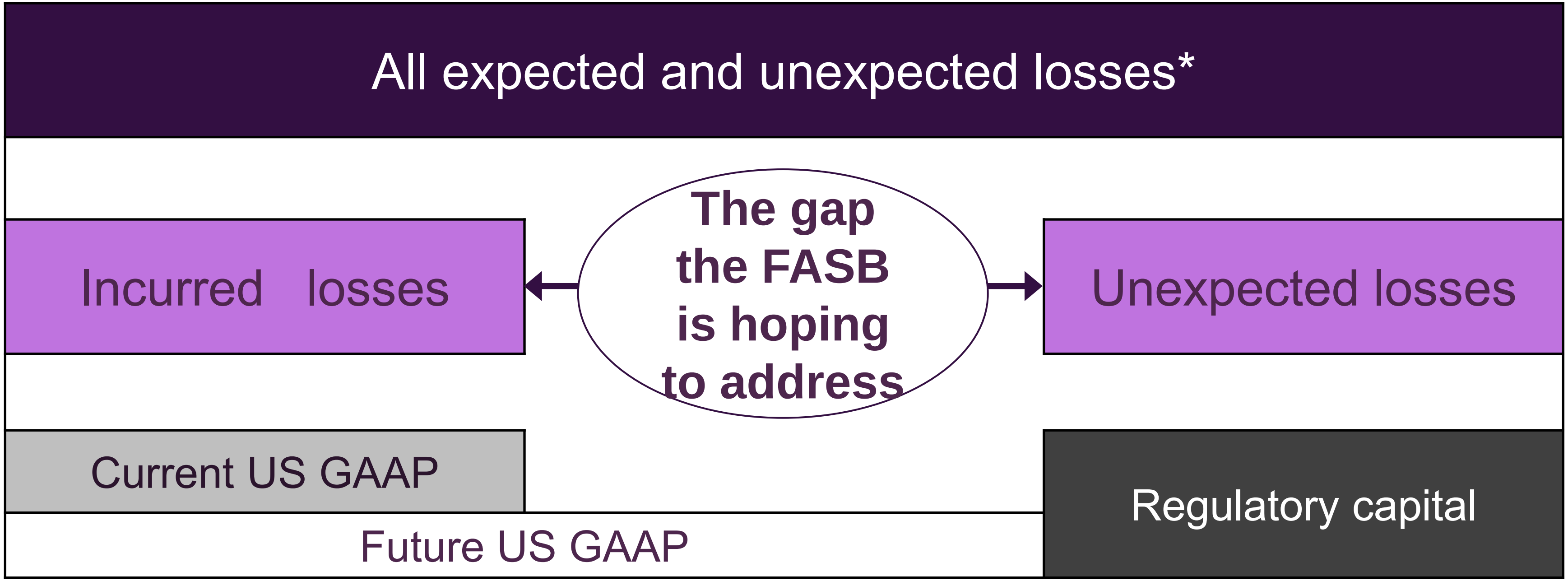
Building a better working world

FASB's Current expected credit loss model

Background

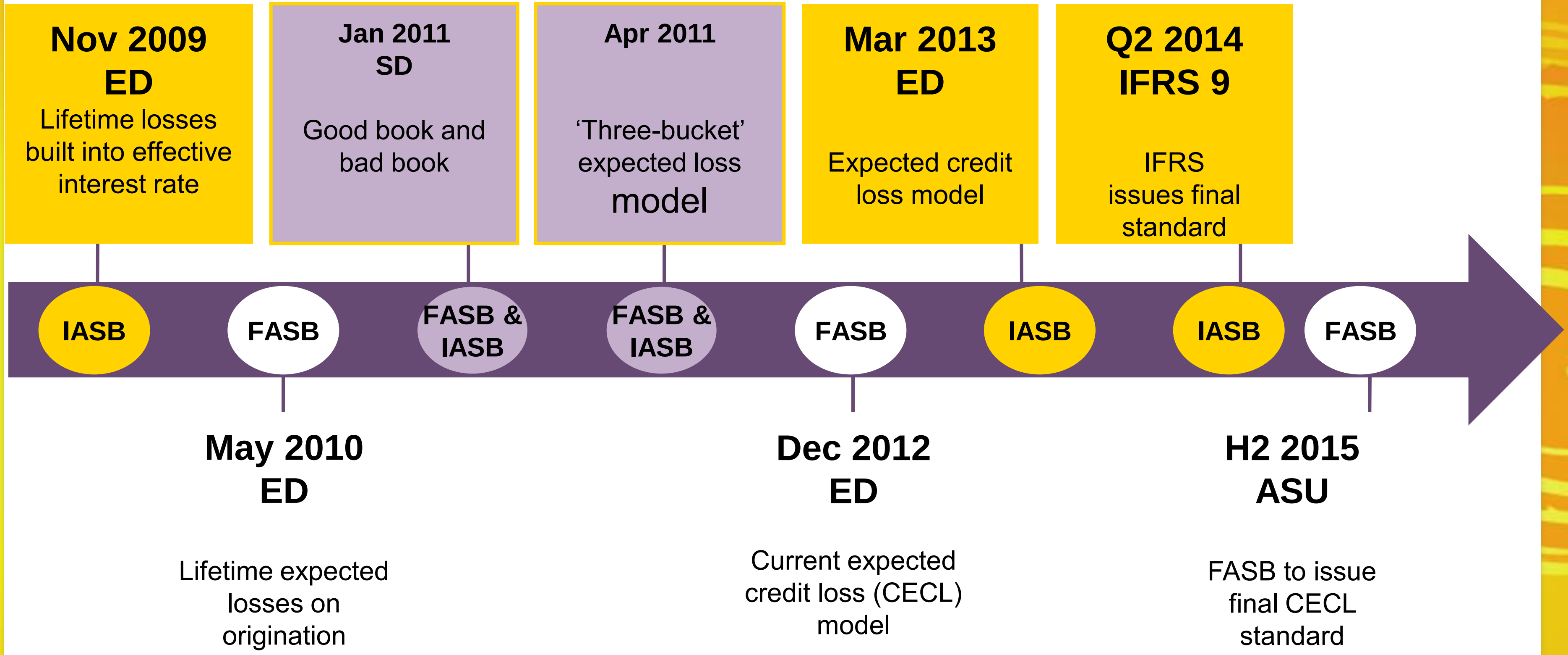
- Financial Crisis Advisory Group organized by FASB and IASB in October 2008
  - Consider how improvements in financial reporting could help enhance investors' confidence in financial markets
- Primary weaknesses identified
  - Delayed recognition of losses associated with loans and other financial instruments
  - Complexity of multiple impairment approaches
- Recommended that the Boards explore an alternative to the incurred loss model that would use forward-looking information

Expected credit losses
The concept



*This diagram is **not** drawn to scale.

The credit impairment journey



Scope

- Entities would apply the proposal to financial assets including:

Debt instruments recognized at amortized cost
(Loans, held-to-maturity debt securities, trade and reinsurance receivables)

Lease receivables recognized by lessors

Loan commitments

Proposal
CECL Model
(to replace ASC 310-10, 310-30, 320-10, & 450-20)

Available-for-sale debt securities

Proposal
Retain current US GAAP
(with modifications to ASC 320-10)

Available-for-sale debt securities

- Today's other-than-temporary impairment (OTTI) model would continue to be applied to available-for-sale (AFS) debt securities with some modifications:
  - An allowance would be used to recognize the credit portion of an OTTI, so an entity would recognize reversals of those losses immediately upon improvement in credit quality
  - When assessing OTTI, an entity would no longer consider:
    - The length of time that the fair value of the AFS debt security has been less than its amortized cost basis
    - Recoveries or additional declines in the fair value of the AFS debt security after the balance sheet date

Current expected credit loss model
As proposed (December 2012 ED)

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

At least two possible outcomes, one of which reflects a credit loss

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events	Information about current conditions	Reasonable and supportable forecasts

Time value of money

FASB removed the multiple outcomes approach;
a probability-weighted analysis of scenarios not required

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

For periods beyond which the entity is able to obtain reasonable and supportable forecasts, the entity would revert to its unadjusted historical credit loss experience

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events	Information about current conditions	Reasonable and supportable forecasts

Time value of money

Acceptable methods and models include: discounted cash flow, loss rate, probability of default and loss given default, provision matrices

Current expected credit loss model
Other clarifications

- Unit of measurement: measure credit losses on a collective (pool) basis when similar risk characteristics exist
  - Measure credit losses on an individual financial asset basis only when that asset does not share similar risk characteristics with other financial assets of the entity

- Collateral-based practical expedients for subsequent measurement of expected losses include:
  - For a collateral-dependent financial asset, measure CECL allowance as the difference between the collateral’s fair value (adjusted for selling costs, when applicable) and the amortized cost basis of the asset
  - For a financial asset in which the borrower must continually adjust the amount of collateral securing the financial asset, limit the CECL allowance to the difference between the collateral’s fair value (adjusted for selling costs) and the amortized cost basis of the asset

Current expected credit loss model
Other clarifications (continued)

- All contractual cash flows should be considered
  - The full contractual term of the financial asset, adjusted for expected prepayments
  - Expected extensions, renewals and modifications would not be considered unless the entity reasonably expects to execute a troubled debt restructuring with the borrower
- For the funded portion of loan commitments, expected credit losses should be estimated in the same manner as for other loans
  - Expected credit losses for unfunded loan commitments should reflect the full contractual period over which the entity is exposed to credit risk via a present legal obligation to extend credit, unless unconditionally cancellable by the issuer
- Areas for which FASB decided to retain current US GAAP
  - Write off when the financial asset is deemed uncollectible (also applicable to AFS debt securities)
  - Nonaccrual practices

Current expected credit loss model
Practical considerations

- Lenders would need to develop estimation techniques that aim to faithfully estimate lifetime expected credit losses

- Unit of measurement
  - FASB's proposal was drafted with a pooled view, however, a bank would be permitted to measure credit losses on an individual financial asset basis only when that asset does not share similar risk characteristics with other financial assets of the entity
  - Measuring credit losses for individual loans
    - Use of fair value would not be permitted as a practical expedient
    - Requirement to use collateral when foreclosure is probable would be removed
    - Proposal would change definition of collateral-dependent
      - A financial asset for which the repayment is expected to be provided primarily or substantially through the operation (by the lender) or sale of the collateral, based on an entity's assessment as of the reporting date

Current expected credit loss model
Practical considerations (continued)

- Unit of measurement
  - Measurement of credit losses for pools of loans
    - Are companies considering the need for new or different modelling techniques or approaches to achieve the lifetime loss objective?
    - If not, what changes to current modelling techniques may be needed to capture the movement from incurred to lifetime expected losses
    - Commercial versus consumer loans
      - Different product lines for consumer loans (residential vs. credit cards)
    - Modelling assumptions
      - Policy elections
      - Estimation judgments
  - Measurement of credit losses for unfunded loan commitments
- Data needs and availability

Current expected credit loss model
Purchased credit impaired financial assets

- Current guidance for so-called purchased credit-impaired (PCI) financial assets (SOP 03-3) would be replaced with a “gross up” model
  - Recognize a CECL allowance for expected credit losses on PCI assets
  - Initial cost basis of the asset would equal the sum of (1) the purchase price and (2) the estimate of expected credit losses as of the date of acquisition
  - Subsequent accounting for PCI assets would be the same as other originated loans
- Example:

Assume Company A acquires a debt instrument with the following characteristics:

- Par amount of $100,000
- Purchase price of $80,000 (the instrument has experienced significant deterioration in credit quality since origination)
- Expected credit loss embedded in the $20,000 discount to par is determined to be $15,000

Journal entry at purchase:

Debt instrument (par amount)	100,000	
Debt instrument (noncredit discount)		5,000
Allowance for expected credit losses		15,000
Cash		80,000

- Non-credit discount of $5,000 would be accreted into interest income over the life of the instrument under ASC 310-20
- Allowance would be remeasured each reporting period

What does this mean for REITs?

- Significant impacts expected, particularly for MREITs and Equity REITs that invest in structured products
- Accounts Receivable and Lease Receivables would be in scope therefore proposed changes could be a ‘sleeper’ issue for Equity REITs
  - Change in reserves unlikely to be material but could have significant process and controls implications
- Many implementation issues remain
  - Little additional guidance provided during redeliberations
  - How to apply to high credit quality debt securities i.e. Treasuries vs. Agencies
  - Proposed accounting for purchased credit impaired financial assets could create volatility in comparison to current GAAP

Current expected credit loss model
The path forward

- Significant matters to be discussed at future meetings:
  - Transition (expect to be discussed in March 2015)
  - Effective date (to be discussed once a staff draft of the final standard has been prepared)
- We anticipate the FASB will reach final decisions in the first half of 2015 and issue a final standard in the second half of 2015

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 15, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2013-220, Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*

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 or the Board) on Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

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 U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT recommends that the FASB continue with its approach in the Proposal to provide companies with the ability to recognize and measure financial assets and financial liabilities based on a business model assessment. NAREIT commends the Board for working with the International Accounting Standards Board (IASB) (collectively, the Boards) in developing a mixed attribute model for the recognition and measurement of financial assets (*i.e.*, amortized cost, fair value through other comprehensive income, and fair value through net income) and financial liabilities (*i.e.*, amortized cost and fair value through net income). NAREIT has supported a mixed attribute model for financial instruments previously. For example, NAREIT recommended that the Board develop a mixed attribute model in its September 30, 2010 submission[2] regarding the FASB's Proposal on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

In NAREIT's view, a mixed attribute model would be consistent with the business models of companies that own and operate real estate, as well as companies that finance transactions involving real estate. These companies typically hold or issue financial assets and financial liabilities for collection or payment of contractual cash flows for principal and interest. We believe that the amortized cost method more accurately reflects this business strategy, rather than measuring these financial instruments at fair value implying that the intention is to trade financial instruments. In addition, for companies that hold mortgage backed securities for collection or payment of contractual cash flows for principal and interest or for sale, we believe that the fair value through other comprehensive income method appropriately reflects this business strategy. For financial instruments held for trading purposes, we agree with the Board that fair value through net income is a more appropriate method.

While NAREIT supports the FASB's mixed attribute model, we recommend the following enhancements to the Proposal:

- **Synchronize embedded derivatives guidance for financial assets with financial liabilities**

- **Eliminate the assessment for cash flows based solely on principal and interest**

- **Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models in allowing for the reversal of previously recorded impairment charges**

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.
[2] http://www.reit.com/~/media/Files/Policy/NAREITFinancialInstrumentsLetter1810-100.ashx

- **Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Synchronize embedded derivatives guidance for financial assets with financial liabilities

NAREIT contends that the Proposal, as written, creates asymmetry between financial assets and financial liabilities. While financial liabilities would continue to be evaluated for bifurcation of embedded derivatives, the corresponding embedded derivative guidance for financial assets would no longer exist. As a result, the *mere existence* of an embedded derivative in a financial asset, even if of quite limited magnitude, would cause the entire financial instrument to be subject to the cash flow characteristics and business model assessment to determine its classification and measurement. In NAREIT's view, this could result in different accounting treatment for economically similar arrangements.

Common investments amongst NAREIT's membership are debt investments, which may have embedded derivatives designed to remove uncertainty about future cash flows. NAREIT believes that to the extent that an embedded derivative *exists* in debt instruments, these instruments would fail the proposed cash flow characteristics test. Consequently, these investments would be measured at fair value with changes in value recognized in net income. Thus, NAREIT believes that it is not the existence of the derivative, but the function of the derivative that should matter. An instrument with an embedded derivative that is economically similar to an instrument that qualifies for amortized cost should be accounted for at amortized cost (*i.e.*, a single instrument). If an embedded derivative is not clearly and closely related to the host contract, it should be bifurcated and accounted for separately.

NAREIT recommends that the FASB retain existing embedded derivatives guidance for financial assets, which would create symmetry with financial liabilities. NAREIT does not believe that the current embedded derivative guidance for financial assets is broken. Currently, an embedded derivative is bifurcated and accounted for separately if it is not clearly and closely related to the host contract. Preparers account for the host contract separately from the embedded derivative, which is measured at fair value with changes in value recognized in net income. In this manner, changes in fair value are isolated to the embedded derivative only, as opposed to the entire financial asset as required by the Proposal.

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NAREIT also notes that the proposed cash flow test would *add* to complexity because the embedded derivative bifurcation rules would still be needed for financial liabilities. And no doubt, the proposed new test would lead to more questions and interpretation.

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While we welcome the simplified approach to recording impairment charges, we are concerned that the Proposal would only allow preparers to record downward adjustments and not reverse those losses in situations where the fair value of investments subsequently increases. With the benefit of hindsight, we could observe whether market downturns are sustained. To the extent that markets stabilize, we believe that an accounting model that allows for reversals of previously recorded impairment write-downs would more accurately reflect the financial position of a company. In our view, this symmetric accounting model would provide the best information to users of financial statements.

Further, NAREIT observes that the proposed impairment model is divergent from the models proposed by the FASB and the IASB in their respective Credit Impairment models. NAREIT notes that both the FASB and IASB Credit Impairment proposals allow for the reversal of previously recorded allowance for credit losses. In our view, providing companies with the ability to reverse previously recorded impairment write-downs would serve as an opportunity for the FASB to synthesize impairment guidance within U.S. GAAP with respect to financial instruments and achieve convergence with the IASB at the same time.

Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category

NAREIT understands that the Proposal would eliminate the concept of "tainting" from U.S. GAAP that occurs when a company sells financial instruments that are classified as held to maturity. Under the Proposal, the FASB indicates that such sales should be rare and infrequent. However, the Proposal does not articulate how many times such sales could occur. Nor does the Proposal indicate what the consequences are of executing sales from the amortized cost category. In order to reduce the possibility for improper sales from the amortized cost category, and work towards reducing situations whereby some companies might try to "game the system," NAREIT recommends that the FASB clearly articulate a threshold for sales (and the consequence of selling beyond this threshold) of financial assets that are classified in the amortized cost category.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[3] on the FASB's *Disclosure Framework* discussion paper, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.,* 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[4]) when compared with annual SEC financial reporting deadlines (*i.e.,* 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[5]). According to APB 28: *Interim Financial Reporting*, each interim period is an integral part (as opposed to a discrete part) of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

Other Comments

NAREIT notes that in the FASB's consequential amendments document, hedge accounting for interest rate risk is not permitted for debt securities measured at amortized cost, but apparently is permitted for loans measured at amortized cost. NAREIT found this difficult to understand given that the Proposal overall treats securities and loans in the same manner. NAREIT believes hedge accounting should be permitted for both loans and securities which would be consistent with good treasury risk management practices (*e.g.,* see paragraph 825-10-55-73 in the Proposal).

NAREIT observes that the proposed held-for-sale criteria for equity method investments may be interpreted very broadly. We are concerned that this may result in certain investments being inappropriately reported at fair value through net income, which may be contrary to the Board's intention. For example, investments reported under the equity method of accounting (*e.g.,* investments in joint ventures, partnerships and limited liability companies) might be considered held-for-sale investments simply because (1) the underlying arrangements may contain explicit or implied end/termination dates or (2) management often considers a wide range of exit plans depending on future developments over a long time horizon. NAREIT does not believe this result would represent the most useful financial reporting and questions whether or not the Board intended this result.

[3] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[4] http://www.sec.gov/answers/form10q.htm

[5] http://www.sec.gov/answers/form10k.htm

In summary, we urge the FASB and the IASB to remain committed on their convergence efforts. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

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 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 31, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2012-260
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2012-260, *Financial Instruments – Credit Losses (Subtopic 825-15)*

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 from the Financial Accounting Standards Board (FASB or the Board) on *Financial Instruments – Credit Losses (Subtopic 825-15)* (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 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 U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT concurs with the FASB's goal of developing a financial reporting model that more accurately reflects the timing and degree to which companies sustain credit losses on financial assets. However, with respect to the FASB's proposed current expected credit loss model (CECL), we believe that there are a number of areas that need improvement for the model to become operational for preparers and understandable for users, regulators, and auditors alike. Therefore, NAREIT proposes the following enhancements with regard to the CECL model:

- **Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero**

- **Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset**

- **Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the <u>originally</u> anticipated amount**

- **Exclude trade receivables and lease receivables from the scope of the Proposal**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero

NAREIT understands that the Proposal would require companies to book a credit loss upon execution of the transaction based on multiple possible outcomes. The estimate would be neither a worst-case scenario nor a best-case scenario, but rather would be based on an entity's assessment of current conditions and reasonable and supportable forecasts about the future. As such, the Proposal would expressly prohibit companies from utilizing a "best estimate" or "most likely outcome" approach that may result in recognizing zero credit losses.

NAREIT does not believe that the Proposal, as written, would faithfully present the underlying economics of certain transactions. NAREIT questions the Proposal's outcome when the model is applied to securities that are measured at fair value with changes in value recognized in other comprehensive income. For example, preparers would be required to record an allowance for credit losses immediately upon purchasing an AA-rated bond, a U.S. Treasury bond, or an Agency

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.

mortgage-backed security and thus "expect" credit losses of something other than zero. The vast majority of companies have never incurred a credit loss with respect to these particular investments. Therefore, NAREIT questions why the Board would require management to book an allowance for credit losses for these types of financial instruments, regardless of how small, when management's long-standing history indicates that there has never been a credit loss incurred historically. Further, the purchase price already inherently reflects what little credit risk exists.

The results of the CECL model become further perplexing when considering the fact that a company would record ***no allowance for credit losses*** at the date of purchase if these financial instruments are measured at fair value, with changes in value recognized in net income.

In NAREIT's view, the Board could easily address this accounting anomaly in the Proposal by permitting management to utilize a "best estimate" of expected credit losses. The concept of "best estimates" has conceptual merits in current U.S. GAAP. For example, FASB Concepts Statement No.7, *Using Cash Flow Information and Present Value in Accounting Measures*, defines the term *best estimate* as follows:

> The single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode. In the past, accounting pronouncements have used the term *best estimate* in a variety of contexts that range in meaning from "unbiased" to "most likely[2]."

NAREIT believes that providing management with the ability to use a "best estimate" approach within the CECL model would more accurately report management's view of the financial position of a company to users of financial statements.

Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset

A literal reading of the Proposal suggests that the allowance for credit losses estimate would be based on the cash flows that management does not expect to collect over the *contractual* life of the financial instrument. NAREIT questions whether it was the Board's intention for management to use the entire contractual life in all instances. For example, based on information obtained from the Federal Housing Finance Agency, the historical assumption for the average life of a 30-year residential mortgage loan is approximately 10 years[3]. The shorter life is due to prepayments that result when homeowners either sell their homes to move, decide to refinance due to decreasing interest rates, or default on the mortgage loan. NAREIT does not believe that an allowance for credit losses that is based on the entire 30-year life of the mortgage loan would be an accurate estimate.

NAREIT recommends that the Board discontinue use of the phrase "contractual cash flows" and utilize the term "expected cash flows" in its place. This would permit management to take

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[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820900214&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs at page CON7-5.

[3] http://www.fhfa.gov/webfiles/25006/MIRS_Feb_2013_final.pdf at page 2.

prepayments into consideration when estimating the expected life of a loan. NAREIT believes that making this change would dispel the confusion regarding whether the Board's intention was for preparers to estimate credit losses over the life-time contractual term of financial instruments that surfaced after the Proposal was issued. Subsequently, the Board attempted to address its intention in question 8 of the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* Frequently Asked Questions document.

Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount

While we understand the impetus for the development of an expected credit loss model, we are concerned about any model that would only allow preparers to record downward adjustments and not reverse those credit losses in situations where the fair value of investments (*e.g.,* estimates of future cash flows) subsequently increases. With the benefit of hindsight, a preparer could observe whether market downturns later reverse. To the extent that market conditions stabilize, we believe that an accounting model that allows for reversals of previously recorded credit losses would more accurately reflect the financial position of a company. Thus, in that regard, we agree with the Proposal as an improvement over current practices for debt securities.

However, NAREIT believes that preparers should be able to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceed the *originally* anticipated amount, unlike the Proposal that would record an immediate gain. In our view, the accounting model that we recommend would provide the best information to users of financial statements as well as address the uncertainty of estimates in a prudent manner.

Exclude trade receivables and lease receivables from the scope of the Proposal

NAREIT fails to see the benefit of including trade receivable and lease receivables within the scope of the Proposal. NAREIT observes that the Board is inconsistent when it comes to defining whether a lease is a financial asset. For example, lease receivables are excluded from the scope of the project that deals with financial assets (*e.g.,* the Proposed Accounting Standards Update on *Financial Instruments: Recognition and Measurement*), while in projects such as this, the FASB includes lease receivables as financial assets within the scope of the Proposal. Further, we note that trade receivables are generally short term and present few accounting issues under current U.S. GAAP.

To avoid confusion and complexity, NAREIT recommends that the Board exclude these assets from the scope of the Proposal. NAREIT believes that the accounting treatment for credit losses with respect to these asset types is best suited for the chapters in the codification that address these asset types. For example, credit losses for leases should be included within the codification section that is dedicated to leases. In order to ensure that convergence is achieved, the FASB and IASB should include the accounting for credit losses for leases within the scope of the *Leases* Project.

In the event that the Board does not decide to follow our recommendation, NAREIT requests that the Board clearly articulate the types of leases that would be in scope of the Proposal (*e.g.,* both operating and finance lease receivables?). Depending on the Board's anticipated timing for the effective date, this scoping decision should contemplate both leases under current U.S. GAAP and leases that would exist under the proposed *Leases* standard.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[4] on the FASB's *Disclosure Framework* discussion paper and in its May 15, 2013 submission[5] on the FASB's *Financial Instruments: Recognition and Measurement* Proposal, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[6]) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[7]). According to APB 28: *Interim Financial Reporting* (Accounting Standards Codification Topic 270), each interim period is an integral part (as opposed to a discrete part) of the annual reporting period.

NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

We urge the FASB and the IASB to work toward a converged solution. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

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 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

[4] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[5] http://www.reit.com/~/media/2013/NAREIT%20Comment%20Letter%20on%20FASB%20Recognition%20and%20Measurement%20Proposal.ashx

[6] http://www.sec.gov/answers/form10q.htm

[7] http://www.sec.gov/answers/form10k.htm

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula

Christopher T. Drula
Vice President, Financial Standards
NAREIT

cc: Mr. Hans Hoogervorst, Chairman, International Accounting Standards Board

Ms. Sue Lloyd, Senior Director, Technical Activities, International Accounting Standards Board

Mr. Alan Teixeira, Senior Director, Technical Activities, International Accounting Standards Board

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SFO Alert (August 8, 2014)

August 8, 2014

FASB DECISIONS ON THE CLASSIFICATION AND MEASUREMENT FOR EQUITY INVESTMENTS

On July 30, the Financial Accounting Standards Board (FASB or Board) continued its redeliberations on the Accounting for Financial Instruments Classification and Measurement Project. At the meeting, the Board reaffirmed the guidance included in the February 2013 proposed Accounting Standards Update, Financial InstrumentsOverall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (the Proposal) related to the classification and measurement of equity investments. This decision will be of interest to NAREIT member companies that hold equity investments.

The Board decided that all investments in equity securities would be measured at fair value through net income, except for the following:

- Investments in equity securities accounted for under the equity method of accounting (*e.g.*, investments in unconsolidated joint ventures); and,
- Investments in equity securities without readily determinable fair values for which the entity has elected to apply the practicality exception to carry them at cost, adjusted for both impairment and observable price changes.

Thus, the FASB would preclude recognizing changes in value for equity securities through other comprehensive income. While this represents a significant change to current practice for investments in equity securities, investments in debt securities will not be impacted by this decision. Under current U.S. GAAP companies are provided an option to classify equity securities as either:

- Trading (*i.e.*, equity securities are measured at fair value on the balance sheet, with changes in value recognized in earnings) or,
- Available-for-sale (*i.e.*, equity securities are measured at fair value on the balance sheet, with changes in value recognized in other comprehensive income).

The Board plans to finalize redeliberations on the Proposal in the coming months. The Board has not discussed an effective date for the Proposal.

CONTACT

Please contact Christopher Drula, VP, financial standards, at cdrula@nareit.com.

General Counsels Agenda Meeting

Wednesday, April 1st
9:45am – 11am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Shirley Goza, General Counsel, QTS Realty Trust, Inc.

Panelists:
Daniel Adams, Partner, Goodwin Procter LLP
Frank Burt, SVP & General Counsel, Boston Properties, Inc.
Elizabeth Sacksteder, Partner, Paul Weiss

[As reprinted from *REIT Zone Publications*, September 3, 2014]

GETTING NOTHING FOR SOMETHING

James J. Hanks, Jr.*

A lot of controversy has recently been swirling around Subtitle 8 of Title 3 of the Maryland General Corporation Law ("Subtitle 8"), especially its provision that allows a board of directors to classify itself into three classes without a stockholder vote and despite any contrary provision in the charter or bylaws. In fact, Subtitle 8 has been the law in Maryland since 1999, when the Maryland legislature, by overwhelming margins, approved the Unsolicited Takeovers Bill, which was signed by the Governor and became effective on June 1, 1999.

Subtitle 8 (occasionally called the "Maryland Unsolicited Takeovers Act" or "MUTA") permits a Maryland corporation (or a Maryland real estate investment trust formed under Title 8) with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors to elect, by provision in its charter or bylaws or by resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to be subject to any or all of five provisions, including:

- a classified board;
- a two-thirds vote of outstanding shares to remove a director;
- a requirement that the number of directors be fixed only by vote of the board of directors;
- a requirement that a vacancy on the board of directors be filled only by the affirmative vote of a majority of the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred and until a successor is elected and qualifies; and
- a provision that a special meeting of stockholders must be called upon stockholder request only on the written request of stockholders entitled to cast a majority of the votes entitled to be cast at the meeting.

Subtitle 8 also permits the charter or a board resolution to prohibit the corporation or a Title 8 real estate investment trust from electing to be subject to any or all provisions of the Subtitle. (For convenience hereafter, we shall refer just to a REIT, whether formed under the Maryland General Corporation Law as a corporation or under Title 8 as a real estate investment trust.)

For many years, newly formed Maryland REITs have adopted classified boards and the substance of the other Subtitle 8 protections in their original charters or bylaws and have

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* Partner, Venable LLP, Baltimore, Senior Lecturer, Northwestern Law School. Author, *Maryland Corporation Law* (Wolters Kluwer, 1990, supplemented annually). Mr. Hanks participated in the drafting of Subtitle 8.

thus not needed to opt in to Subtitle 8. Some pre-1999 REITs and some post-1999 REITs without classified boards or other Subtitle 8 provisions have opted in to Subtitle 8 to adopt one or more of its provisions.

For the past several years, classified boards, like shareholder rights plans and plurality voting, have been under attack by proxy advisers, institutional shareholders and academics. These attacks have asserted the need for more "accountability" and a fear of "entrenchment." In more recent years, some of these same activists have gone even further and demanded that boards not only declassify, redeem their rights plans and give up plurality voting but also promise never (at least without a shareholder vote) to reclassify, adopt a new rights plan or revert to plurality voting. In Maryland, as Barry Vinocur has pointed out, at least 13 REIT boards have declassified (or promised to do so in the near future) and adopted a charter provision that the REIT will not reclassify under Subtitle 8 without a shareholder vote. A shareholder vote, of course, requires an annual or special meeting of shareholders, a process likely to take at least several months, typically not soon enough to provide any timely or effective benefit to a company under attack.

Nevertheless, the pressure for REIT boards to give up the right to classify (or reclassify) under Subtitle 8 continues. Boards are wise to resist this pressure for several reasons:

1. *There is no economic benefit to the REIT.* Declassifying (or promising not to classify or reclassify) will not lease more space, increase rents or lower interest rates. It may pick up some points on Green Street's scorecard but plenty of REITs have successfully sold equity with classified boards. Generally speaking, it is better for a company to have more choices than fewer. For example, I do not know of a single REIT charter that caps a board's power to borrow. So, why give up, for no economic benefit to the REIT, an option that may provide some protection against an effort by investors or activists with goals other than those typically held by long-term shareholders to seize control of the company on a short-term basis in what may be temporarily unfavorable market conditions? The decision to opt out of Subtitle 8 is not whether to classify the board, which would at least be discussable in terms of good or bad corporate governance (see next paragraph), but whether to effectively give up *even the choice* of classifying the board at some future time under unknown circumstances, thereby tying the hands of all future boards.

2. *There is no significant reliable data showing a correlation, much less causation, between non-classified boards and economic performance.* Economic performance of REITs is driven by management and assets, not by corporate governance. Just last year, using a comprehensive sample for the period from 1978 through 2011, Martijn Cremers, Lubomir P. Litov and Simone M. Sepe, in *Staggered Boards and Firm Value, Revisited*, showed that firms adopting a classified board increase in firm value and, conversely, that declassifying is associated with a decrease in firm value. Likewise, in 2010, Michael E. Murphy, in *Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal*, concluded that the value of companies with and without classified boards was nearly identical and that the effects on company value were insignificant if the company's shares are widely held, without a ten percent or greater shareholder.

Indeed, Murphy surveyed previous literature (including articles by Harvard Law Professor Lucian Bebchuk, a well-known vocal opponent of classified boards) to conclude that classified boards do not affect operational performance and noted that there is some evidence to support the conclusion that companies with classified boards have improved operational performance. In short, Murphy concluded that classified boards actually have a very wide range of impacts on companies, and thus a "case-by-case" approach is best. There are other studies reaching similar conclusions.

3. *The primary purpose of classified boards is to provide continuity and stability to the company and its management in developing and executing its strategies.* Classified boards have been around for nearly 100 years. They encourage the recruitment and retention of new directors by permitting them a reasonable period of time to become familiar with the company before coming up again for election. Developing, implementing and executing a long-term strategy can generally not be done in only one year. REIT boards and managements found this out during the financial crisis when they were forced to refinance their companies and reposition their assets, often resulting in major strategic changes, the benefits of which may not be realized in only one year. The courts for years have held that the power to set the time horizon over which the company will be operated rests squarely with the board. As a necessary corollary, the board is entitled to protect the company from changes to its strategies and policies. This is especially true where the board makes a choice explicitly conferred on it by the legislature.

4. *The board, as the elected representatives of the shareholders and with more information than any single shareholder, is in the best position to decide on appropriate protections for its strategies.* Not content with electing the board and letting it choose and evaluate the CEO and collaboratively develop the company's strategy, some shareholders and uninvested activists want to tell the board what to do. We see this encroachment especially in the recommendations of Institutional Shareholder Services Inc. ("ISS") to withhold or vote against directors for a single small infraction of ISS's policies, *regardless of the company's economic performance*. ISS also threatens to, and often does, recommend against directors who fail to implement within the following year even just one precatory proposal approved by shareholders, regardless of the company's economic performance – a position diametrically opposite to generations of settled corporate law in Maryland, Delaware and elsewhere. Even more vividly, we see this encroachment in the efforts to restrict the board's exercise of its rights under Subtitle 8 to protect its strategies and policies. These moves are often advanced as a supposed antidote to "entrenchment" or as promoting "accountability." Entrenchment, of course, is a loaded label and accountability sounds good but the result of depriving the board of the opportunity for limited protection of its business plan is exposure to attacks by holders with very different economic (or other) goals than shareholders generally. Take, for example, arbitrageurs, hedgers and "underweight" holders who openly pursue investment strategies very different from the value maximization sought by most shareholders. Indeed, one labor organization whose primary interest is organizing employees, not shareholder value, Unite Here, typically a small holder in its target companies, has

successfully proposed opting out of the Subtitle 8 classified board provision at several lodging REITs.

5. *A classified board will not prevent a takeover*. It is now common for a bidder in a hostile tender offer to reinforce its tender offer with an announcement of intention to file a competing slate of director nominees at the next annual meeting of shareholders. A classified board will give the incumbent directors additional time to consider the bidder's proposal, explore alternatives and, often, negotiate with the bidder. Because the board has the power to declassify (if it has classified itself under Subtitle 8) or to initiate declassification (if the board is already classified in the charter) and to remove other defensive measures, it has leverage in negotiating with an otherwise hostile bidder, who will almost always prefer paying more for a sure deal today than running proxy contests of uncertain outcome at two annual shareholders meetings.

In summary, it is difficult to see how a board maximizes value for the shareholders – the ultimate goal of any for-profit enterprise – by tying the hands of future boards by surrendering, effectively forever, a valid choice, like the power to classify, specifically conferred by statute, in return for no economic benefit for the REIT. Directors should be especially careful that they do not fall into the trap, of which they are so often unjustly accused, of appearing to act in their own self-interest by yielding to pressure, especially from unelected activists with little or no skin in the game, to opt out of Subtitle 8, in order to avoid a recommendation by ISS or Glass Lewis & Co. to withhold or vote against directors in a subsequent election.

2014-2015 YEAR-END TOOL KIT

DODD-FRANK COMPENSATION DISCLOSURE AND CONFLICT MINERALS UPDATE

December 2014

Update on Pending Compensation Rulemaking Under the Dodd-Frank Act

Speed read: The status of the four compensation-related SEC rulemaking mandates remains unclear. The SEC has proposed (but not adopted) rules for pay ratio disclosure, and has yet to propose rules for CEO pay for performance, clawbacks and hedging. In late November 2014, an informal, non-binding regulatory agenda published by the SEC indicated that the SEC had established October 2015 as the target date for adoption of final CEO pay ratio disclosure rules and proposal of the pay for performance, clawbacks and hedging disclosure rules. These rules are the subject of ongoing political controversy, and it is possible that the new Congress will act to amend or repeal the sections of the Dodd-Frank Act that required the SEC to adopt these rules. Companies should continue to monitor the status of these rules.

The Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to adopt rules relating to CEO pay ratio disclosure, stock exchange listing standards requiring clawbacks of incentive compensation in certain circumstances, hedging policy disclosure and pay for performance disclosure. As of mid-December 2014, the SEC had taken no action since September 2013 on these rulemaking mandates. The CEO pay ratio disclosure rules remain in the form proposed by the SEC in September 2013, and the SEC had not yet proposed rules for clawbacks of incentive compensation under stock exchange rules, hedging policy disclosure or pay for performance disclosure.

Proposed CEO Pay Ratio Disclosure Rules. The SEC proposed CEO pay ratio disclosure rules pursuant to a Dodd-Frank mandate on September 18, 2013. As proposed, the CEO pay ratio rules provided a transition period under which disclosure would not have been required for calendar year 2014 compensation (to be disclosed in 2015 proxy statements). As noted above, an internal SEC agenda indicates that the SEC may not adopt final rules until October 2015. Based on the phase-in provided in the original proposal, it is possible that if the SEC adopts final CEO pay ratio rules in late 2015, CEO pay ratio disclosure would not be required for calendar-year companies until 2016 (for disclosure in 2017 proxy statements).

Under the CEO pay ratio proposal, public companies would have to disclose the median of annual total compensation for all employees of the company other than the chief executive officer for the last completed fiscal year; the annual total compensation of the chief executive officer for the last completed fiscal year; and the ratio of these two amounts. The disclosure of the pay ratio may be presented as a fraction (*e.g.*, "1 to [the appropriate multiple]"), or in narrative form (*e.g.*, "the CEO's annual total compensation is X times that of the median of the total annual compensation of all employees"). The proposed rules contained exemptions for smaller reporting companies, emerging growth companies and foreign private issuers.

The proposed CEO pay ratio disclosure would cover all employees of the company and any subsidiary of the company (defined as an affiliate controlled by the company directly or indirectly through one or more intermediaries), including all full-time, part-time, temporary, seasonal and non-U.S. employees who were employed as of the last day of the company's prior fiscal year. Workers who are not employed by the company or its subsidiaries, including independent contractors, "leased" employees or other temporary workers employed by a third party, would be omitted.

Under the proposed rules, companies could annualize the total compensation of permanent employees who were employed for less than the full fiscal year. Companies could not, however, make full-time equivalent adjustments for part-time employees, annualize compensation for temporary or seasonal workers, or make cost-of-living adjustments for non-U.S. employees.

The proposed rules would allow companies to select a reasonable method to identify the median employee and to use reasonable estimates to determine any element of total compensation for the median employee and the annual total compensation for the median employee. The proposed rules would require companies to disclose briefly the methodology used to identify the median employee, including the compensation measure used and any material assumptions, adjustments or estimates. The narrative disclosure is intended to be a brief overview, and disclosure of technical analyses or formulas is not required. If a company estimates total annual compensation, the resulting disclosure would need to be clearly identified as an estimated amount and include a brief description of the estimates used by the company. If a company changes its methodology from a prior period and the effects of such change are material, the company must briefly describe the change, the reasons for the change and the expected impact on the median and the ratio.

For additional information about the SEC's proposed pay ratio rules, see our Client Alert "SEC Issues Proposed "Pay Ratio" Disclosure Rules" (October 2, 2013).

Clawbacks. The Dodd-Frank Act requires the SEC to adopt rules directing stock exchanges to prohibit the listing of securities if the company has not developed and implemented a policy for the recovery of incentive-based compensation in certain circumstances. Unlike the comparable clawback requirements of the Sarbanes-Oxley Act clawback provision, the Dodd-Frank Act clawback policy must cover both current and former executive officers, rather than just the chief executive officer and the chief financial officer, and applies to any accounting restatement resulting from material non-compliance, without regard to whether the executive officer is responsible for misconduct that led to the restatement. Companies would be required to disclose their clawback policies.

Some companies have adopted clawback policies in advance of the final rules, in some cases because adoption and disclosure of a clawback policy may affect corporate governance ratings by proxy advisory firms. Because the SEC's current internal agenda indicates that the Dodd-Frank clawback rules may not be proposed until October 2015, and implementation of these rules will require rulemaking proposals and adoption by the SEC and then by the stock exchanges, the Dodd-Frank clawback rules are not likely to affect companies until at least the 2016 proxy season.

Hedging. The Dodd-Frank Act also requires the SEC to adopt rules requiring companies to disclose whether employees and directors are permitted, directly or indirectly, to hedge the market value of compensatory securities grants and awards. This disclosure is in addition to existing SEC requirements that companies disclose any policies regarding hedging the economic risk of owning company securities by the company's named executive officers in proxy statements.   Like the clawback rules, the SEC's internal agenda for its rulemaking proposal indicates that it is unlikely that the hedging policy disclosure requirements will apply until at least the 2016 proxy season.

Pay for Performance. The third compensation-related Dodd-Frank Act rulemaking mandate that remains unproposed at this time is the requirement that the SEC to adopt pay for performance disclosure rules. These rules would require companies to disclose material information showing the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the company's stock and the dividends paid by the company. Like the clawback and hedging rules, the SEC's internal agenda for its rulemaking proposal indicates that it is unlikely that the hedging policy disclosure requirements will apply until at least the 2016 proxy season. Companies should monitor SEC rulemaking in this area, however, because the proposed rules may provide insights concerning final SEC rules that compensation committees may wish to consider when they adopt compensation programs and make compensation decisions.

Update on Conflict Minerals

Speed read: The final status of the SEC's conflict minerals rules remains uncertain. There has been no substantive change from the legal position when 2013 reports were filed in late May and early June 2014. Litigation still pending before the D.C. Court of Appeals could strike the current limited order that prevents public companies from being required to state whether their products are "DRC conflict free." That would ultimately result in companies becoming obligated to comply with the conflict minerals rules as originally adopted by the SEC, after all appeals had been dealt with. Meanwhile, it is also possible that legislation that would amend the Dodd-Frank Act to eliminate the conflict minerals rule could be adopted by the House of Representatives and the Senate in 2015. Until these uncertainties are resolved, companies should continue to monitor developments, and should be prepared to file reports in 2015 on the same basis that they did in 2014.

Section 1502 of the Dodd-Frank Act required the SEC to adopt rules requiring public companies to disclose their use of coltan, cassiterite, gold and wolframite if those minerals (i) originated in the Democratic Republic of the Congo (the "DRC") or an adjoining country and (ii) are necessary to the functionality or production of their products. As a required by the Dodd-Frank Act, the SEC adopted Rule 13p-1 in August 2012, which requires companies to prepare and file annually a Form SD and, in some circumstances, a Conflict Minerals Report.

After the U.S. District Court for the District of Columbia ruled against a challenge to the SEC's conflict minerals rule, the U.S. Court of Appeals for the D.C. Circuit issued an opinion in April 2014 upholding the lower court's decision in all respects other than on First Amendment grounds. The Court of Appeals held that the relevant section of the Dodd-Frank Act and the SEC's conflict minerals rule violated the First Amendment by unconstitutionally compelling speech to the extent they require issuers to report to the SEC and state on their website that any of their products have "not been found to be 'DRC conflict free.'"

To deal with the resulting uncertainties about how companies should comply with the conflict minerals rule in light of the litigation, the SEC Division of Corporation Finance issued a statement in April 2014 indicating that companies were required to comply with the conflict minerals rule and to file a Form SD by the June 2, 2014 deadline, but were not required to describe their products as being "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable." Pending further action, companies would also not be required to obtain an independent private sector audit unless they voluntarily described their products as "DRC conflict free." The April 2014 SEC statement can be found here.

Following up on the April SEC statement, the SEC issued an order in May 2014 staying the effective date for compliance with the portions of the conflict minerals rule and Form SD that had been found invalid by the courts. The SEC's May 2014 press release discussing the order can be found here, and the order itself can be found here.

As of mid-December 2014, the conflict minerals litigation remains unresolved. On August 1, 2014, the full U.S. Court of Appeals for the District of Columbia Circuit issued an opinion in the appeal of *American Meat Institute v. US Department of Agriculture* that upheld a Department of Agriculture "country-of-origin" labeling requirement that had been challenged on First Amendment grounds that were similar to the grounds on which the SEC conflicts minerals rules had been declared in part unconstitutional. On November 18, 2014, the three-judge panel of the D.C. Circuit Court of Appeals that had issued the decision finding the SEC conflict minerals rule invalid in part on First Amendment grounds issued an order requiring the parties to submit briefs relating to the impact of the *American Meat Institute* decision on its earlier conflict minerals ruling and deferring action on pending motions for *en banc* rehearing of an appeal in the conflict minerals rule litigation.

It is possible that the conflict minerals provisions of the Dodd-Frank Act will be among those that the new Congress will consider amending in 2015. For these reasons, companies required to file Form SD should monitor developments in the coming months to determine if any disclosure changes are needed and whether the Congress modifies or eliminates the conflict minerals mandate.

Corporate Governance

June 23, 2014
DJIA: **16,937** | RMZ: **1030** | 10-Yr Treasury Note: **2.62%**

Green Street Advisors

Ranking the Public Real Estate Companies

Overview: The wide range of corporate governance practices within the REIT industry can meaningfully impact share prices. A systematic approach to evaluating the spectrum of practices is essential to gain perspective. The updated governance rankings contained herein provide the necessary framework.

Corporate Governance Highlights:

- Overall, the REIT industry stacks up in line with corporate America on governance
- There is more to good governance than "checking-the-boxes"; a full one-quarter of the Green Street ranking system is based on board conduct
- **Prologis, Host, DCT Industrial Trust,** and **DiamondRock** all recently took steps to ensure that MUTA, a particularly objectionable entrenchment device available to the 70% of REITs that are incorporated in Maryland, will never be used against shareholders. The other Maryland REITs should follow their lead.
- **LaSalle Hotel Properties** and **Mack-Cali Realty** became the latest REITs to do away with the classified board structure. The 10% of REITs that have retained this outdated structure increasingly stick out like sore thumbs.

Peter Rothemund, CFA

660 Newport Center Drive, Suite 800, Newport Beach, CA 92660
T 949.640.8780 F 949.640.1773

This excerpt is from Green Street Advisors' Executive Compensation and Corporate Governance Report, June 23, 2014.

Corporate Governance
Overview

Corporate Governance
A Review of Governance Practices in the Public Real Estate Sector

Companies with good governance should and do trade at valuation premiums relative to companies with poor governance. Because of this, Green Street regularly and systematically assesses governance for each of the companies in our coverage universe. Our rankings take into account subjective factors specific to individual companies as well as objective factors unique to the REIT industry, both of which serve to differentiate these rankings from those published by governance ranking specialists (e.g., ISS). These governance scores constitute a key input in our primary REIT valuation model.

Assessing corporate governance is no easy task because it is comprised of so many different variables. Governance is a composite of structural features embedded in corporate charters and bylaws, the make-up and structure of the board of directors, and the attitudes and behavior of management and the board. The goal of providing a comprehensive overview needs to be balanced with the competing goal of keeping an eye on the big picture.

Our governance rankings are predicated on two key observations:

1. Companies have a litany of anti-takeover devices from which they can choose. The choices a company makes on this front send a strong signal about the board's attitude toward governance. It is fair to assume that boards that avail themselves of more potential anti-takeover devices are more likely to use them in a manner adverse to the interests of outside shareholders.

2. The center of governance in any corporation is its board of directors. Boards that make themselves accountable to shareholders via annual elections are much more likely to behave in a shareholder-friendly manner. Also, boards comprised of members who have no conflicts and/or have serious "skin in the game" are desirable.

Recent changes to the ranking system: Last September two changes were made to the governance scoring system: 1) greater emphasis was placed on board behavior (25 pts out of the maximum possible of 100 are now reserved for board conduct) and 2) governance scores for companies where insiders control enough votes to act as deterrents to activists/suitors were lowered. See Heard on the Beach – Let the Mob Rule, Sept 3 2013 for more detail.

Corporate Governance
The Ranking System

Green Street's Governance Scoring System: Our governance ranking system 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., quirks in Maryland corporate law, the 5 or fewer rule) are ignored by others. Scoring is on a 100-point basis with the key inputs highlighted below. A more thorough description of the variables can be found in Appendix D.

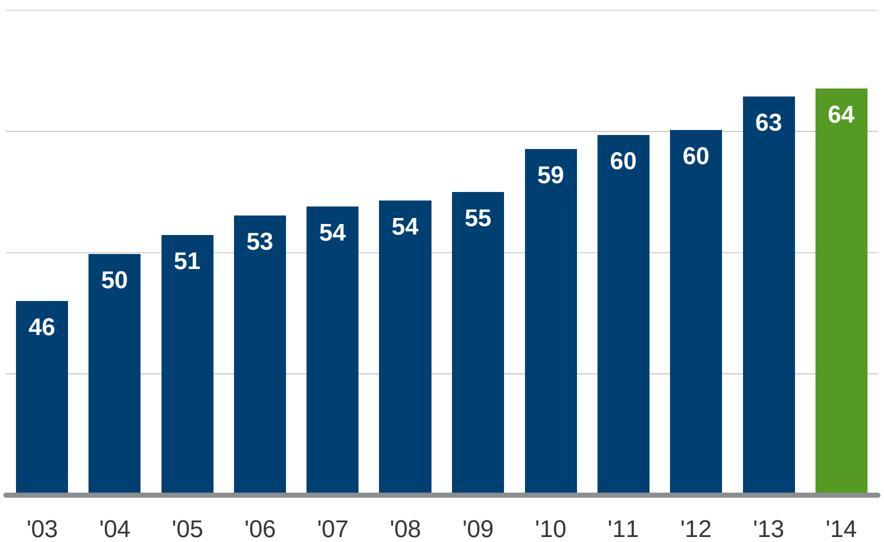
Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders 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 Blocking Power
Total	**35**	
Potential Conflicts of Interest:		
Business Dealings with Management	6	No Business Dealings
Divergent Tax Basis of Insiders	4	Basis Near Share Price
Total	**10**	
Perfect Score	**100**	

Insider blocking power: 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 the anti-takeover variables. For example, a REIT that scores a zero on the blocking power variable (because insiders own enough shares to effectively control any vote) will have any points credited for shareholder-friendly takeover elections the company has made cut in half.

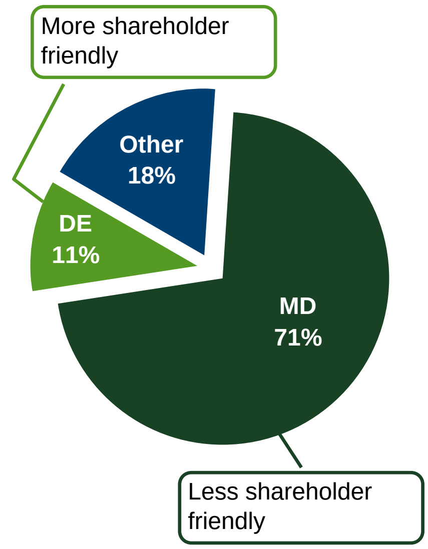
Corporate Governance
Notable Developments

Progress: The push over the past decade to clean up governance structures has led to a dismantling of takeover defenses across REITland and Corporate America alike. Only 10% of REITs retain the outdated classified board structure and a little less than that currently have a poison pill in place – impressive numbers that are comparable to the percentages for S&P 500 companies.

Average Corporate Governance Score



State of Incorporation



Getting Smarter on State Law

Boards have several anti-takeover devices at their disposal and a powerful one available to REITs incorporated in Maryland featured prominently in a takeover battle last year. **The Maryland Unsolicited Takeover Act (MUTA) permits a Maryland corporation to add various anti-takeover provisions, chief among them the ability to stagger the board, to its charter without shareholder approval.** Having a destaggered board, while at the same time retaining the ability to classify it (probably at just the time it matters most), is insulting to investors. REITs incorporated in Maryland should follow the lead of long-time corporate governance leader **Prologis** and the six other REITs that have taken steps to ensure that boards will never be reclassified, by leaving that power in the hands and votes of shareholders.

Highlights

MUTA — **DCT Industrial Trust, DiamondRock Hospitality, Host Hotels & Resorts,** and **Prologis** all recently added language to their corporate charters that prohibits staggering the board without first obtaining shareholder approval.

Destaggering — **LaSalle Hotel Properties** and **Mack-Cali Realty** became the latest REITs to do away with the classified board structure.

Conduct — Board members at **BRE Properties** responded to investor frustation and ultimately "did the right thing." Will the trustees at **Associated Estates** do the same or will investors' voices go unheard?

This excerpt is from Green Street Advisors' Executive Compensation and Corporate Governance Report, June 23, 2014.

Corporate Governance
The Rankings

Wide Disparity: Some REITs have excellent governance structures; others have structures that give insiders enormous powers to ignore the wishes of shareholders. Clients with access to our "Data Tools" product can access detailed company-level scoring on our web site. Perfect score = 100.

Company	Score	Change	Company (cont'd)	Score	Change
Prologis	98	+6	HCP, Inc.	68	+1
Health Care REIT	87		Kimco Realty	68	-1
Ventas	86		MAA	68	
Sunstone Hotel Inv	83	+4	Regency Centers	68	+1
DDR Corp	82	+1	Spirit Realty Capital Inc.	68	-7
DCT Industrial Trust	81	+8	Westfield Group	68	-7
DiamondRock Hospitality	81	+17	Healthcare Trust of America	67	+1
American Tower Corp	79	-6	Liberty Property Trust	67	+3
Brixmor Property Group	79	+1	Macerich	67	-1
American Campus	77		Strategic Hotels	67	+4
Equity Residential	77	+5	Corporate Office Properties	64	-2
Highwoods Properties	77	+1	Public Storage	63	+5
Retail Opportunity Investments Corp	77	-1	UDR, Inc.	63	
Boston Properties	76		Omega Healthcare Investors	62	+1
Federal Realty	76		Alexandria Real Estate Equities	61	+3
Digital Realty Trust	75		LaSalle Hotel Properties	61	+12
Acadia Realty Trust	74		CBL & Associates	60	-1
EastGroup Properties	74		BioMed Realty Trust	59	-2
Host Hotels & Resorts	74	+5	Sun Communities	58	+3
Post Properties	74	-2	AVIV REIT, Inc.	57	
Extra Space	73		Brandywine Realty Trust	56	
First Industrial Realty	73		Washington Prime	56	
Camden Prop Trust	72		Campus Crest Communities	55	-7
Essex Property Trust	72		CoreSite Realty Corp	55	+2
Home Properties	72		AIMCO	53	
Retail Properties of America	72	+2	PS Business Parks	52	
Tanger Factory	72		Pennsylvania REIT	51	+1
Realty Income Corp	71		Equity One	47	-2
Weingarten Realty	71		Mack-Cali Realty Corp	46	+20
AvalonBay	70		General Growth	44	
Douglas Emmett	70	+1	American Assets Trust	42	
National Retail Properties, Inc.	70		Rouse Properties, Inc.	42	
Pebblebrook Hotel Trust	70	-9	Associated Estates	39	+4
Piedmont Office Realty Trust	70		Dupont Fabros Tech	38	
Simon Property Group	70		Washington REIT	37	
Duke Realty Corp	69	-2	Felcor Lodging Trust	34	-2
Kilroy Realty Corp	69		SL Green Realty	34	-1
RLJ Lodging Trust	69	-4	Empire State Realty	33	+1
Cousins Properties	68		Glimcher Realty Trust	33	-3
CubeSmart	68	+5	Healthcare Realty Trust	28	
EdR	68	+5	Vornado Realty Trust	25	
Equity Lifestyle Props	68		Taubman Centers	18	+1
			Average Score	**64**	**+1**

This excerpt is from Green Street Advisors' Executive Compensation and Corporate Governance Report, June 23, 2014.

Appendix D

Corporate Governance Ranking System – The Variables

I. Introduction

Companies with good governance should and do trade at valuation premiums relative to companies with poor governance. Because of this, Green Street regularly and systematically assesses governance for each of the companies in our coverage universe. Our rankings take into account subjective factors specific to individual companies as well as objective factors unique to the REIT industry, both of which serve to differentiate these rankings from those published by governance ranking specialists (e.g., ISS). These governance scores constitute a key input in our primary REIT valuation model.

Assessing corporate governance is no easy task because it is comprised of so many different variables. Governance is a composite of structural features embedded in corporate charters and bylaws, the make-up and structure of the board of directors, and the attitudes and behavior of management and the board. The goal of providing a comprehensive overview needs to be balanced with the competing goal of keeping an eye on the big picture.

Our governance rankings are predicated on two key observations:

1. Companies have a litany of anti-takeover devices from which they can choose. The choices a company makes on this front send a strong signal about the board's attitude toward governance. It is fair to assume that boards that avail themselves of more potential anti-takeover devices are more likely to use them in a manner adverse to the interests of outside shareholders.
2. The center of governance in any corporation is its board of directors. Boards that make themselves accountable to shareholders (via annual elections) are much more likely to behave in a shareholder friendly manner. Also, boards comprised of members who have no conflicts and/or have serious "skin in the game" are desirable.

II. About the Ratings

Our evaluation of corporate governance is separated into three key categories. The first of these is an evaluation of the make-up of each board, and, importantly, whether the board is accountable to shareholders. The second broad category measures the power that the board has to make governance decisions vs. the power vested in shareholders. The final category measures potential conflicts of interest between key insiders and shareholders. Our ratings are structured such that the "perfect REIT" would garner a score of 100, with the variables weighted according to the importance we believe they deserve.

A. Rating the Board

No aspect of corporate governance is more important than the composition of a company's board. Boards control enormous power. In the specific case of change of control issues, boards generally control the “trigger” with regard to some extremely potent weapons. In addition to these change of control issues, boards are responsible for ensuring that corporations behave in a manner consistent with the best interests of shareholders on all other fronts. Because the board's roles are so varied and important, any analysis of corporate governance has to place substantial weight on both the structure and membership of the board. 55 of the 100 points available in our rating system pertain to the quality and structure of the board.

As defined herein, the "perfect board" would have the four characteristics described below. Not surprisingly, these same characteristics constitute the variables we use to rate board strength.

1. **Boards should have an annual, not staggered, election of all directors.** Investors feel much more comfortable giving boards considerable power if they have a way of reigning in or firing boards that abuse those powers. **Accountability is so important that this is one of the most important variables (20 of 100 points) in our rating system.**
2. **A high percentage of directors should be independent.** The New York Stock Exchange has guidelines that afford considerable leeway for companies to define what constitutes an "independent" director. The idea that boards are left with discretion to make this determination strikes us as inappropriate, and our categorization of independent directors leaves much less room for business relationships between the director, or his employer, and the company.

3. **Multiple board members, including both insiders and independents, should hold sizable investments in the company.** Most board members today have impressive looking resumes, but when they don't "eat their own cooking", they tend not to utilize the skills that made them successful in the first place. Companies can promote this goal by paying board fees in stock, requiring members to hang on to that stock, and imposing share ownership minimums on board members.
4. **Reputation matters.** While this variable is obviously subjective, it is also very important. Some boards have been stress tested on change-of-control questions, many have dealt with issues where shareholder interests and managerial interests diverge, and all have dealt with executive pay questions. Our annual review of Executive Pay can have a big influence on this variable.

B. Evaluating the Anti-Takeover Tools

The primary entrenchment tools available to all companies are state antitakeover laws and poison pills. Anti-takeover devices that are more unique to the REIT sector include ownership limitations arising from the "5 or fewer" rule and the ability of founders/insiders to veto major transactions. It is impossible to determine ahead of time whether boards that have availed themselves of these tools would use them inappropriately, and it is also unwise to assume that a board that does not have certain of these features in place today might not put them in place when push comes to shove. Nevertheless, insight regarding the mindset of a board can be gleaned by reviewing which of these objectionable devices are in place.

1. **State Antitakeover Laws -** Well over half of the REITs in our coverage universe are incorporated in Maryland, a state whose corporate law (known by the acronym "MGCL") can be used to thwart the possibility of hostile takeovers. A number of other states have similar laws. MGCL establishes provisions that protect shareholders from "business combinations" involving "interested stockholders" as well as unsolicited takeover attempts. The key sections of this law serve as enormous impediments for hostile takeovers. A Maryland company may choose to opt out of these provisions, although boards generally hold the power to change prior elections any time in the future.

   - **Section 3-602: Otherwise referred to as the "Business Combination" provision.** The law prohibits for a period of five years a merger (or similar transaction) between a company and an "interested stockholder". An interested stockholder is defined as someone owning 10% or more of the voting stock. A business combination that is approved by the Board before a person becomes an interested stockholder is not subject to the five-year moratorium or special voting requirements. After five years, three things are required:
     1. Approval of the transaction by the Board of Directors.
     2. Approval by >80% of all shares outstanding.
     3. Approval by >2/3 of all shares excluding those owned by the interested stockholder.
   - **Section 3-701 through 3-710: Otherwise referred to as the "Control Share Acquisition" provision.** Defines a "Control Share Acquisition" as having occurred when a shareholder passes any of three ownership thresholds (20%, 33.3% and 50%). Once an individual or group passes one of these thresholds, voting power is stripped from their shares unless such voting power is reaffirmed by a 2/3 vote of shares not held by the acquiring person.
   - **Section 3-801 through Section 3-805: Otherwise referred to as "The Maryland Unsolicited Takeover Act (MUTA)":** Among other things, the law permits, without shareholder approval, the board of Maryland corporation to:
     1. Elect a classified board
     2. Enact a majority requirement for calling a special meeting of stockholders
     3. Require a two-thirds vote to remove directors
     4. Restrict the number and replacement of existing directors

   A REIT that has not opted out of these clauses would appear to be "takeover proof" absent the blessing of the Board. Explicit bylaw safeguards are necessary to ensure that these onerous laws can never be used to fend off a suitor absent the approval of shareholders. Companies incorporated in Maryland or similar states are accorded credit in our system if they have opted out of these laws. They are accorded more credit if they have bylaws preventing them from ever opting in. Companies located in states that don't have laws of this sort do not have these anti-takeover devices available, so they receive a good score in our rating system.

2. **Poison Pills or Shareholder Rights Plans -** Although their terms and conditions vary considerably, the stated purpose of a poison pill is to force potential bidders to negotiate with a target company's board of directors. If the board approves the deal, it may redeem the pill. If the board does not approve a bid and the potential acquirer proceeds anyway, the pill would be triggered. The "poison" in the pill is generally the issuance of a new class of preferred stock that is massively dilutive to the ownership and voting power of the suitor. Poison pills typically do not have to be ratified by shareholders, and even those companies that do not currently have a poison pill can put one in place subsequent to receiving a hostile bid. Our scoring gives credit for not having a pill in place (most REITs fit this category), and additional credit is given to companies that have explicitly transferred authority regarding poison pills to shareholders, instead of their boards (though rare, a small number of REITs have done this).

3. **Ownership Limits Arising from the "5 or Fewer" Rule -** One of the requirements in the tax code for a company electing REIT status is that not more than 50% of the outstanding shares of a REIT may be owned by five or fewer individuals ("individuals" may include certain entities). As a result, the vast majority of REITs have a rule restricting ownership of any individuals or entities to eliminate any chance that this rule may be violated. In most instances, the ownership limit is just below 10%, although for some companies where insiders (who are typically exempted from this rule) control a large amount of stock, the limit is more restrictive. More than any other attribute unique to REITs, the presence of these restrictions makes REITs harder to take over than is the case for other corporations.

   While the presence of these ownership limits is entirely legitimate, their use as an anti-takeover device has nothing to do with their original intent. Most potential hostile acquirers would present no threat of violating the "5 or fewer" rule. By way of example, if the acquirer is a REIT, the tax code allows a "look through" of the REIT entity to the numerous shareholders of that REIT. Because of this, the acquisition of a sizable share block by another REIT presents no cause for concern that the target's tax status would be compromised, but a Board could still use the ownership limit as a deterrent to a hostile takeover.

   The vast majority of REITs have ownership limitations in place, and most have written these limitations in a manner where they could be used by the board to deter a suitor. Since REITs have the entire arsenal of normal corporate anti-takeover devices at their disposal, it is objectionable that so many have made this added entrenchment device available as well. Credit is given in our scoring system to companies that have explicitly attempted to neutralize the anti-takeover aspects associated with their ownership limitations.

4. **Insider Blocking Power -** Companies where insiders control a large stake can, for all practical purposes, only be taken over if management agrees. And in many instances, management will never agree. Our scoring system penalizes companies where insider blocking power is present. Further, because this power trumps everything else, companies where insiders control the vote should not receive full credit on the other anti-takeover variables even if they've made the right choices. Companies with complete veto power will receive only half credit on the other anti-takeover variables, and companies with partial blocking power (i.e., 15-35% insider votes) will receive something between half and full. An exception is made in those cases where the interests of the controlling shareholder are aligned with those of outside shareholders; these companies are typically awarded full credit for their anti-takeover elections even though they score less than perfect on the insider blocking variable.

C. Potential Conflicts of Interest

Potential conflicts arising from divergent interests of key insiders and shareholders represent the final category of variables that comprise our governance ratings.

1. **Business Relationships with Management/Board Members -** REITs have come a long way from earlier structures in which they were generally externally advised, i.e., they contracted with insider-owned entities for most management services. Indeed, business dealings between insiders and their companies are either non-existent or immaterial at the large majority of the companies in our coverage universe.

2. **Extent to which Insiders' Basis Differs from Outside Shareholders' Basis -** A CEO who has been at the helm of a successful company for a long time generally has a tax basis in his shares that is much lower

than the basis of an investor who has built a position in recent years. Divergent tax bases can create a large difference in the way two parties perceive major transactions, such as a cash sale of the company. Because of this, interests of insiders and shareholders are generally better aligned where tax bases are more closely aligned. Because it is very difficult to obtain tax basis information for insiders, our ratings on this variable represent our best estimate based on how long insider shares have likely been owned and how much appreciation (and real estate depreciation) has taken place over that time. It is somewhat ironic that certain underperforming REITs score high on this variable solely because their stock prices have been stagnant, but in terms of rating governance, this is appropriate. It does, however, highlight the need to consider factors other than governance in selecting stocks.

Green Street's Disclosure Information

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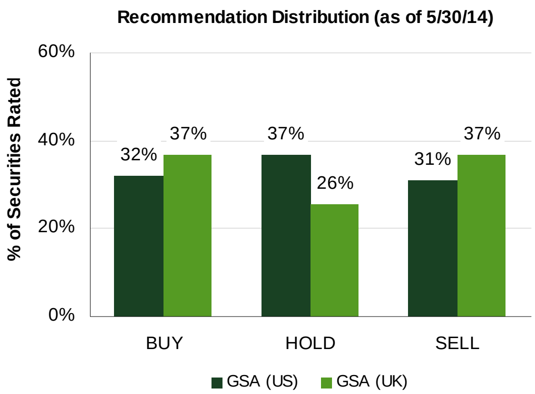
At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.



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.

North American Team

Green Street Advisors

Research 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780

Research	Mike Kirby, Director of Research	mkirby@greenst.com
	Craig Leupold, President	cleupold@greenst.com
Health Care/Lab Space	Michael Knott, CFA, Managing Director	mknott@greenst.com
	Kevin Tyler, Senior Associate	ktyler@greenst.com
	Christina Zhang, Associate	czhang@greenst.com
Industrial/Towers	Eric Frankel, Analyst	efrankel@greenst.com
	Dillon Essma, Associate	dessma@greenst.com
Lodging	Lukas Hartwich, CFA, Senior Analyst	lhartwich@greenst.com
	Jonathan Taylor, CPA, Associate	jtaylor@greenst.com
Mall	Daniel Busch, Senior Analyst	dbusch@greenst.com
	Spenser Allaway, Associate	sallaway@greenst.com
Net Lease	Cedrik Lachance, Managing Director	clachance@greenst.com
	Tyler Grant, CFA, Associate	tgrant@greenst.com
Office/Data Centers	Jed Reagan, Senior Analyst	jreagan@greenst.com
	John Bejjani, CFA, Analyst	jbejjani@greenst.com
	Bayle Smith, Associate	bsmith@greenst.com
	Katherine Corwith, Associate	kcorwith@greenst.com
Residential/Self-Storage	Dave Bragg, Managing Director	dbragg@greenst.com
	Ryan Burke, Analyst	rburke@greenst.com
	David Segall, Senior Associate	dsegall@greenst.com
	Conor Wagner, Senior Associate	cwagner@greenst.com
	John Pawlowski, Associate	jpawlowski@greenst.com
Strip Centers	Jason White, CFA, CPA, Analyst	jwhite@greenst.com
	Jay Carlington, CFA, Senior Associate	jcarlington@greenst.com
Real Estate Analytics/Quant	Andrew McCulloch, CFA, Managing Director	amcculloch@greenst.com
	Jason Moore, CFA, Manager	jmoore@greenst.com
	Peter Rothemund, CFA, Analyst	prothemund@greenst.com
	Kawika Tarayao, CFA, Analyst	ktarayao@greenst.com
	Joi Mar, Senior Associate	jmar@greenst.com
	Matt Larriva, Senior Associate	mlarriva@greenst.com
	Casey Thormahlen, Associate	cthormahlen@greenst.com
	Amul Bhatia, Associate	abhatia@greenst.com

Subscription Sales & Marketing 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780

Sales	Damon Scott, Managing Director, Subscription Sales	dscott@greenst.com
	Kevin Johnson, Manager, Subscription Sales	kjohnson@greenst.com
Marketing	Rosemary Pugh, Manager, Marketing	rpugh@greenst.com

Advisory & Consulting 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780

Jim Sullivan, Managing Director	jsullivan@greenst.com
Dirk Aulabaugh, Managing Director	daulabaugh@greenst.com
Matthew Wokasch, CFA, Senior Vice President	mwokasch@greenst.com
Phillip Owens, CFA, Senior Vice President	powens@greenst.com
David De La Rosa, Vice President	ddelarosa@greenst.com
Justin Brown, Senior Associate	jbrown@greenst.com
Dawn Seo, Senior Associate	dseo@greenst.com
Adam Goldblatt, Associate	agoldblatt@greenst.com

Administration 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780

Warner Griswold, CFA, Chief Operating Officer	wgriswold@greenst.com
Michael Kao, Managing Director, Technology	mkao@greenst.com
Robyn Francis, Manager, Compliance	rfrancis@greenst.com
Jimmy Meek, Controller, Accounting	jmeek@greenst.com

Brokerage services offered through Green Street Trading

Trading & Institutional Sales 600 North Pearl Street, Suite 2310 Dallas, TX 75201 1.800.263.1388 (Trading) +1.214.855.5905 (Sales)

Trading	Michael Vranich, Managing Director, Trading	mvranich@greenstreettrading.com
	Laurie Hauck, Vice President, Trading	lhauck@greenstreettrading.com
	Scott Lee, Vice President, Trading	slee@greenstreettrading.com
	Hayden Glasstetter, Trading Associate	hglasstetter@greenstreettrading.com
Institutional Sales	Anthony Scalia, Director, Institutional Sales	ascalia@greenstreettrading.com
	Tim Joy, Vice President, Institutional Sales	tjoy@greenstreettrading.com
	Scott Bell, Vice President, Institutional Sales	sbell@greenstreettrading.com
	Seth Laughlin, Vice President, Institutional Sales	slaughlin@greenstreettrading.com
	Kris Hoffman, Vice President, Institutional Sales	khoffman@greenstreettrading.com
	Eric Lovett, Institutional Sales	elovett@greenstreettrading.com

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PUBLIC COMPANY ADVISORY

JULY 27, 2010

Dodd-Frank Wall Street Reform and Consumer Protection Act - Public Company Impact

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act is aimed in part at accountability and transparency in the financial system and represents the most comprehensive financial reform legislation since the Great Depression. The Act also includes a number of provisions relating to executive compensation, corporate governance, credit ratings agency reforms and other matters that generally apply to public companies. This Advisory describes these provisions of the Act and how they may impact publicly traded companies.

Executive Compensation

The Act includes several provisions relating to executive compensation, which are summarized below. These include provisions relating to "say on pay," "say on golden parachute pay," independence of compensation committee members, independence of compensation committee advisors, additional executive compensation disclosures (pay vs. performance and internal pay comparison), clawback of erroneously awarded compensation and disclosure regarding employee and director hedging.

Say on Pay [§ 951]

The Act provides for say on pay for shareholders of all public companies. Under the Act, each company must give its shareholders the opportunity to vote on the compensation of its executives at least once every three years. The vote will be non-binding and will take the form of a resolution submitted to shareholders to approve the compensation of the company's executives as disclosed in the company's proxy statement. The frequency of the say-on-pay vote (i.e., every one, two or three years) will be determined by a separate shareholder vote at least once every six years. The Act permits the SEC to exempt companies or classes of companies from these requirements, taking into account, among other factors, whether the requirements disproportionately burden small companies.

It is important to note that this provision of the Act does not modify the executive compensation disclosure required in companies' proxy statements to require any additional disclosure of current or expected future compensation. Accordingly, as the say-on-pay vote will relate to the executive compensation that is disclosed in the proxy statement, it will primarily relate to historical compensation focusing on the compensation paid for or awarded during the prior year.

Effective Date: Companies must submit the say-on-pay vote and the vote to determine the frequency of future say-on-pay votes to their shareholders at the first annual meeting (or other shareholder meeting for which executive compensation disclosure is required in the proxy statement) occurring on or after January 21, 2011. As a result, most companies with a calendar year end will be required to submit these votes to their shareholders at their 2011 annual meetings.

Say on Golden Parachute Pay [§ 951]

In addition to the required say-on-pay votes, the Act also adds disclosure and voting requirements for golden parachute compensation that is payable to named executive officers in connection with sale transactions. These requirements apply to shareholder meetings at which shareholders are asked to approve a merger, consolidation, or sale of all or substantially all of the company's assets. In the proxy materials for such a meeting, the company soliciting proxies will be required to disclose, in a clear and simple form in accordance with regulations to be adopted by the SEC, any agreements or understandings with any named executive officer concerning any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the transaction and the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer. In addition, unless such agreements and understandings have already been subject to a say-on-pay vote, the company must give its shareholders a non-binding vote on such agreements and understandings and total compensation at the meeting for the transaction.

The Act permits the SEC to exempt companies or classes of companies from these requirements, taking into account, among other factors, whether the requirements disproportionately burden small companies.

Effective Date: These new requirements will apply to any meeting of shareholders at which shareholders are asked to approve a merger, consolidation, or sale of all or substantially all of the company's assets occurring on or after January 21, 2011.

Independence of Compensation Committee Members [§ 952]

The Act provides that the SEC must issue rules directing the stock exchanges (i.e., national securities exchanges and associations) to prohibit listing classes of equity securities if the company's compensation committee members are not independent. Under the Act, the SEC's rules must require the stock exchanges to consider the following in defining independence for compensation committee members: (i) sources of compensation for each compensation committee member, including any consulting, advisory or other compensatory fee paid by the company to the member, and (ii) whether the compensation committee member is affiliated with the company. This requirement is similar to the heightened independence standards that were placed on audit committee members by the Sarbanes-Oxley Act, except that the SEC rules to be adopted under the Act only require the stock exchanges to *consider* the factors described above in determining the independence standards for compensation committee members whereas the Sarbanes-Oxley Act effectively required the stock exchanges to *prohibit* persons from serving on the audit committee who (i) receive any consulting, advisory or other compensatory fee from the company or (ii) are affiliated with the company. However, if the stock exchanges adopt compensation committee independence rules that parallel current audit committee independence rules (which they might) then otherwise independent directors who are currently prohibited from serving on the audit committee will also be prohibited from serving on the compensation committee.

Once final SEC and stock exchange rules are adopted, companies will need to reevaluate the composition of their compensation committees to ensure that they meet whatever heightened independence standards are adopted.

These new requirements do not apply to controlled companies (i.e., companies where 50% of the voting power is held by an individual, a group or another company), foreign private issuers that provide annual disclosures to shareholders of the reasons they do not have an independent compensation committee or open-ended management investment companies that are registered under the Investment Company Act of 1940. In addition, the SEC rules must permit the stock exchanges to exempt categories of companies from these requirements and, in determining appropriate exemptions, the stock exchanges must take into account the potential impact of the requirements on smaller reporting companies.

Effective Date: The SEC is required to adopt rules by July 16, 2011 directing the stock exchanges to prohibit the listing of any securities of a company that is not in compliance with these requirements.

Independence of Compensation Committee Advisors [§ 952]

The Act provides that a company's compensation committee may only select a compensation consultant, legal counsel or other advisor after taking into consideration factors to be identified by the SEC that affect the independence of a compensation consultant, legal counsel or other advisor. These will include the following five specific factors identified in the Act:

- the provision of other services to the company by the person that employs the compensation consultant, legal counsel or other advisor[1];
- the amount of fees received from the company by the person that employs the compensation consultant, legal counsel or other advisor, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other advisor;
- the policies and procedures of the person that employs the compensation consultant, legal counsel or other advisor that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other advisor with a member of the compensation committee; and
- any stock of the company owned by the compensation consultant, legal counsel or other advisor.

The Act does not require companies' compensation committees to make formal independence determinations with respect to any compensation consultant, legal counsel or other advisor that it engages, but it does require each company to disclose in its proxy materials for its annual meetings, in accordance with regulations of the SEC, whether its compensation committee retained or obtained the advice of a compensation consultant and whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed. Under current rules, companies are already required in their proxy statements to identify any compensation consultants used in determining or recommending the amount or form of executive or director compensation and include some disclosure relating to potential conflicts of interest of such compensation consultants. However, as the current rules do not appear to squarely address all of the new disclosure requirements of the Act, we expect the SEC to adopt additional rules relating to the disclosure of conflicts of interest.

The Act also requires that (i) the compensation committee be directly responsible for the appointment, compensation and oversight of the work of a compensation consultant, independent legal counsel and any other advisor that it retains and (ii) companies provide appropriate funding as determined by the compensation committee for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other advisor to the compensation committee. However, the Act does not require the compensation committee to retain a compensation consultant, independent legal counsel or any other advisor, and it does not prohibit the compensation committee from receiving advice from a compensation consultant, legal counsel or other advisor to the company that was not specifically selected or retained by the compensation committee.

These new requirements do not apply to controlled companies (i.e., companies where 50% of the voting power is held by an individual, a group or another company). In addition, the SEC rules must permit the stock exchanges to exempt categories of companies from these requirements and, in determining appropriate exemptions, the stock exchanges must take into account the potential impact of the requirements on smaller reporting companies.

Effective Date: The proxy disclosure requirements described above apply to proxy materials for annual meetings occurring on or after July 21, 2011, provided that no specific deadline is set for the additional SEC regulations that appear to be contemplated by the Act regarding these disclosure requirements. The SEC is required to adopt rules by July 16, 2011 directing the stock exchanges to prohibit the listing of any securities of a company that is not in compliance with these requirements.[2] Lastly, the SEC is directed to identify factors that affect the independence of a compensation consultant, legal counsel or other advisor, but there is no specific deadline placed on the SEC for the identification of such factors.

Additional Executive Compensation Disclosures (Pay vs. Performance and Internal Pay Comparison) [§ 953]

The SEC is required under the Act to issue rules obligating companies to disclose in proxy materials for annual meetings of shareholders information that shows the relationship between executive compensation actually paid to their named executive officers and their financial performance, taking into account any change in the value of the shares of the company's stock and any dividends or distributions. The SEC is also required to amend Item 402 of Regulation S-K to require each company to disclose the median of total annual compensation for all employees of the company except the CEO, the total annual compensation of the CEO and the ratio of these two figures. Total compensation for the employees of a company will be calculated on the same basis as it is for purposes of the Summary Compensation Table required by Item 402 of Regulation S-K (i.e., including salary, bonus, grant date fair value of equity awards, perks, etc.). Depending on the number of employees a company has and the complexity of its compensation arrangements, among other things, determining the median of total annual compensation for all employees other than the CEO may impose a substantial additional administrative burden on the company.

Effective Date: Neither the date by which the SEC must adopt these rules nor the date by which any such rules must become effective is specified in the Act.

Clawback of Erroneously Awarded Compensation [§ 954]

The Act provides that the SEC must issue rules directing the stock exchanges to prohibit listing any security of a company unless the company develops and implements a policy providing (i) for disclosure of the policy of the company on incentive-based compensation that is based on financial information required to be reported under the securities laws and (ii) that, in the event that the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws, the company will recover from any current or former executive officer of the company who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the company is required to prepare the restatement based on the erroneous data, any excess compensation above what would have been paid under the restatement. This clawback requirement is significantly broader than the clawback contained in the Sarbanes-Oxley Act, which, among other things, only applied to restatements that resulted from misconduct and only applied to a company's CEO and CFO.

Due to the draconian nature of the clawback required, this provision of the Act may lead companies to consider restructuring their incentive-based compensation to either (i) include a deferral feature to reduce the amount of compensation that is paid out prior to the expiration of the clawback period, (ii) move more towards discretionary incentive-based compensation programs or (iii) utilize non-financial metrics such as stock price appreciation or total return to shareholders.

Effective Date: Neither the date by which the SEC must adopt these rules nor the date by which the stock exchanges must have adopted rules addressing these requirements is specified in the Act.

Disclosure Regarding Employee and Director Hedging [§ 955]

The Act requires the SEC, by rule, to require that each company disclose in the proxy materials for its annual meetings whether any employee or board member is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange traded funds) designed to hedge or offset decreases in the market value of equity securities granted as compensation or otherwise held by the employee or board member. As a result, companies that do not already have a comprehensive policy addressing the use of hedging instruments, whether in their insider trading policies and procedures or elsewhere, may want to consider adopting one.

Effective Date: Neither the date by which the SEC must adopt these rules nor the date by which any such rules must become effective is specified in the Act.

Corporate Governance

The Act includes several provisions relating to corporate governance, which are summarized below. These include provisions relating to proxy access, disclosure of Chairman and CEO structure, and broker discretionary voting.

However, in the area of general public company corporate governance, perhaps the most notable part of the Act is what is not included. The Act does not mandate majority voting in uncontested director elections, declassified boards or independent chairmen of the board, all of which had been in previously proposed legislation that was supplanted by the Act.

Proxy Access [§ 971]

The Act clarifies that the SEC may, but is not required to, promulgate rules that would require that a company's proxy materials include a nominee for the board of directors submitted by a shareholder. The Act also gives the SEC the authority to exempt companies or classes of companies from these requirements and specifically directs the SEC to consider whether the requirements would disproportionately burden small issuers. Prior versions of the Act (and its predecessors) had included limitations on the SEC's ability to adopt proxy access (e.g., limiting the shareholders entitled to access to those who had held at least 1% of a company's stock for at least two years). The most notable feature of this provision of the Act is that it does not include any such limitation and gave the SEC full flexibility to determine the parameters of proxy access. The SEC's latest proposal regarding proxy access, from June 2009, was summarized in Goodwin Procter's July 2, 2009 Public Company Advisory.

Effective Date: July 21, 2010.

Disclosure of Chairman and CEO Structure [§ 972]

Pursuant to the Act, the SEC must issue rules requiring companies to disclose in their annual proxy sent to investors the reasons why the company has the same person serving as chairman of the board and CEO or has different individuals serving in those roles. Given that Item 407 of Regulation S-K already requires companies to disclose their board leadership structure along with an explanation of why the company selected the structure, it is unclear what additional steps will need to be taken, if any, in response to this provision.

Effective Date: The SEC is required to issue rules by January 17, 2011 regarding this disclosure requirement.

Broker Discretionary Voting [§ 957]

The Act requires stock exchanges to have rules prohibiting their members (i.e., brokers) from voting securities that they do not beneficially own (unless they have received voting instructions from the beneficial owner) with respect to the election of a member of the board of directors (other than an uncontested election of directors of an investment company registered under the Investment Company Act of 1940), executive compensation or any other significant matter, as determined by the SEC by rule. The potential impact of the restriction on discretionary voting for directors by brokers should have already been determined by most companies given the recent amendment to NYSE rules eliminating discretionary voting for director elections for annual meetings of shareholders held on or after January 1, 2010. NYSE rules have also prohibited discretionary voting by brokers on many of the most typical matters relating to executive compensation, such as the adoption or amendment of an equity compensation plan. As a result, for most companies, this provision of the Act should not have a significant impact on their shareholder voting.

Effective Date: July 21, 2010. The Act does not specify a date by which the SEC must adopt rules identifying any "other significant matters" with respect to which discretionary voting must be prohibited (or even if the SEC must adopt any such rules).

Credit Ratings Agency Reforms [§§ 931 et seq.]

The Act includes a number of provisions that are targeted at improving the reliability of credit ratings. The precise impact of these reforms on companies and credit ratings agencies will not be fully known until the numerous additional rules the Act has charged the SEC with adopting and implementing have been promulgated. However, it does appear that these reforms could have a significant impact. Please note that the foregoing does not address the specific implications of the provisions of the Act relating to credit ratings agency reform as they apply to offerings of asset-backed securities.

One of the significant provision of the Act, in this respect, is the repeal of Rule 436(g) under the Securities Act of 1933, as amended (the "Securities Act"), which had provided that a credit rating disclosed in a registration statement (including any prospectus) was not considered an expertized portion of the registration statement requiring written consent of the applicable credit ratings agency for inclusion. In theory, this would require companies to either obtain the consent of the credit ratings agency or exclude the credit rating from the registration statement. However, because consenting to the inclusion of the credit rating would subject the ratings agency to potential liability under Section 11 of the Securities Act, the credit ratings agencies have indicated that they will not be willing to provide their consent. As a result, generally, companies will be required to exclude credit ratings from their registration statements (including any prospectuses) unless and until the credit ratings agencies change their positions. However, companies will still be permitted to refer to a credit rating orally, in a free writing prospectus or in communications complying with Rule 134 under the Securities Act, without obtaining the consent of the applicable credit rating agency and, therefore, the framework for offering rated debt securities as it currently exists (other than with respect to asset-backed securities) should not be effected materially by this change. In addition, the SEC has issued interpretive guidance confirming that companies (i) may still include disclosure of credit ratings if the disclosure is related only to changes to a credit rating, the liquidity of the company, the cost of funds for the company or the terms of agreements that refer to credit ratings[3] and (ii) may continue to use registration statements that were declared effective before July 22, 2010 that included or incorporated by reference credit ratings without obtaining the consent of the applicable credit ratings agency until the next required amendment of the registration statement pursuant to Section 10(a)(3) of the Securities Act[4], provided that no subsequently incorporated periodic or current report contains ratings information other than that described in clause (i) above.

The reforms also include several provisions that will change the type of information provided by credit ratings agencies and may change the type of information provided by public company issuers to credit ratings agencies. For example, the Act will require credit ratings agencies to publicly disclose additional information regarding the data relied upon to determine a credit rating and information on uncertainty of such credit rating (including information on the reliability, accuracy and quality of the data relied on in determining such credit rating and any limits on the accessibility to information that would have better informed such credit rating). Additionally, the SEC is directed to revise Regulation FD to remove the blanket exemption for a public company's disclosure to entities whose primary business is the issuance of credit ratings. Therefore, a public company will have to determine whether a disclosure to a given credit ratings agency is a disclosure that is subject to Regulation FD, and if it is, whether another exemption, such as the exemption that permits material non-public information to be shared with a person who expressly agrees to maintain the disclosed information in confidence, may be relied upon.

The Act also requires the SEC, along with all other federal agencies, to modify all of its regulations to remove any reference to or requirement of reliance on credit ratings and to substitute an alternative standard of credit-worthiness that is deemed appropriate by the SEC. Among other things, this would require the SEC to replace the Form S-3 eligibility requirement relating to the issuance of non-convertible securities that are "investment grade securities." The SEC has previously proposed replacing this eligibility requirement with an alternative requirement that would be satisfied by companies that had issued at least $1 billion in aggregate principal amount of non-convertible securities, other than common equity, for cash (not exchange) in registered offerings in the prior three years. If this previously proposed standard is adopted, it would exclude a number of companies, such as operating partnerships of REITs that have not met this volume threshold, from using Form S-3 to publicly issue investment grade debt securities.

Effective Date: Generally, final regulations with respect to the credit ratings reforms are to be issued by the SEC by July 21, 2011. The SEC is required to revise Regulation FD by October 19, 2010. The repeal of Rule 436(g) is effective on July 21, 2010.

Various Other Provisions

The Act includes several other provisions that will impact public companies that are summarized below. These include provisions relating to a revised accredited investor standard, exemption for non-accelerated filers from Section 404(b) of the Sarbanes-Oxley Act, Section 13 and 16 reporting, reporting of short sales and certain votes by institutional investment managers and securities litigation matters.

Revised Accredited Investor Standard [§ 413; § 926]

The Act directs the SEC to make certain adjustments to the accredited investor standard relating to a natural person's net worth under the Securities Act, including for purposes of Regulation D. Regulation D provides a safe harbor for securities offerings that meet certain requirements from the registration requirements of the Securities Act. Under the most commonly used Regulation D exemption, offers and sales of securities are only exempt if, among other things, (i) there are no more than 35 purchasers in the offering who do not qualify as accredited investors and (ii) the company furnishes each purchaser in the offering who is not an accredited investor with detailed disclosure similar to that required in a registered offering. As a result, the definition of who qualifies as an accredited investor is very important, and companies routinely limit sales in private placements to investors who qualify as accredited investors.

The existing accredited investor standard relating to a natural person's net worth, which is one of the ways a natural person may qualify as an accredited investor, provides that a natural person will qualify as an accredited investor if his or her net worth (or joint net worth with his or her spouse) at the time of purchase exceeds $1,000,000. The Act changes the net worth standard to "$1,000,000, excluding the value of the primary residence of such natural person" during the four-year period that begins on July 21, 2010, which is the date of enactment of the Act. Although this change was effective on the date of enactment, the Act also directs the SEC to adopt rules that will incorporate this change and permits the SEC to review and adjust other accredited investor standards for natural persons. The Act also directs the SEC to review and authorizes the SEC to adjust the definition of accredited investor in its entirety, as it applies to natural persons, at least once every four years to determine whether the definition should be adjusted or modified for the protection of investors and in light of the economy, provided that any adjustment to the net worth standard must be to an amount more than $1,000,000, excluding the value of the natural person's primary residence.[5] Companies intending to complete a private placement in reliance on this exemption after July 21, 2010 may need to take additional steps to ensure that this exemption will be available for offerings that were not closed before July 21, 2010.

In a separate provision, the Act also directs the SEC to issue rules to disqualify certain "bad actors" from participating in a private placement that is intended to satisfy the most commonly used Regulation D exemption (i.e., Rule 506 exemption).

Effective Date: The change in the accredited investor net worth standard is effective as of July 21, 2010. The SEC is required to issue rules by July 21, 2011 regarding the disqualification of "bad actors."

Exemption for Non-Accelerated Filers from Section 404(b) of the Sarbanes-Oxley Act [§ 989G]

The Act amends Section 404 of the Sarbanes-Oxley Act by exempting non-accelerated filers (i.e., generally, those companies with less than $75 million of non-affiliate common equity market capitalization) from the requirements to provide an independent auditor attestation of management's assessment of the effectiveness of the company's internal control over financial reporting. These companies will still be required to maintain internal control over financial reporting and assess the effectiveness of their internal controls on an annual basis. Previously, the SEC had temporarily delayed the application of this requirement to non-accelerated filers several times. This amendment will provide some much appreciated certainty on this issue for non-accelerated filers. The Act also requires the SEC to conduct a study to determine how it could reduce the burden of Section 404(b) of the Sarbanes-Oxley Act on companies with market capitalization between $75 million and $250 million.

Effective Date: July 21, 2010.

Section 13 and Section 16 Reporting [§ 929R; § 766]

The Act eliminated the requirement under Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), for persons filing a Schedule 13D to send copies to the issuer and the exchanges on which such securities are listed and the requirement under Section 16 of the Exchange Act for reporting persons to file their Section 16 reports with any national securities exchange on which the underlying securities are registered. The Act also modified Section 13(d) and Section 16 to permit the SEC to require persons to make their initial filings under these sections (i.e., Schedule 13Ds or Form 3s, respectively) within less than 10 days of the triggering event (i.e., becoming a 5% or greater shareholder or becoming a director, officer or 10% shareholder).

The Act also amends Section 13 of the Exchange Act to provide that a person will be deemed to have acquired beneficial ownership of an equity security for the purposes of Section 13 or Section 16 based on the purchase or sale of a security-based swap only to the extent that the SEC by rule, after consultation with banking regulators and the Treasury, makes certain determinations regarding the security-based swap and its comparability to the underlying security. The Act then amends Section 13(d), Section 13(f) and Section 13(g) of the Exchange Act to provide that such deemed beneficial ownership will be considered beneficial ownership of the underlying equity securities for purposes of the reporting requirements contained in those subsections.

Effective Date: July 21, 2010.

Reporting of Short Sales and Certain Votes by Institutional Investment Managers [§ 929X; § 951]

The Act requires the SEC to prescribe rules providing for monthly or more frequent public disclosure of short sales by institutional investment managers who are currently subject to reporting under Section 13(f) of the Exchange Act. Additionally, the Act requires these institutional investment managers to disclose their votes on say on pay and say on golden parachute pay at least annually unless they are otherwise required to report such votes publicly. These rules may provide additional insight to companies regarding shorting of their securities and how certain institutional investors voted on the new say-on-pay votes.

Effective Date: The provision relating to the reporting of say-on-pay votes is effective on July 21, 2010; however, as it only relates to annual reporting of votes required under the Act (which are only required for meetings occurring on or after January 21, 2011), the first reporting may not occur until late 2011 or early 2012. With respect to the rules regarding the disclosure of short sales, the Act does not specify the date by which the SEC must adopt such rules or the date by which they must become effective.

Securities Litigation Matters

The Act also has a number of provisions designed to promote the SEC's and private litigants' litigation efforts, including, among others, the following:

- establishing aiding and abetting liability for persons who knowingly or recklessly provide substantial assistance to another person in violation of the Securities Act with respect to civil actions brought by the SEC under certain provisions of Section 20 of the Securities Act;

- changing the liability standard for aiding and abetting liability with respect to civil actions brought by the SEC under certain provisions of Section 21(d) of the Exchange Act to includes persons who "recklessly" provide substantial assistance to another person in violation of the Exchange Act in addition to persons who do so "knowingly";

- increasing whistleblower protections relating to violations of securities laws and allowing whistleblowers to collect a portion of monetary sanctions collected by the SEC relating to the matter the whistleblower provided information regarding; and

- the addition of specific anti-fraud prohibitions relating to short sales.

Please note that this Advisory does not necessarily describe the specific impact of each of the provisions of the Act summarized above on voluntary filers, foreign private issuers, asset-backed issuers, registered investment companies and others subject to unique requirements.

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[1] Presumably, where the compensation consultant, legal counsel or other advisor is a firm or other entity, the phrase “the person that employs the compensation consultant, legal counsel or other advisor” is intended to refer to such firm or other entity.

[2] Note that the Act does not explicitly limit the application of these provisions to companies listed on stock exchanges (or state that they don’t otherwise apply to all companies as of July 21, 2010). However, based on the provisions relating to the stock exchanges and their ability to exempt certain companies (among other things), we do not believe that the Act should be construed in this manner.

[3] This position is consistent with the preliminary position that the SEC articulated in a concept release issued in 2009 relating to the potential repeal of 436(g).

[4] For registration statements on Form S-3, a Section 10(a)(3) updating amendment will occur upon the filing of a company’s annual report on Form 10-K.

[5] As written, this requirement only applies to the accredited investor definition under Rule 215 under the Securities Act and not the definition for purposes of Regulation D. However, we believe it is likely that the SEC will review and adjust both at the same time.

If you would like additional information about the issues addressed in this Client Advisory, please contact:

Daniel Adams	dadams@goodwinprocter.com	617.570.1966
Marian Tse	mtse@goodwinprocter.com	617.570.1169
Scott Webster	swebster@goodwinprocter.com	617.570.8229
Lisa Haddad	lhaddad@goodwinprocter.com	617.570.8311
James Barri	jbarri@goodwinprocter.com	617.570.1105
Ettore Santucci	esantucci@goodwinprocter.com	617.570.1531
Lynda Galligan	lgalligan@goodwinprocter.com	617.570.1090
John O. Newell	jnewell@goodwinprocter.com	617.570.1475
David Roberts	droberts@goodwinprocter.com	617.570.1039

I. Public company structure vs. private equity fund model

A. REITs Generally[1]

Real estate investment trusts (REITs) are entities that satisfy certain U.S. federal income tax requirements and elect to be taxed as REITs. In general, the tax requirements ensure that the REITs (a) are passive investors in real estate (and related assets), (b) do not retain their earnings, and (c) are beneficially owned by a diversified stockholder base.

REITs can be publicly traded or privately held as long as they satisfy the organization and operational requirements for REIT status, as described below. The three general types of REITs are:

- publicly traded REITs
- public non-traded REITs and
- private REITs.

The Internal Revenue Code sets forth the requirements for each type of REIT.

B. Public REITs[2]

REITs become public companies in the same way as non-REITs, although there are additional disclosure obligations for REITs and compliance with certain rules regarding roll-ups may be required. Public REITs (both traded and non-traded) are subject to reporting and other requirements of public companies under the federal securities laws. Publicly traded REITs are subject to additional regulatory requirements of their exchanges, such as the NYSE. Some REITs also may be able to take advantage of more lenient requirements available to emerging growth companies under the Jumpstart Our Business Startups (JOBS) Act of 2012.

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[1] Matthew Hudson. Funds: Private Equity, Hedge and All Core Structures, (John Wiley & Sons) (2014).
[2] Nilene R. Evans et al., Frequently Asked Questions About Real Estate Investment Trusts, Morrison& Foerster LLP (2013), *available at* http://www.mofo.com/files/Uploads/Images/FAQ_REIT.pdf.

1. Publicly Traded REITs[3]

Publicly traded REITs must comply with securities laws and regulations that apply to all public companies, as well as the disclosure requirements of Form S-11 and SEC Industry Guide 5 of the Securities Act of 1933, as amended (the "Securities Act"), and in some cases, Section 14(h) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Securities and Exchange Commission ("SEC") rules specify the disclosures to be made in a prospectus for a public offering of securities, as well as for ongoing disclosures once an issuer becomes a public company. For most initial public offerings by a U.S. domestic entity, Form S-1 sets forth the required disclosures. REITs, however, must use Form S-11 and include information responsive to SEC Industry Guide 5. In addition to the same kinds of disclosures required by Form S-1, Form S-11 sets forth the following additional disclosure requirements:

- Investment policies regarding investments in real estate, mortgages and other real estate interests based on the REIT issuer's prior experience in real estate;

- Location, general character and other material information regarding all material real properties held or intended to be acquired by or leased to the issuer or its subsidiaries ("material" is defined in this case as any property whose book value is 10% or more of the total assets of the consolidated issuer or the gross revenues from which is at least 10% of aggregate gross revenues of the consolidated issuer for the last fiscal year);

- Operating data of each improved property, including the occupancy rate, number of tenants and principal lease provisions; and

[3] *Id.*

- Arrangements with respect to the management of the REIT's real estate and the purchase and sale of mortgages for the REIT issuer.

SEC Industry Guide 5 contains the following additional requirements:

- Disclose risks relating to (i) REIT management's lack of experience or lack of success in real estate investments, (ii) uncertainty if a material portion of the offering proceeds is not committed to specified properties, and (iii) real estate limited partnership offerings in general;

- Disclose the general partner's or sponsor's prior experience in real estate; and

- Disclose risks associated with specified properties, such as competitive factors, environmental regulation, rent control regulation, fuel or energy requirements and regulations.

REITs listed on a securities exchange are generally subject to the same rules as non-REITs. For a REIT that does not have a three-year operating history, however, the NYSE typically will permit listing if the REIT has at least $60 million in stockholders' equity, including the funds raised in any IPO related to the listing.

Publicly traded REITs have historically exhibited price volatility in correlation with broader equity markets.[4] Similarly, distribution yields paid by traded REITs vary with the movement in stock price in addition to the value of the assets held by the REIT itself.[5]

[4] Dr. Randy Anderson, Investing in Non-Traded REITs (Investment Program Association) (June, 2013), *available at:* http://www.ipa.com/?wpdmact=process&did=MzQzLmhvdGxpbms=.
[5] *Id.*

2. Public Non-Traded REITs[6]

Public non-traded REITs have offered securities to the public pursuant to the Securities Act and are subject to the ongoing disclosure and other obligations under the Exchange Act, but are not listed on a stock exchange. According to Blue Vault Partners, which tracks non-traded REITs, there were 69 non-traded REITs with an estimated $78.60 billion in assets as of June 30, 2013. Through the first eight months of 2014, non-traded REITs had raised in excess of $10 billion.[7] Shares of non-traded REITs generally are sold directly or through brokers and their prices are set by the REIT sponsor or may be based on net asset value as determined by independent valuation firms. Shares in non-traded REITs are available only to qualified investors, and the success of a non-traded REIT is measured by total return, including cash distributions during the lifespan of the REIT and any appreciation of principal realized as the result of a liquidity event.[8] Up-front fees for non-traded REITs range from 12% to 15%.[9]

As described above, exchange-traded REITs and non-traded REITs are both publicly registered, but shares of non-traded REITs are not listed and do not trade on a national securities exchange. As a result, shares of non-traded REITs typically have limited secondary markets and generally are significantly less liquid than exchange-traded REIT securities. As a result, investors can typically expect to hold shares in a non-traded REIT for the lifespan of the REIT, which is typically seven to ten years.[10] The life cycle of a non-traded REIT consists of four distinct phases: capital raising, property acquisition, asset management, and disposition (which may include a decision to list the REIT on a

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[6] Evans et al., Frequently Asked Questions About Real Estate Investment Trusts.
[7] Robbie Whelan, Report Finds Non-Traded REITs Trail Publicly Listed Peers, The Wall Street Journal (Sep. 4, 2014), *available at:* http://blogs.wsj.com/developments/2014/09/04/report-finds-non-traded-reits-trail-publicly-listed-peers/.
[8] Dr. Randy Anderson, Investing in Non-Traded REITs.
[9] *Id.*
[10] *Id.*

public exchange).[11] Non-traded REITs are obligated to execute an exit strategy to return invested capital and any appreciation to investors, which also poses a unique risk.[12]

Because of the limited market in securities of non-traded REITs, the industry standard in the past was to set the initial offering price at $10 per share and to maintain it at that level, sometimes for many years, irrespective of the operating performance of the issuer. The Financial Industry Regulatory Authority, Inc. ("FINRA") also recently proposed revisions to Rule 2340 regarding per share estimated valuations for unlisted REITs, which were approved by the SEC on October 10, 2014, as described below.[13] In some cases, non-traded REITs may have limited annual redemption programs to provide some liquidity to investors. Such redemption programs are costly to investors in that they always are at a discount from the purchase price, and they also are typically limited by the number of shares that may be redeemed and may be suspended if market conditions dictate.[14]

The SEC, FINRA and others have scrutinized non-traded REITs because of allegedly high upfront and continuing fees paid to the sponsor and its affiliates, as well as the fact that the share price (which is based on the net asset value calculated by the REIT sponsor) generally does not change even with changes in the issuer's operating results or related matters, such as calculation of dividend yields and appreciation.[15] For example, some non-traded REITs have paid dividends out of proceeds from issuing debt without correspondingly decreasing net asset values in their holdings, giving an illusion of a stable price.[16] Critics of non-

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[11] *Id.*
[12] *Id.*
[13] SEC Release No. 34-73339; File No. SR-FINRA -2014-006 (October 10, 2014).
[14] *Id.*
[15] *See also* FINRA Regulatory Notice 09-09 (Feb., 2009), *available at*: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117795.pdf.
[16] Tim Husson, PhD et. al., A Primer on Non-Traded REITs and Other Alternative Real Estate Investments (Securities Litigation & Consulting Group) (2012), *available at:*

traded REITs claim that positioning them as investments that don't have volatility is also misleading to investors because they are not traded and therefore volatility cannot be measured.[17] Additionally, it is not uncommon for non-traded REITs to have conflicts of interest due to commonalities of key individuals and entities.[18]

In October 2011, FINRA issued an investor alert[19] to warn investors of certain risks of publicly registered non-traded REITs, including:

- Distributions are not guaranteed and may exceed operating cash flow (the REIT's board of directors, in its discretion in exercising its fiduciary duties, decides whether to pay distributions and the amount of any distribution);

- Investors may suffer adverse tax consequences resulting from distributions and REIT status;

- There is no public trading market, which results in illiquidity and valuation complexities;

- Early redemption features often are restrictive and may be expensive;

- Fees may be significant;

- REIT's properties may not be specified; and

- Possible lack of diversification.

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http://www.slcg.com/pdf/workingpapers/Non%20Traded%20REITs%20White%20Paper.pdf.

[17] Robbie Whelan, Non-Traded REITs Trail Publicly Listed Peers.

[18] Tim Husson, PhD et. al., A Primer on Non-Traded REITs and Other Alternative Real Estate Investments.

[19] Public Non-Traded REITs—Perform a Careful Review Before Investing, (Financial Industry Regulatory Authority, Inc.), *available at:* http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/REITS/P124232.

In August 2012, FINRA reissued an alert to inform investors of the features and risks of publicly registered non-traded REITs.[20] FINRA also provides investors with tips to deal with these risks. On July 16, 2013, the SEC also issued guidance regarding disclosures by non-traded REITs on distributions, dilution, redemptions, estimated value per share or net asset value, supplemental information, compensation to sponsor, and prior performance, among other things.[21]

C. Private REITs[22]

Like other companies, REITs may issue equity securities without registration under the Securities Act if there is an available exemption from registration, such as Section 4(a)(2) of the Securities Act (often in accordance with Regulation D) or Regulation S or Rule 144A under the Securities Act.

Unlike public REITs, private REITs are subject to restrictions on how many shareholders they may have, although they must have at least 100 holders. Section 12(g) of the Exchange Act requires a company to register under the Exchange Act and be subject to its periodic reporting and other obligations if it has at least 2,000 shareholders of record or 500 shareholders who are not accredited investors, and the Investment Company Act requires registration of investment companies that have more than 100 holders who are not qualified purchasers unless another exemption is available. In addition, the equity securities of private REITs are not traded on public stock exchanges, and generally have less liquidity than those of publicly traded REITs.

To satisfy ownership and holder requirements, a typical private REIT structure has one or a handful of shareholders who may own

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[20] *Id.*

[21] SEC Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts, CF Disclosure Guidance: Topic No. 6 (July 16, 2013), *available at*: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm.

[22] Evans et al., Frequently Asked Questions About Real Estate Investment Trusts.

all the common stock, along with a special class of preferred shares owned by at least 100 holders in order to satisfy the requirement of having at least 100 shareholders. A private REIT also must satisfy the "not closely held" requirement. In most cases, however, the "not closely held" requirement is not an issue because the holders of shares in a private REIT will be corporations or partnerships with many investors. The “not closely held" rule is applied by looking through those entities to their investors. In some cases, special considerations may apply when direct or indirect shareholders are tax-exempt.

Alternatively, some companies provide services to help a private REIT fulfill the 100 shareholder requirement. Such companies also may provide administrative service relating to ownership and holder requirements, including maintaining the shareholder base, creating and maintaining shareholder records and keeping records of the ownership changes.

II. Recent SEC staff guidance and areas of focus, including implications for capital raise transactions

A. Valuation Rules Change for Non-Listed REITs

On October 10, 2014, the SEC approved a FINRA-proposed revision to NASD Rule 2340 regarding per share estimated valuations for unlisted REITs.[23] FINRA first submitted the proposed rule changes in January 2014. The rule will become effective 18 months after the approval date (April 10, 2016). Key rule changes include:[24]

- Firms must include a per-share estimated value for an unlisted direct participation program or a REIT on customer statements using one of two methodologies presumed to be reliable: (1) net investment methodology (reflecting the "net investment" disclosed in the issuer's

[23] SEC Release No. 34-73339; File No. SR-FINRA-2014-006 (October 10, 2014).
[24] "SEC Valuation Rule Changes for Non-Listed REITS," Duff & Phelps (October 2014).

most recent periodic or current report, based on the amount available for investment percentage shown in the offering prospectus), or (2) appraised value methodology (consisting of the appraised valuation disclosed in the issuer's most recent periodic or current report). Under the net investment methodology, firms also have to spell out to customers in a statement that part of their distribution includes a return of capital, and any distribution that represents a return of capital reduces the estimated per-share value shown on the customer's account statement.

- Non-listed REIT issuers must include general disclosures: (1) there is no liquid market for the REIT securities; (2) even if a shareholder is able to sell the security, the price received may be less than the per share estimated value provided in the customer statement; (3) what methodology was used to calculate the value reported, and (4) that the value reported was based on a reliable methodology.

- Net investment may not be used for more than two years plus 150 days after breaking escrow. Firms may not include an over distribution deduction in net investment methodology.

- Independent valuation methodology requires the firm to retain a third-party, independent valuation expert to perform or provide material assistance in the valuation beginning at a minimum of two years plus 150 days after breaking escrow. Firms also must update the valuation annually thereafter.

- The independent valuation must be accompanied by a written opinion or report by the issuer delivered annually to the broker-dealer that explains the scope of the review, the methodology used and the basis for the values reported.

B. SEC Guidance on Real Estate Acquisitions

On July 16, 2013, the SEC's Division of Corporation Finance posted an updated Financial Reporting Manual on the SEC's website. The Financial Reporting Manual reflects numerous substantive updates to the Staff's guidance on REIT disclosure issues related to real estate acquisitions. Effective immediately upon release, the Manual guidance includes updates regarding the application of Rule 3-14 of Regulation S-X, as well as confirmation that Rule 3-14 financials are not triggered at the time of a shelf takedown. The SEC also stated that in some cases, a REIT issuer may use pro forma assets to measure the significance of an acquisition for Rule 3-14 purposes.

C. SEC Guidance on Public Non-Listed REIT Disclosures

The SEC's Division of Corporation Finance also released guidance on non-traded REIT disclosures on July 16, 2013.[25] The guidance encourages non-traded REITs to streamline prior performance disclosure so that potential investors can accurately evaluate the business characteristics and economic position of the non-traded REIT. The Staff explains that prior performance disclosure should reflect "an appropriate balance between the benefits of providing investors useful prior performance disclosure and the risk that voluminous and complex prior performance disclosure may obscure other material information about the registrant."

According to the guidance, a non-traded REIT is required to disclose its ability to maintain or increase its historical distribution yield and the source of funds used to cover a shortfall if the cash flow cannot cover distributions. Newly formed non-traded REITs that have no distribution history should disclose estimated distribution yield, share values, and assets values in SEC filings, as well as the basis for their estimates. In addition, non-traded REITs should disclose any potential dilution that could affect the value of

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[25] SEC Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts, CF Disclosure Guidance: Topic No. 6 (July 16, 2013), *available at*: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm.

shares and explain the dilutive impact of aggregate distributions paid in excess of earnings.

The guidance also indicates that non-traded REITs should disclose information about their redemption programs. Because investments in non-traded REITs are generally illiquid, many non-traded REITS provide investors with limited liquidity through their redemption programs. But such programs always have restrictions on the number of the shares that could be redeemed per year and the source of funds that could be used for redemptions. Therefore, the guidance asks the non-traded REITs to summarize their redemption history with a description of the number of requests honored, the number of requests deferred and the source of funds used to honor these request.

D. SEC Guidance on Conflict Minerals May Impact REITs

In May 2013, the SEC provided guidance on the new conflict minerals disclosure requirements that apply to public companies if conflict minerals are necessary to the production of a product that the company manufactures.[26] The guidance clarifies that the equipment used to provide services and retained by or returned to the company or intended to be abandoned by the customer following the term of the service is not "product" under the rule. This interpretation supports the conclusion that the development or redevelopment of real estate assets that are primarily held for lease are not subject to the conflict mineral disclosure requirements.

E. SEC Accounting Guidance Affecting REITS

In August 2013, the SEC published amendments to its Financial Reporting Manual to clarify and modify certain requirements related to the filling of financial statements by REITs.[27] The

[26] Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions, *available at* http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm.
[27] Financial Reporting Manual, *available at* http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

amendments generally reduced the required financial statement disclosures. Key provisions include:

- "*Significant in the Aggregate*" *Acquisitions*: For purposes of evaluating individually insignificant acquisitions, REITs need only file the acquisitions since the latest audited year-end, not the acquisitions made during the last audited fiscal year.[28]

- *Triple Net Lease Properties*: If a REIT acquires a property subject to a triple net lease and such property represents a significant portion of the REIT's assets, the REIT must provide full audited financial statements of the lessee, co-lessee or guarantor. The term "significant portion" means a property exceeds 20% of the REIT's total assets as of the most recent balance sheet date. [29]

- *Shelf Takedowns*: The SEC clarified that Rule 3-14 financial statements are not triggered at the time of shelf takedown.[30]

- *Equity Investment*: If a REIT acquires an equity interest in a pre-existing legal entity that holds only real estate under lease/debt and the acquisition is significant, then the REIT needs to provide Rule 3-14 financial statements. If the pre-existing legal entity engages in other activities, however, then Rule 3-05 financial statements are required if the acquisition is significant.[31]

- *Real Estate Operations*: For purposes of Rule 3-14, "real estate operations" refer only to properties that generate revenue solely through leasing.[32]

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[28] *Id.* § 2320. 2.
[29] *Id.* § 2340.
[30] *Id.* § 13110.2.
[31] *Id.* § 2305.3.
[32] *Id.* § 2305.2.

- *Pro Forma Financials*: The guidance permits REITs to use pro forma financial information to calculate the significance of a real estate acquisition made after the filling of a Form 8-K that includes historical audited financial statements for a prior significant acquisition.[33]

- *Rental History Less Than Nine Months*: The staff will accept unaudited financial statement if the REIT acquired operating property that has rental history of more than three months but less than nine months.[34] No financial statements are required if the leasing history is less than three month.[35]

- *Blind Pool Offering*: In determining significance for property acquired during the distribution period of a blind pool offering, the guidance is revised to allow a REIT to compare its investment in the property to total assets as of the date of the acquisition plus the proceeds (net of commissions) it expects to raise in the registered offering over the next 12 months.[36]

E. SEC Areas of Focus

Based on a review of various publicly available SEC comment letters issued to REITs regarding their SEC periodic and other filings during 2014, the Staff most frequently sought additional disclosure or explanation concerning:

- Use of non-GAAP financial measures;
- Related party/affiliate transactions;
- Leasing activity generally, including a comparison of rates on new or renewed leases to prior rates;
- MD&A disclosure regarding trends and recent market impacts, including the interest rate environment; and

[33] *Id.* § 2025.3.
[34] *Id.* § 2330.8.
[35] *Id.* § 2330.10.
[36] *Id*. § 2305.5.

- Assumptions used in arriving at certain financial statement amounts, including depreciation, amortization, interest expense, asset management fees, deferred financing costs, cash, accounts payable and accrued expenses, and due to affiliates.

F. Auditing Estimates and Fair Value Measurements

On October 31, 2014, the National Association of Real Estate Investment Trusts ("NAREIT") issued a letter in response to the solicitation for public comment by the Public Company Accounting Oversight Board ("PCAOB") with respect to the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*, *August 19*, *2014* (the "Staff Paper").[37]

NAREIT suggests that a change to the existing audit framework for auditing estimates is not proper for two reasons. First, a single standard for auditing estimates and fair value measurement will not work because of the multiple iterations of GAAP accounting estimates. Second, the change will expand audit work without increasing the reliability or credibility of the audited financial statements. In NAREIT's view, the PCAOB fails to specify the underlying problem that would warrant a change in auditing standards. While NAREIT admits that there are shortcomings in the audit work surrounding estimates, it argues that those shortcomings could be caused by "auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves."

NAREIT also objects to expanding the scope of audit work where a third party specialist or pricing service is used. In particular, NAREIT disagrees with the requirement that the auditor needs to test and evaluate the information or audit evidence obtained from third-party sources as if it were produced by the company. NAREIT argues that neither management of the company nor the

[37] A Letter to the PCAOB on the Staff Consultation Paper Auditing Estimates and Fair Value Measurements, National Association of Real Estate Investment Trusts, *available at* http://www.reit.com/nareit/policy-issues/financial-standards.

external auditor is able to evaluate third parties' processes and controls because (1) the third party specialists and pricing services are independent from the company, and (2) the estimates are based on many subjective factors that are not testable. In general, companies hire third parties to provide estimates because (a) the company does not have the time or expertise to perform the work, and/or (b) estimates of the third parties are more reliable and objective than the internal estimates. Requiring company management and the auditor to evaluate the third parties' processes and controls is not feasible, given the reasons above.

Finally, preparers, auditors and investors all understand that the estimates are not accurate and are based on the management's "knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take." The auditor's responsibility is to evaluate the reasonableness of the estimates, rather than to determine whether the estimates are correct or wrong.

NAREIT instead urges PCAOB, when considering changes to existing auditing framework, to use a targeted approach to address specific sections of audit guidance, rather than wholesale changes to the entire audit framework.

III. From private to public: considerations in planning an IPO

Like most companies, REITs must make legal and operational changes before moving forward with an initial public offering ("IPO") to sell securities to the public. The majority of corporate governance policies and procedures, federal securities law requirements and securities exchange requirements must be in place when the IPO registration statement is filed, as described below.

A. Why Go Public?

The primary reasons that REITs move from private to public companies include:

- Ability to raise money to expand operations

- Deleverage financing on existing property portfolios
- May increase market value
- Enables REIT to acquire other companies/properties
- Helps attract and retain employees
- Allows founders/shareholders to diversify personal holdings and provides exit strategy
- Provides liquidity for existing owners/shareholders
- Typically enhances REIT's reputation and business profile in the market

B. Disadvantages of Going Public

If a REIT has another way to raise capital, it may opt not to go public. An IPO is very expensive and there is no guarantee it will be successful. Typical IPO expenses include legal fees and accounting fees, filing fees, travel costs, printing costs and underwriters' discount and commission, among other things. The IPO process is also very disruptive to the REIT's day-to-day business.

Once the REIT is public, it will be subject to scrutiny from securities regulators and investors, particularly in the areas of executive compensation and related party transactions, among other things. Public REITs also must comply with securities law reporting requirements, which can be time-consuming and expensive. Public company officers and directors face increased liability risks for false or misleading statements in securities filings.

Another disadvantage is the potential for loss of some control. Ownership limitation provisions are common for REITs in order to protect REIT tax status. These provisions reduce the likelihood of hostile transactions; however, there is still a reduction in management's control when operating in the public market.

Public REIT directors and officers also face a loss of privacy. The registration statement and subsequent reports require disclosure of many facets of the REIT's business, operations, and finances that may never before have been known outside the company. Sensitive Information will be available to competitors, customers, and employees, such as: (1) director and officer compensation; (2) security holdings of officers, directors, and major shareholders; (3) details of transactions, including filing of material contracts; and (4) extensive financial information (such as financial position, operating revenue, operating costs, net operating income, net income, segment data, related-party transactions, borrowings, cash flows, major tenants/customers, and assessment of internal controls).

Public companies also face constant pressure to increase earnings. Many investors have a short-term focus, hoping to sell stock quickly if the price increases. Shareholders expect steady growth in areas such as leasing, profits, market share and innovation. Management is under constant pressure to balance short-term demands for growth with strategies that achieve long-term results. If management is unable to meet analysts' expectations of short-term earnings, the marketplace's long-term valuation of the REIT will be diminished.

Directors and officers of public companies must balance this earnings pressure, along with the risk of takeover attempts by unhappy investors or rivals.

C. Key Issues to Consider With Advisers

When considering an IPO, a REIT's directors and officers should discuss the following types of key issues with their legal, financial and accounting advisers:

- Does our REIT have an attractive earnings and growth track record?
- Does our REIT have the necessary financial processes, internal controls and financial statement integrity to support Sarbanes-Oxley reporting obligations?
- When and on which exchange to launch the IPO?

- What are the relevant regulatory requirements for an IPO on the desired exchange and can the REIT meet them?
- Will the REIT need to change its corporate structure, its capital structure and/or its management team?
- What are the chances of a successful IPO?
- Will selling stockholders be allowed to participate in the IPO and/or in the over-allotment option?
- Will the REIT qualify as an emerging growth company (EGC)?
- If the REIT is an EGC, what exemptions and scaled disclosure accommodations may apply?

D. Key Participants in the IPO Process

The REIT's Board of Directors. SEC rules require that a majority of the REIT's directors sign the registration statement, so directors must be involved in the IPO process from start to finish. If directors are not involved, they may be unable to establish a due diligence defense and may have liability for material errors or omissions in the registration statement. In general, non-employee directors typically are not involved in the working group sessions, but they do review and comment on interim drafts of the registration statement. The REIT board typically forms a pricing committee comprised of one or two directors who have the authority to negotiate with the managing underwriters to establish the terms and conditions of the offering (including pricing terms). In preparing the REIT for an IPO, REIT directors and officers should review current board composition with its attorneys and investment bankers to ensure that the REIT complies with all rules and regulations applicable to public companies.

Investment Banker/ Lead Manager. The lead investment bank manages the IPO process and coordinates with the REIT's other advisers. Depending on the terms of its engagement, the lead investment bank typically assumes some or all of the roles below. The lead manager(s) makes the major decisions regarding the structure, allocation, timing and pricing of the offering, the drafting of the registration statement and the timing and content of the road show. The managing underwriters may coordinate a larger group of investment banks (referred to as the "underwriting syndicate") to help distribute the stock and bear the risk of the offering. The lead manager and co-managers are the main members of the underwriting syndicate involved in the IPO preparation process, drafting sessions and the road show.

Underwriter. The lead investment bank and one or more other underwriters typically underwrite the offering. The majority of IPOs are made with firm commitment underwriters. In a firm commitment offering, the REIT sells the IPO shares to the underwriters at a discount to the price at which the shares are sold to the public. The underwriters then either sell the stock directly or through other members of a selling group, to investors who subscribe to the offering.

Financial Adviser. Financial advisers work with REIT directors and officers on, among other things, the timing of the IPO, the structure of the offering(s), the REIT's capital structure, the REIT's board composition, corporate governance, the marketing strategy and process, valuation and pricing issues and any arrangements with principal shareholder(s).

Stabilizing Manager. If an offering includes stabilization (a process in which the lead underwriter supports the market price of the securities in order to prevent or slow down a decline in the price of the securities), the lead underwriter typically assists in that process. To accomplish stabilization, the lead underwriter generally buys and sells securities in the open market, normally by means of an over-allocation of the securities. Stabilization creates the impression that there is demand for the securities at a particular price or at various prices. This practice promotes orderly operation of the market, helps reduce investor anxiety, meets demand and counteracts short selling

Counsel for the Company and the Selling Stockholders.
If there are no conflicts of interest, the same law firm may act as securities counsel for the company and any selling stockholders. In many cases, however, selling stockholders require separate legal counsel, especially when there are conflicts of interest between the

REIT and selling stockholder. The REIT's law firm has numerous responsibilities throughout the IPO process, including:

- If necessary, reorganizing the structure of the REIT.
- Coordinating and conducting due diligence.
- Drafting the registration statement and ensuring compliance with the requirements of the securities laws.
- Filing or confidentially submitting the registration statement with the SEC.
- Coordinating, drafting and filing responses to SEC comments on the registration statement.
- Preparing and submitting the securities exchange listing application.
- Negotiating the underwriting agreement.
- Assisting the company with implementing the necessary corporate governance structures.
- Advising the board of directors of their role throughout the IPO process.
- Advising the company about the many on-going reporting and other disclosure obligations imposed by the securities laws and the securities exchanges.

Counsel for the Underwriters. Underwriters' counsel is responsible for:

- Assisting the underwriters in satisfying their due diligence obligations.
- Participating in the drafting process.
- Obtaining FINRA clearance of the underwriting arrangements.
- Complying with applicable state securities laws and regulations.
- Drafting and negotiating the underwriting agreement.
- Coordinating the closing with the REIT's counsel.

Company's Auditors. The REIT's auditors ensure that the financial information included in the registration statement complies with the SEC financial disclosure requirements, which in some cases differ from and are more extensive than US GAAP. Other auditor responsibilities include:

- Providing a comfort letter to the underwriters and the REIT's board of directors confirming that the financial statements contained in the registration statement comply with accounting requirements, and tying the tables and other financial information included in the registration statement to the financial statements and other financial records of the REIT.
- Participating in the due diligence process relating to the financial statements, pro forma financial information (if any) and management's discussion and analysis.
- Identifying significant accounting issues that may warrant a pre-filing conference with the SEC.

Public Relations Consultants. A public relations (PR) firm can play a valuable role in the success of an IPO. By generating positive publicity for the REIT prior to the IPO, PR consultants can help ensure that potential investors are made aware of the REIT and its properties. However, this process must be carefully monitored by legal counsel to avoid violations of the SEC rules. After the IPO, ongoing press interest can help sustain awareness of the REIT and liquidity in its shares.

E. Preparing for the IPO

1. Corporate Structure

Most public REITs are organized in Maryland as either a corporation of a trust because Maryland has a special REIT law and is perceived as business-friendly to REITs. Non-REIT public companies, however, typically incorporate in Delaware if they are preparing for an IPO.

2. Timing Issues

REIT IPOs typically take somewhat longer than other types of IPOs. In general, the IPO process may take between three to eight months, depending on, among other things, the REIT's readiness to go public, market conditions, the time necessary to complete required audits of the financial statements for property acquisitions, and the availability of the information that must be disclosed in the registration statement. For a successful, orderly IPO, begin planning and acting like a public company at least one and possibly two years before the desired IPO launch date.

3. Corporate Documents

REIT management and legal advisers must examine the company's organizational documents to determine whether they are suitable for a public company, focusing on the following:

- Remove any anachronistic provisions, such as pre-emptive rights and rights of first refusal
- Remove any restrictions on stock transfers
- Delete all unneeded provisions (close corporations)
- Alter special voting provisions, class votes
- Consider anti-takeover provisions (supermajority voting for certain transactions; remove action by written consent or ability to call special meeting; put poison pill in place; ability for board to amend the bylaws without stockholder approval)

4. Corporate Governance

Public companies generally must comply with each provision of the Sarbanes-Oxley Act of 2002. In order to prepare for the IPO, private companies should consider complying with the following provisions of the Sarbanes-Oxley Act several months before launching the IPO:

Internal controls. The public REIT's management (CEO and CFO) must provide certain certifications in SEC periodic filings regarding the company’s internal controls. In addition, on an annual basis, the external auditor is required to audit the company’s internal controls over financial reporting. To prepare for the applicable public company internal controls certifications, REIT management should establish, document, and monitor compliance of executing internal controls at least one year before launching the IPO, if possible.

*Board committees***.** Public companies must have independent audit committee members, including one qualified as a financial expert, as well as compensation committees and nominating committees. REITs considering an IPO should form such committees in advance, prepare committee charters and make certain the members of the committees meet SEC and securities exchange requirements.

Board of directors/trustees. The majority of the directors/trustees must be truly independent, as defined by SEC and securities exchange rules. In addition, at least one board member must have a financial background—either as a CPA or as a previous CFO. The Board also must meet in executive session. A REIT board considering an IPO should evaluate its board membership criteria, policies and practices to ensure that it is functioning as a public company board before launching the IPO.

Independent auditor. A public company's external auditor cannot provide certain nonaudit services, including but not limited to internal audit, legal, and valuation services. In addition, permissible nonaudit services must be preapproved by the audit committee. REITs should evaluate their existing relationship with outside audit firms to ensure compliance and SEC and exchange rules.

Code of ethics. Public companies must establish a code of ethics. A REIT planning an IPO should establish a code of ethics in advance to demonstrate diligence and compliance in preventing corporate misconduct.

Loans to executives. Public companies cannot extend or maintain credit in the form of personal loans to or for any director or executive officer. A REIT planning an IPO should adopt policies to make prohibit such loan arrangements.

5. Director and Officer Insurance/Indemnification

Private company D&O insurance typically does not cover securities offerings, such as an IPO. A REIT considering an IPO should review its D&O coverage and seek additional coverage for the public offering. In addition, the company should consider a separate form of officer and director indemnification agreement providing that the company will indemnify each of its directors and officers to the fullest extent permitted by its organizational documents and the laws of the state of its incorporation.

6. Management and Employees

Employment arrangements for members of management and key employees must be in a form that is suitable for a publicly listed company. In the months before the IPO, the REIT Compensation Committee should work with management on such employment agreements, as well as incentive compensation plans. Once the REIT is public, certain provisions of the federal securities laws will apply to the REIT's benefit plans. The REIT also should consider setting up an employee stock purchase plan if it has not already done so.

7. Other Corporate Matters

Banking Facilities. Any banking facilities or other financing arrangements of the REIT need to be reviewed to ensure that they are sufficient for its capital requirements as a publicly listed company (taking into account the proceeds of any new issue of shares). The underwriters may suggest that the company enter into a banking facility prior to the IPO to ensure that the company will have sufficient capital following the IPO.

Contracts. Important contracts need to be reviewed to ensure that there are no change of control or other provisions which would be triggered by the IPO and which could have an adverse effect on the business of the company. While conducting due diligence, company counsel should review all contracts to ensure that the company owns all relevant assets and that these are not held, for example, by stockholders. There also may be commercial arrangements to be entered into between the company and its stockholders which may not have been formalized, such as for the provision of services and the use of property.

IV. REIT Spin-offs, Conversions and Alternative Capital Structures

A. REIT Spin-offs/Separation Transactions[38]

Many companies have significant real estate holdings in connection with their businesses. While holding real estate gives a company control over critical operation assets, it also ties up capital and often requires significant management attention. A potential way to tax-efficiently unlock the value of a company's real estate is to separate the company into a REIT that owns the company’s real estate and a separate operating company. Contractual relationships including leases can be set up between the operating entity and the REIT to allow the business to continue to utilize the real estate on acceptable terms.

REIT separation transactions can be complicated, especially as a result of the requirements for tax-free treatment and the requirements that the resulting entity must satisfy in order to enjoy treatment as a REIT. To ensure tax-free treatment, the following criteria must be satisfied, among others:

- There must be a non-tax business purpose for the separation.
- Following the spin-off, the REIT has to be involved in an "active trade or business."
- The REIT may not have any earnings or profits from the period prior to becoming a REIT.

Examples of recent REIT separation transactions include: Penn National Gaming's creation of the first-ever casino REIT in 2013; Simon Property's separation of its strip center and smaller enclosed malls businesses into a REIT in 2014; and CBS's 2014 IPO of CBS Outdoor Americas.

[38] Gregory E. Ostling and David K. Lam, Spin Offs: The Decision to Separate and Considerations for the Board (Practical Law The Journal: Transactions & Business) (Sep. 2014).

A parent (non-REIT) entity that owns a corporate subsidiary that could qualify as a REIT can distribute or spin-off the subsidiary stock to its shareholders.[39] After the distribution or spin-off, the subsidiary can elect to be taxed as a REIT.[40] At least one publicly traded company announced plans to convert to REIT status by spinning off its real estate assets into a publicly traded REIT and at least one other announced plans to explore the possibility of creating a REIT for its real estate assets.[41]

To qualify as a tax-free transaction, a spin-off must meet the following general rules:

- Both parent and the subsidiary must have been engaged in an active trade or business before and after the spin-off ("active business requirement");
- There must be an independent business reason for the spin-off ("business purposes requirement").

Even if the spin-off would otherwise meet the requirements of a tax-free transaction, it should be noted that to qualify as a REIT after a spin-off the subsidiary must disgorge earnings and profits from the time period prior to becoming a REIT. Furthermore, a corporate tax on the excess of the value of assets over their tax basis will apply to the REIT if its sells assets within ten years of the REIT conversion.

If the general spin-off requirements above are met, a REIT can also spin-off a subsidiary to its shareholders in a tax-free transaction. However, the incentive to qualify the spin-off as tax-

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[39] Micah W. Bloomfield and Mayer Greenberg, REITs: Overview (Practical Law Company, Practice Note) (2011).
[40] *Id.*
[41] Cecile Daurat and Caitlin McCabe, Windstream to Spin Off Networks Into Publicly Traded REIT, Bloomberg (Jul. 29, 2014), *available at:* http://www.bloomberg.com/news/2014-07-29/windstream-to-spin-off-telecom-assets-into-publicly-traded-reit.html.; Sara Germano, Gym Owner Life Time Fitness Considers a REIT, The Wall Street Journal (Aug. 25, 2014), *available at:* http://online.wsj.com/articles/gym-owner-life-time-fitness-considers-a-reit-1408998441.

free may be reduced if the parent was always a REIT, as a REIT is not subject to tax on any gain recognized in the spin-off.

B. Mergers[42]

Two separate REITS can merge in either a taxable or a tax-free transaction. If common stock in the acquiring REIT comprises the sole consideration paid in the merger, the merger will generally qualify as a tax-free. As a result, the target REIT and its shareholders would not recognize any taxable gain or loss.

A merger may still qualify as tax-free if a "substantial portion" (35% to 40%) of the consideration is payable in stock, even if the remainder of the consideration is cash. In this case, shareholders would recognize gain to the extent of the cash consideration. If the stock received does not qualify as a "substantial portion," the merger is generally a taxable event. Therefore shareholders would recognize gain on the amount of cash and the value of stock received.

REIT mergers most commonly take the following forms:

- **Target REIT into acquiror REIT**. Whether the merger is taxable or tax-free depends on the amount of the cash consideration as described above. Because the target does not survive, approval for the transaction is likely required to maintain contractual relationships and regulatory licenses.
- **Target REIT into wholly-owned subsidiary of acquiror REIT**. Whether the merger is taxable or tax-free depends on the amount of the cash consideration as described above. Approval for the transaction is likely required to maintain contractual relationships and regulatory licenses.
- **Subsidiary of acquiror REIT into target REIT**. This is a taxable transaction. At least one industry group has requested a change to the IRS guidance governing this situation, which if adopted would make this the preferred

[42] Bloomfield and Greenberg, REITs: Overview.

form of tax-free merger as it likely would not require approval to maintain the contractual relationships and regulatory licenses.

- **Merger of REITs that are in the UPREIT format**. To qualify as tax-free, the merger must be completed in two steps: (i) a merger of the REITs, and (ii) a combination of the operating partnerships. How the operating partnerships are combined depends in part on whether any unit holders object to the merger and the provisions of the operating partnership agreement governing the approval procedures for mergers or asset sales. Additionally, some unit holders may have acquired units in exchange for contributions of property, which may implicate agreements containing tax protection provisions triggering certain rights upon the disposition of property.

C. REIT conversions[43]

The number of companies pursuing conversions from a regular taxable C-corporation to a REIT structure continues to increase. A REIT conversion can improve a company's tax efficiency as well as provide additional sources of capital. Because most REITs trade at higher multiples than taxable C-corporations a conversion can also increase shareholder value.

Reasons for increased interest in REIT conversions include:

- **Tax Benefits:** Converting to a REIT could avoid corporate-level taxation on REIT earnings that are distributed to shareholders. REITs generally avoid corporation tax because they are entitled to a dividends-paid deduction and must distribute 90% of ordinary income each year. However, unlike other pass-through entities, a REIT cannot pass-through the losses to its shareholders. Additionally, dividends paid by a REIT to an individual are not eligible for the lower rate of qualifying

[43] Micah W. Bloomfield and Daniel Martinez, REIT Conversions (Practical Law The Journal: Transactions & Business) (Oct. 2014).

dividend income, and instead are treated as ordinary income.

- **Relaxed REIT Qualification Requirements:** Over the past years, the general liberalization of the rules and definitions make it feasible for non-traditional real estate companies to consider REIT conversions. For example, the Housing Act of 2008 permitted REITs to engage in a broader range of transactions through the expansion of relevant definitions. The IRS has issued private letter rulings that have broadened the types of real properties to include cold-storage warehouses, telecommunications towers, billboards, data centers, casinos and private prisons. Additionally, the IRS published a proposed regulation in May, 2014 that provides a long non-exclusive list of property that could be considered as real property, including outdoor advertising displays and transmission lines.

- **Higher Valuations for REIT Stocks:** REIT stocks trade at higher multiples than stocks of C-corporations because they provide higher rewards to shareholders due to REIT qualification rules (they must distribute annually at least 90% of their income to shareholders). Therefore, converting to a REIT typically results in meaningful increases in stock prices.

D. REIT Conversion Requirements[44]

1. Organizational and Operational Requirements for REIT Status

To convert to a REIT, a company must meet the following organizational requirements: (a) be managed by trustees or directors; (b) be beneficially owned by 100 or more persons; (c) issue transferable shares or certificates; (d) be taxable as a US corporation; (e) not be a bank or an insurance company; and (f) not be more than 50% owned by five or fewer individuals.

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[44] *Id.*

Additionally, the company must satisfy the following operational requirements: (a) 75% of its gross income must be related to real estate; (b) 95% of its gross income must be passive; (c) at least 75% of the value of the REIT's assets must be real estate, cash and government securities; (d) not more than 25% of the value of the REIT's assets can be represented by securities, other than securities included in the 75% asset test; and (e) may not own more than 10% of the total vote or value of the outstanding securities of any one issuer, and not more than 5% of a REIT's assets may be invested in the securities of one issuer.

As a result of the above organizational and operational requirements, a REIT conversion always requires a reorganization that splits the business into two or more parts.

2. Purging Earnings and Profits

A previously taxable corporation with accumulated earnings and profits that converts to a REIT must distribute its accumulated earnings and profits to shareholders before the end of its first taxable year. As a result, it is common for companies undergoing a REIT conversion to declare a special "purging" dividend in the first year of its qualification as a REIT.

The allocation of earnings and profits between the spun-off company and its parent company following a REIT conversion is subject to relevant Treasury regulations. For a newly formed spin-off, the earnings and profits are usually allocated proportionally to the fair market value of the businesses that are spun off and retained. In some cases, however, the allocation is made in proportion to the net tax basis of the assets transferred and retained. Special regulations also apply if the companies are part of a consolidated group. A company's REIT election could be deemed ineffective, making it be subject to corporate-level taxation, for failing to properly purge accumulated earnings and profits.

Because a purging dividend comes out of the company's available cash, it may be difficult for a company to issue an all-cash purging dividend. An alternative approved by the IRS in a private letter ruling is for the company to issue a taxable stock dividend, offering shareholders the right to elect to receive either cash or REIT shares, subject to a 20% limitation on the aggregate amount of cash distributed to all shareholders. Consequently, a company can purge $100 of accumulated earnings and profits by distributing $20 of cash and $80 of stock. This method of conserving cash has become common in REIT conversions.

3. Built-in Gains Tax

If a REIT acquires property from a C-corporation in a non-taxable transaction (including a non-taxable REIT conversion), the REIT may have to pay taxes on any appreciated assets with built-in gains if those assets are sold within ten years.

4. Other Issues in REIT Conversions

Companies also should consider the following additional impediments to REIT conversions:

- The organizational documents of the company electing REIT status need to be amended to restrict stock ownership to meet the REIT ownership requirements and avoid being closely-held (greater than 50% ownership by five or fewer individuals) and ensure the REIT has 100 or more shareholders. A good number of REITs are incorporated in Maryland to maximize enforceability of these provisions.[45]

- REIT organizational requirements may require that certain debt covenants be modified. Existing debt covenants may restrict dividend distributions, contrary to the requirement that REIT distribute most of its income. Furthermore, the existence of outstanding convertible debt may result in a potential violation of stock ownership requirements.

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[45] Ameek Ashok Ponda, Key REIT Conversion Considerations (Sullivan & Worcester LLP) (2013), *available at:* http://www.sandw.com/assets/htmldocuments/Key%20REIT%20Conversion.pdf.

Making necessary modifications to existing debt arrangements may result in additional expenses to the company.

- Tax considerations accompanying a REIT election often require reclassification of some property from personal property (generally depreciable over five to seven years) to real property (generally depreciable over 39 years). This may result in significant tax liability because of the resulting recapture of depreciation and amortization expenses attendant with the reclassification of real estate.

- Compliance with asset and income tests, limitations on related tenants and independent contractor requirements all require increased recordkeeping and accounting.

- Existing dividend reinvestment plans, share repurchase plans and employee equity incentives may need to be reviewed to ensure compliance with REIT requirements.

- Existing lease agreements should be reviewed to ensure that the rent received qualifies as good rent to meet the REIT income test.

- All services provided should be reviewed to ascertain if they are customary or need to be performed by a taxable REIT subsidiary ("TRS"). TRSs should be adequately compensated at arms-length pricing for services provided to avoid redetermination of rents.[46]

E. REIT Conversion Structures[47]

There are three common ways to structure a REIT conversion.

- Internal restructuring with REIT election by the parent company.

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[46] *Id.*

[47] Bloomfield and Martinez, REIT Conversions.

- Spin-off of REIT or operating subsidiary.
- Stapled ownership.

1. Internal Restructuring with REIT Election

The converting company places non-REIT assets and activities into a new subsidiary that will be classified as a TRS. The TRS will be subject to income taxes, although in its taxable income may be reduced by rent and other payments (including to third parties or to the REIT itself).

This structure is beneficial because the shareholders continue to own the entire business, including the real estate and the operating company. However, limitations on how much stock and debt can be held by the parent REIT restrict the circumstances in which this structure is feasible (the value of the securities of the TRS held by the parent REIT must be 25% or less of the assets of the parent REIT). Restrictions on rent from related parties also makes the structure feasible only for businesses deriving rent from unrelated parties, or for hotels and healthcare facilities that qualify for an exception from the related party rent rules.

2. Spin-off of REIT or Operating Subsidiary (PropCo/OpCo Structure)[48]

A second REIT conversion structure is to have the converting corporation place its assets into newly formed real estate and non-real estate subsidiaries. This can typically be accomplished tax-free, subject to some state and local transfer taxes. Either subsidiary can then be distributed or spun-off to shareholders. Following the spin-off, the real estate entity elects to be taxed as a REIT, and the operating entity ("OpCo") remains a taxable corporation. PropCo will then lease its real estate back to OpCo,

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[48] *See also* Ed Liva and Greg Williams, Unlocking the Value Hidden in Real Estate Holdings: REIT Conversion Benefits (KPMG, LLC) (2013), *available at:* http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/unlocking-value-hidden-real-estate-holdings.pdf.

and OpCo will pay tax-deductible rent payments to PropCo. These payments will not be subject to corporate-level tax as long as PropCo qualifies as a REIT. The related party limitations on rent do not apply as long as OpCo and PropCo do not have a shareholder that actually or constructively owns 10% of both companies, making this an advantageous alternative to other structures. However, separating the operations from the real estate assets, may not be the most economically efficient way to use the assets.

A transaction must meet strict requirements under IRC Section 355 to qualify as a tax-free spin-off. One of the requirements of a tax-free spin-off is that both the distributing and the distributed corporations must be engaged in an active trade or business for at least five years before the distribution. Additionally, there must be a valid corporate business purpose is a prerequisite to a tax-free spin-off, even if it is not the main purpose of the transaction. Importantly, a reduction in US federal income taxes does not qualify as a valid corporate business purpose. IRS staff has informally indicated that the intention to make a REIT election may in itself be a sufficient business purpose, particularly if the REIT intends to raise equity capital.

The IRS does not issue private letter rulings on whether there is a valid corporate business purpose, and instead such determination is made upon an examination of the taxpayer's return. Therefore, it is common for a company undergoing a REIT conversion through a spin-off to request a letter from an investment bank that describes the corporate business purpose for the transaction.

3. Stapled Ownership

In the final REIT conversion structure, the REIT is partially owned by a taxable C-corporation ("Parent"), and partially owned by other shareholders who are also the owners of Parent, and shares of the REIT trade together with shares of Parent as one unit. This structure allows Parent to keep assets and operations together and be controlled by the same management team, making it advantageous to the PropCo/OpCo structure. However, the shareholders receive less than half of the benefits of REIT ownership because more than 50% of the shares of the REIT are owned by a taxable corporation. As a result, this structure makes sense when it is important to keep assets and operations under common control, but where a TRS structure is not possible.

F. Recent Examples - Non-traditional REIT Conversions[49]

- GEO Group Inc. and Corrections Corporation of America, which own and operate correctional and detention facilities, each placed a small portion of their respective businesses not related to real estate into wholly-owned TRSs to achieve REIT status. GEO also had to divest all healthcare facility management contracts because of stringent rules pertaining to the operation and management of healthcare facilities by REITs.

- Penn National Gaming, Inc., which operates gaming and racing facilities, completed a tax-free spin-off of Gaming and Leisure Properties, Inc., which owns the real estate associated with 21 gaming facilities, and became the first REIT focused on gaming facilities.

- Iron Mountain Incorporated, a storage and information management services company received a favorable private letter ruling from the IRS on June 25, 2014 and will proceed with its REIT conversion by making a REIT election as of January 1, 2014.

- Windstream Holdings, Inc., a provider of advanced communications and technology solutions, including cloud computing and managed services, announced plans to separate its business into two publicly traded, independent companies. Windstream will reclassify its copper and fiber optic lines as real property assets and place them with other real property assets into a REIT. Windstream will retain operational control of the network assets via a long-term triple net exclusive master lease agreement.

[49] Bloomfield and Martinez, REIT Conversions.

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NAREIT's REITwise 2015 - General Counsel Agenda Panel

General Counsel Agenda Panel

PANELISTS:	TOPICS:
Dan Adams, Goodwin Procter	1. In-house as Gatekeepers
Frank Burt, Boston Properties	2. Governance Risk & Compliance in 2015
Shirley Goza, QTS Realty Trust	3. Crisis Management Plans
Elizabeth Sacksteder, Paul Weiss	4. Enforcement Issues
	5. Dodd-Frank Claw Back Rules

In-house as Gatekeepers

What is risk/what are the components of risk?

- Financial
- Compensation
- Fraud
- Property/Casualty
- Third-Party Claims Liability
- Reputational
- M&A

Calculated Risk

- What is the role of economics?
- Integration of the lawyer as a member of the business team
- The creative legal solution—the lawyer as a value-add
- The business' responsibility for its own decisions

Where does compliance report in your organization?

- Legal?
- CEO?
- CFO?
- Board?
- Stand-Alone?
- Executive level?

Investigations

- Who should conduct them?
- Why or why shouldn't legal conduct investigations?
- Who does investigations in your organization?

Governance Risk and Compliance in 2015

- How worried should a company be about their ISS or Greenstreet score?
- What do we know about the new ISS rules and how they've changed?
- What problems have people seen with the ISS methodology and its application?

Governance Risk and Compliance in 2015

- How is MUTA driven by Greenstreet in a way that is different from ISS?
- What are you seeing with regard to REITS being on the NY comptroller list (8/75).

Governance Risk and Compliance in 2015

ISS QuickScore 3.0 - New

- Annual Board Evaluation Policy
- Recent Board Action that "Materially Reduces" shareholders' rights?
- Number of women on Board - now scored
- Number of Financial Experts on Audit Committee – now scored
- If the company has an "unequal voting structure," does it have a sunset provision?
- Is there a controlling shareholder? (this is a zero-weight factor)

Governance Risk and Compliance in 2015

ISS Scoring Problems?

- Subjective weights?
- Peer group selection
- Less than 80% S/H vote for director
- Non-executive directors with more than 9 years of service
- Relativity of score – broad groups
- Total stockholder return (TSR) – financial rather than governance measure

Crisis Management Plans

- Anticipation of the unexpected
- The comprehensive crisis management plan
- Training

Enforcement Issues

- E-discovery – “threat of litigation”
- Section 16 Enforcement Actions
- NLRA “mutual aid and protection”
- Social media for Reg FD releases
- Non-deal roadshows

Dodd-Frank Claw Back Rules

- Policies being adopted prior to rule release?
- How do you drive the right incentives?

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 74240 / February 10, 2015

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3636 / February 10, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16381

In the Matter of WILLIAM SLATER, CPA and PETER E. WILLIAMS, III Respondents.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against William Slater and Peter E. Williams, III ("Respondents").

II.

In anticipation of the institution of these proceedings, the Respondents have submitted Offers of Settlement (the "Offers") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over each and over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

Summary

1. This matter involves misstated revenues in the professional services organization at Saba Software, Inc. ("Saba" or "the Company"), a Silicon Valley-based enterprise software company. The misstatements were the result of the falsification of time records over a period of more than four years by professional services managers in multiple geographies directing consultants in Saba's Indian subsidiary (the India Consulting Group or "ICG") to falsify time records by either recording time in advance of performance of work or failing to record time for hours worked in order to achieve their quarterly revenue and margin targets.

2. As a result, Saba reported materially false financial results in its financial statements filed with the Commission over the period from October 4, 2007 through January 6, 2012. As Saba announced on August 6, 2012 and November 5, 2012, management has determined that the Company is required to restate its financial statements for fiscal years 2008 through 2011, as well as the first two quarters of fiscal 2012, as a result of misconduct. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

3. Saba's former Chief Financial Officers, William Slater and Peter E. Williams, III, realized Saba stock-sale profits and received bonuses during the 12-month periods following the filings containing financial results that Saba is required to restate. The Commission does not allege that Slater and Williams participated in the misconduct giving rise to the restatement. Slater and Williams have not, however, reimbursed Saba for stock-sale profits and bonuses they are required to reimburse the Company under Section 304(a) of the Sarbanes-Oxley Act.

Respondents

4. **William Slater**, age 63, is a resident of San Diego, California. He served as Chief Financial Officer and Principal Accounting Officer of Saba from December 9, 2008 through October 27, 2011. He served as Chief Financial Officer, Vice President and Treasurer of another public company from November 10, 2011 to February 15, 2013. Slater was licensed as a certified public accountant in New York from 1978 to 2003, when his license became inactive.

5. **Peter E. Williams III**, age 53, is a resident of Hillsborough, California. Prior to joining Saba as General Counsel in October 1999, Williams was a partner at an international law

[1] The findings herein are made pursuant to Respondents' Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

firm. Williams has been Saba's Secretary from the time of the Company's inception in April 1997. Williams served as Saba's Chief Financial Officer and Principal Accounting Officer from March 2004 to July 2007 and then again, on an interim basis, from October 27, 2011 until January 7, 2012. Since July 2007, Williams has also served as Executive Vice President, Corporate Development. Williams has been licensed to practice law in California since 1987. He has never been licensed as a certified public accountant.

6. **Saba Software, Inc.** ("Saba" or "the Company") is a Delaware corporation headquartered in Redwood Shores, California. The software company provides cloud-based enterprise learning, talent management and social networking tools to businesses and large organizations. At all relevant times, Saba's common stock has been registered pursuant to Section 12 of the Exchange Act. From its IPO in April 2000 until July 31, 2006, its common stock was registered pursuant to Section 12(g). Thereafter, until June 2013, it was registered pursuant to Section 12(b). It traded on the Nasdaq Global Market until it was suspended on April 9, 2013, and then it was delisted effective June 17, 2013 for failure to remain compliant with its SEC reporting obligations. Upon its delisting and deregistration from Section 12(b), it reverted to its previous Section 12(g) registration. Its common stock is currently registered pursuant to Section 12(g) and traded on the OTC Markets. Saba has not filed any periodic reports since January 6, 2012, when it filed its Form 10-Q for the quarter ended November 30, 2011.

Facts

A. Saba's Falsification of Time Records

7. Saba's professional services historically have accounted for about one third of its approximately $120 million in yearly revenues. Professional services have been delivered to customers worldwide by (1) customer-facing field consultants in North America and Europe ("Field Consultants") and (2) off-shore technical development services provided to the Field Consultants by the Company's India Consulting Group ("ICG Consultants"). ICG is an organization within Saba's Indian subsidiary designed to help the Company deliver professional services to its customers at a lower cost than comparable consultants in North America and Europe. By 2011, ICG employed 50-60 consultants who generated approximately 14,000 hours of billable work per quarter, which constituted about 17% of consulting revenue and 6% of total revenue per quarter.

8. Both Field Consultants and ICG Consultants were required to record time worked on customer projects in a timesheet database. Hours input into the system by Field or ICG Consultants were approved on a weekly basis by project managers in North America and Europe, and revenue for the professional services organization was then measured based on the approved number of hours in the timesheet database.

9. Saba disclosed in its public filings that it recognized revenue for both "time and materials" and "fixed fee" contracts as the services were performed. This revenue recognition treatment was consistent with GAAP only if Saba could demonstrate that (1) its customers have historically paid a consistent rate for its services (measured by Vendor Specific Objective Evidence

or "VSOE") and (2) it could accurately estimate how many hours it took to complete projects ("ability to estimate"). Therefore, Saba's finance personnel depended on accurate time records to ensure that Saba recognized revenue in accordance with GAAP.

10. From at least 2008 through the second quarter of Saba's fiscal 2012, Saba professional services employees and managers engaged in two time-keeping practices that led to its false revenue recognition. First, there were multiple incidents of ICG Consultants recording hours and billing customers for the performance of professional services in advance of performing those services in order to accelerate revenue recognition and achieve quarterly revenue targets ("pre-booking"). Second, ICG and Field Consultants regularly failed to report professional services time worked in order to conceal budget overruns from management and finance, instead recording that time to non-billable project codes or not at all ("under-booking").

11. These improper time-keeping practices precluded the time records from serving as reliable evidence under GAAP to recognize revenue in the manner that Saba did. As such, Saba management has concluded that Saba cannot demonstrate VSOE for the period from 2008 through the second quarter of fiscal 2012. Over that period, therefore, Saba was required to recognize professional services revenues on a completed contract basis, which would have required it to defer substantially all of its professional services revenue and much of its license revenue (where software licenses were bundled with professional services) until the contract was completed. Accordingly, virtually all of Saba's professional services revenue was misstated over the relevant time period because revenue was recognized earlier than it should have been under the applicable accounting principles.

12. The practices of pre-booking and under-booking were directed by and known to numerous individuals in the professional services organization and ICG, including the two most senior Saba employees overseeing the professional services organization in North America over the relevant time period. Those senior Saba employees were told on multiple occasions by the finance department that the Company's accountants and auditors needed to understand exactly how many hours were being worked and when (regardless of whether or not they were billed to the customer) in order to ensure that revenue was recognized accurately, and they understood that inaccurate time-keeping would lead to misstatements in Saba's reported professional services revenue and violate the Company's policies regarding financial reporting, including the Code of Business Conduct and the Revenue Recognition Policy.

B. Scope and Impact of the Fraud

13. Saba's professional services revenues, gross margins and income were materially overstated in its periodic filings from October 4, 2007 through January 6, 2012 as a result of the time-reporting misconduct.

14. The practices of pre-booking and under-booking, and the fundamental inaccuracy in Saba's time records revealed by these practices, have led Saba management to conclude that it can no longer rely on its calculation of VSOE of fair value for professional services. In this circumstance, ASC 985-605 (Certain Revenue Arrangements That Include Software Elements) and

ASC 605-35 (Revenue Recognition) require that the Company defer to the point where services are complete, rather than recognize over the period where services are performed, standalone services revenue and revenue on software license and cloud services agreements that contain bundled professional services. Accordingly, Saba has determined and announced that it is required to restate its financial statements for the years 2008, 2009, 2010 and 2011, and the first two quarters of 2012, due to its material non-compliance with GAAP. Although Saba has not yet filed its required restatement, the cumulative impact of this alternative revenue recognition treatment is approximately $70 million over the period from 2008 through the second fiscal quarter of 2012. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

15. These misstatements are material. First, based on the Company's own estimates, the restated financials will reflect overstatements of gross revenue and profit of more than 5% in each year for the period 2008 through 2011. Second, the effect of the inflated revenue was that Saba met analyst expectations for EPS in certain quarters and caused at least one year (2010) to reflect net income when, but for the inflated revenue, the Company should have reported a net loss.

C. Saba's Required Restatement

16. On August 6, 2012, Saba announced that, following an internal accounting review, management had determined that its annual financial results for fiscal years 2011 and 2010, as well as the first and second quarters of fiscal year 2012, should be restated as a result of instances of improper time-recording that it had identified in the Company's professional services business. On November 5, 2012, Saba announced that management had determined that the Company's annual financial results for fiscal years 2009 and 2008 would also need to be restated.

D. Compensation of CFOs Slater and Williams

17. During the 12-month periods that followed the filing of the periodic reports requiring restatement, Slater and Williams received bonuses and realized profits from sales of Saba stock.

18. Slater and Williams have not reimbursed those amounts to Saba.

Violations

19. Section 304 of the Sarbanes-Oxley Act of 2002 requires the chief financial officer of any issuer required to prepare an accounting restatement due to material noncompliance with the securities laws as a result of misconduct to reimburse the issuer for (i) any bonus or incentive-based or equity-based compensation received by that person from the issuer during the 12-month periods following the false filings, and (ii) any profits realized from the sale of securities of the issuer during those 12-month periods. Section 304 does not require that a chief financial officer engage in misconduct to trigger the reimbursement requirement. Slater and Williams both realized Saba stock-sale profits and received bonuses during the 12-month periods following the filings

containing financial results that Saba is required to restate. They have not, to date, reimbursed the Company for those amounts. Slater and Williams have, therefore, violated Sarbanes-Oxley Section 304.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED, pursuant to Section 21C of the Exchange Act, that:

A. Respondents Slater and Williams cease and desist from committing or causing any violations and any future violations of Section 304 of the Sarbanes-Oxley Act.

B. Respondent Slater shall, within 30 days of the entry of this Order, reimburse Saba for a total of $337,375 pursuant to Section 304(a) of SOX. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to Erin Schneider, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, California 94104.

C. Respondent Williams shall, within 30 days of the entry of this Order, reimburse Saba for a total of $141,992 pursuant to Section 304(a) of SOX. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to Erin Schneider, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, California 94104.

By the Commission.

Brent J. Fields
Secretary

PRESS RELEASE

SEC Announces Half-Million Dollar Clawback from CFOs of Silicon Valley Company That Committed Accounting Fraud

FOR IMMEDIATE RELEASE
2015-28

Washington D.C., Feb. 10, 2015 — The Securities and Exchange Commission today announced that two former CFOs have agreed to return nearly a half-million dollars in bonuses and stock sale profits they received while their Silicon Valley software company was committing accounting fraud.

According to the SEC's order instituting a settled administrative proceeding, William Slater and Peter E. Williams III received $337,375 and $141,992 respectively during time periods when Saba Software presented materially false and misleading financial statements. While not personally charged with the company's misconduct, Slater and Williams are still required under Section 304 of the Sarbanes-Oxley Act to reimburse the company for bonuses and stock sale profits received while the fraud occurred. Saba Software overstated its pre-tax earnings and made material misstatements about its revenue recognition practices while Slater served as CFO from December 2008 to October 2011 and while Williams served as CFO from October 2011 to January 2012.

"During any period when a company materially misrepresents its financial results, even executives who were not complicit in the fraud have an obligation to return their bonuses and stock sale profits to the company for the benefit of the shareholders who were misled," said Jina L. Choi, Director of the SEC's San Francisco Regional Office.

Last year, the SEC charged Saba Software and two former executives responsible for the accounting fraud in which timesheets were falsified to hit quarterly financial targets. As part of that settlement, the SEC similarly reached an agreement with the former CEO to reimburse the company $2.5 million in bonuses and stock profits that he received while the accounting fraud was occurring, even though he was not charged with misconduct.

Slater and Williams each consented to the entry of the SEC's order without admitting or denying the finding that they violated Section 304 of the Sarbanes-Oxley Act.

The SEC's investigation was conducted by Mike Foley, Rebecca Lubens, and Erin Schneider of the San Francisco Regional Office.

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Related Materials

- SEC order

PRESS RELEASE

SEC Charges Software Company in Silicon Valley and Two Former Executives Behind Fraudulent Accounting Scheme

CEO Agrees to Return $2.5 Million Under Clawback Provision

FOR IMMEDIATE RELEASE
2014-214

Washington D.C., Sept. 24, 2014 — The Securities and Exchange Commission today charged a Silicon Valley-based software company and two former executives behind an accounting fraud in which timesheets were falsified to hit quarterly financial targets.

An SEC investigation found that company vice presidents Patrick Farrell and Sajeev Menon were atop a scheme at Saba Software in which managers based in the U.S. directed consultants in India to either falsely record time that they had not yet worked, or purposely fail to record hours worked during certain pay periods to conceal budget overruns from management and finance divisions. The improper time-reporting practices enabled Saba Software to achieve its quarterly revenue and margin targets by improperly accelerating and misstating virtually all of its professional services revenue during a four-year period as well as a substantial portion of its license revenue.

Saba Software agreed to pay $1.75 million to settle the SEC's charges, and Farrell and Menon agreed to settle the case as well.

Under the "clawback" provision of the Sarbanes-Oxley Act, executives can be compelled to return to the company and its shareholders certain money they earned while their company was misleading investors. In a separate order instituted today, the SEC required Saba Software's CEO Babak "Bobby" Yazdani to reimburse the company

$2.5 million in bonuses and stock profits that he received while the accounting fraud was occurring, even though he was not charged with misconduct.

"CEOs and CFOs can be deprived of bonuses and stock profits if there is misconduct on their watch that requires a restatement by their employer," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement. "We will not hesitate to pursue clawbacks in appropriate cases."

According to the SEC's order instituting a settled administrative proceeding, Saba Software offers professional services often sold simultaneously with software products. The professional services historically have accounted for about one-third of approximately $120 million in yearly revenues, and the company maintains a group of consultants within its subsidiary in India to help deliver professional services to its customers. The SEC's order finds that Saba Software's timekeeping practices of "pre-booking" and "under-booking" hours worked by these consultants precluded the time records from serving as reliable evidence under U.S. Generally Accepted Accounting Principles to recognize revenue in the manner that the company did. Therefore, from Oct. 4, 2007 to Jan. 6, 2012, Saba Software cumulatively overstated its pre-tax earnings by approximately $70 million.

According to the SEC's order, Farrell and Menon were responsible for ensuring that the professional services group within Saba Software met financial targets set by senior management. Farrell was aware of situations where consultants planned to pre-book hours in order to achieve their quarterly revenue targets yet he failed to stop the practice. In other instances when they had overrun their budgets, he directed consultants to "eat" the hours or back them out of the timesheet database. Menon directed consultants reporting to him to book time to the timesheet database at quarter-end even though those hours would not be worked until the following quarter. In other instances, he advised them to avoid inputting in the timekeeping system non-billable hours that they had worked.

The SEC's order further finds that internal accounting controls at Saba Software were ineffective to counter-balance the revenue and margin targets set by senior management. This problem was particularly acute in Saba Software's India-based consulting group, which was referred to throughout the consulting organization as a "black box." This characterization reflected the fact that U.S. and European managers approving time records of India-based consultants for revenue recognition purposes had little visibility into who was performing what work and when.

"Saba Software used off-shore operations to cut costs, but also cut corners on its internal controls over financial reporting," said Jina L. Choi, Director of the SEC's San Francisco Regional Office. "Weak internal controls create greater opportunity for accounting fraud, and investors are left holding the bag."

Saba Software consented to the entry of an order finding that it violated the anti-fraud, books and records, and internal control provisions of the federal securities laws. In addition to the $1.75 million financial penalty, Saba Software agreed to pay further penalties if it has not filed restatements of its earnings during those periods by later this year, and revocation of the registration for its securities if it doesn't file those restatements by early next year. Without admitting or denying the findings in the order, Saba Software also agreed to cease and desist from committing or causing future violations of these provisions of the securities laws.

Farrell and Menon each consented to the entry of an order finding that they violated the anti-fraud provisions and caused Saba Software's violations. The order also finds that they falsified books and records and circumvented the company's internal controls. Farrell agreed to pay disgorgement and prejudgment interest of $35,017 and a penalty of $50,000, and Menon agreed to pay disgorgement and prejudgment interest of $19,621 and a penalty of $50,000. Without admitting or denying the findings, they each agreed to cease and desist from committing or causing future violations of these provisions the securities laws.

Yazdani consented to reimburse Saba Software for $2,570,596 in bonuses, incentive compensation, and stock sale profits that he received following the regulatory filings that the company is now required to restate. He neither admitted nor denied the findings against the company in the order.

The SEC's investigation, which is continuing, is being conducted by Mike Foley, Rebecca Lubens, and Erin Schneider of the San Francisco Regional Office.

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Related Materials

- SEC order: Saba Software, Farrell, and Menon
- SEC order: Yazdani

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73201 / September 24, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3584 / September 24, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16160

In the Matter of **BABAK ("BOBBY") YAZDANI** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Bobby Yazdani ("Respondent").

II.

In anticipation of the institution of these proceedings, the Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over each and over the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

1. This matter involves misstated revenues in the professional services organization at Saba Software, Inc. ("Saba" or "the Company"), a Silicon Valley-based enterprise software company. The misstatements were the result of the falsification of time records over a period of more than four years by professional services managers in multiple geographies directing consultants in Saba's Indian subsidiary (the India Consulting Group or "ICG") to falsify time records by either recording time in advance of performance of work or failing to record time for hours worked in order to achieve their quarterly revenue and margin targets.

2. As a result, Saba reported false financial results in its financial statements filed with the Commission over the period from October 4, 2007 through January 6, 2012. As Saba announced on August 6, 2012 and November 5, 2012, management has determined that the Company is required to restate its financial statements for fiscal years 2008 through 2011, as well as the first two quarters of fiscal 2012. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

3. Saba's Chief Executive Officer, Bobby Yazdani, received bonuses and incentive- and equity-based compensation from Saba, and also realized Saba stock-sale profits, during the 12-month periods following the filings containing financial results that Saba is required to restate. Yazdani has not, to date, reimbursed Saba for those amounts.

Respondent and Related Entity

4. **Bobby Yazdani**, age 49, has a primary residence in Potomac, Maryland and a condominium in Redwood Shores, California. He founded Saba in April 1997 and served as CEO from then until 2002 and again from 2003 to March 2013. He served as Chairman of the Board from April 1997 until March 2013. He resigned both positions in March 2013. Yazdani is currently self-employed.

5. **Saba Software, Inc.** ("Saba" or "the Company") is a Delaware corporation headquartered in Redwood Shores, California. The software company provides cloud-based enterprise learning, talent management and social networking tools to businesses and large organizations. At all relevant times, Saba's common stock has been registered pursuant to Section

[1] The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

12 of the Exchange Act. From its IPO in April 2000 until July 31, 2006, its common stock was registered pursuant to Section 12(g). Thereafter, until June 2013, it was registered pursuant to Section 12(b). It traded on the Nasdaq Global Market until it was suspended on April 9, 2013, and then it was delisted effective June 17, 2013 for failure to remain compliant with its SEC reporting obligations. Upon its delisting and deregistration from Section 12(b), it reverted to its previous Section 12(g) registration. Its common stock is currently registered pursuant to Section 12(g) and traded on the OTC Markets. Saba has not filed any periodic reports since January 6, 2012, when it filed its Form 10-Q for the quarter ended November 30, 2011.

Facts

A. Saba's Falsification of Time Records

6. Saba's professional services historically has accounted for about one third of its approximately $120 million in yearly revenues. Professional services have been delivered to customers worldwide by (1) customer-facing field consultants in North America and Europe ("Field Consultants") and (2) off-shore technical development services provided to the Field Consultants by the Company's India Consulting Group ("ICG Consultants"). ICG is an organization within Saba's Indian subsidiary designed to help the Company deliver professional services to its customers at a lower cost than comparable consultants in North America and Europe. By 2011, ICG employed 50-60 consultants who generated approximately 14,000 hours of billable work per quarter, which constituted about 17% of consulting revenue and 6% of total revenue per quarter.

7. Both Field Consultants and ICG Consultants were required to record time worked on customer projects in a timesheet database. Hours input into the system by Field or ICG Consultants were approved on a weekly basis by project managers in North America and Europe, and revenue for the professional services organization was then measured based on the approved number of hours in the timesheet database.

8. Saba disclosed in its public filings that it recognized revenue for both "time and materials" and "fixed fee" contracts as the services were performed. This revenue recognition treatment was consistent with GAAP only if Saba could demonstrate that (1) its customers have historically paid a consistent rate for its services (measured by Vendor Specific Objective Evidence or "VSOE") and (2) it could accurately estimate how many hours it took to complete projects ("ability to estimate"). Therefore, Saba's finance personnel depended on accurate time records to ensure that Saba recognized revenue in accordance with GAAP.

9. From at least 2008 through the second quarter of Saba's fiscal 2012, Saba professional services employees and managers engaged in two time-keeping practices that led to its false revenue recognition. First, there were multiple incidents of ICG Consultants recording hours and billing customers for the performance of professional services in advance of performing those services in order to accelerate revenue recognition and achieve quarterly revenue targets ("pre-booking"). Second, ICG and Field Consultants regularly failed to report professional services time

worked in order to conceal budget overruns from management and finance, instead recording that time to non-billable project codes or not at all ("under-booking").

10. These improper time-keeping practices precluded the time records from serving as reliable evidence under GAAP to recognize revenue in the manner that Saba did. As such, Saba management has concluded that Saba cannot demonstrate VSOE for the period from 2008 through the second quarter of fiscal 2012. Over that period, therefore, Saba was required to recognize professional services revenues on a completed contract basis, which would have required it to defer substantially all of its professional services revenue and much of its license revenue (where software licenses were bundled with professional services) until the contract was completed. Accordingly, virtually all of Saba's professional services revenue was misstated over the relevant time period because revenue was recognized earlier than it should have been under the applicable accounting principles.

11. The practices of pre-booking and under-booking were directed by and known to numerous individuals in the professional services organization and ICG, including the two most senior Saba employees overseeing the professional services organization in North America over the relevant time period. Those senior Saba employees were told on multiple occasions by the finance department that the Company's accountants and auditors needed to understand exactly how many hours were being worked and when (regardless of whether or not they were billed to the customer) in order to ensure that revenue was recognized accurately, and they understood that inaccurate time-keeping would lead to misstatements in Saba's reported professional services revenue and violate the Company's policies regarding financial reporting, including the Code of Business Conduct and the Revenue Recognition Policy.

B. Scope and Impact of the Fraud

12. Saba's professional services revenues, gross margins and income were materially overstated in its periodic filings from October 4, 2007 through January 6, 2012 as a result of the time-reporting misconduct.

13. The practices of pre-booking and under-booking, and the fundamental inaccuracy in Saba's time records revealed by these practices, have led Saba management to conclude that it can no longer rely on its calculation of VSOE of fair value for professional services. In this circumstance, ASC 985-605 (Certain Revenue Arrangements That Include Software Elements) and ASC 605-35 (Revenue Recognition) require that the Company defer to the point where services are complete, rather than recognize over the period where services are performed, standalone services revenue and revenue on software license and cloud services agreements that contain bundled professional services. Accordingly, Saba has determined and announced that it is required to restate its financial statements for the years 2008, 2009, 2010 and 2011, and the first two quarters of 2012, due to its material non-compliance with GAAP. Although Saba has not yet filed its required restatement, the cumulative impact of this alternative revenue recognition treatment is approximately $70 million over the period from 2008 through the second fiscal quarter of 2012. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

14. These misstatements are material. First, based on the Company's own estimates, the restated financials will reflect overstatements of gross revenue and profit of more than 5% in each year for the period 2008 through 2011. Second, the effect of the inflated revenue was that Saba met analyst expectations for EPS in certain quarters and reversed at least one year (2010) from a net income to a net loss for the year.

C. Saba's Required Restatement

15. On August 6, 2012, Saba announced that, following an internal accounting review, management had determined that its annual financial results for fiscal years 2011 and 2010, as well as the first and second quarters of fiscal year 2012, should be restated as a result of instances of improper time-recording that it had identified in the Company's professional services business. On November 5, 2012, Saba announced that management had determined that the Company's annual financial results for fiscal years 2009 and 2008 would also need to be restated.

D. Compensation of CEO Yazdani

16. During the 12-month periods that followed the filing of the periodic reports requiring restatement, Yazdani received cash incentive awards and bonuses and also realized profits from sales of Saba stock.

17. Yazdani has not reimbursed those amounts to Saba.

Violations

18. Section 304 of the Sarbanes-Oxley Act of 2002 requires the chief executive officer of any issuer required to prepare an accounting restatement due to material noncompliance with the securities laws as a result of misconduct to reimburse the issuer for (i) any bonus or incentive-based or equity-based compensation received by that person from the issuer during the 12-month periods following the false filings, and (ii) any profits realized from the sale of securities of the issuer during those 12-month periods. Section 304 does not require that a chief executive officer engage in misconduct to trigger the reimbursement requirement. Yazdani received bonuses and incentive- and equity-based compensation from Saba, and also realized Saba stock-sale profits, during the 12-month periods following the filings containing financial results that Saba is required to restate. He has not, to date, reimbursed the Company for those amounts.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 21C of the Exchange Act, that**:**

A. Respondent Yazdani cease and desist from committing or causing any violations and any future violations of Section 304 of the Sarbanes-Oxley Act.

B. Respondent Yazdani shall, within 30 days of the entry of this Order, reimburse Saba for a total of $2,570,596 in Saba bonuses, other incentive-based or equity-based Saba compensation, and Saba stock sale profits pursuant to Section 304(a) of SOX. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to Erin Schneider, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, California 94104.

By the Commission.

Brent J. Fields
Secretary

March 17, 2015

Exclusive Forum Bylaws – New Research Shows Favorable Impact

In recent years, public companies have increasingly become targets of internal affairs litigation over the same corporate action in multiple jurisdictions. Multi-forum litigation can create significant problems, including unnecessarily redundant, inconvenient, costly and time-consuming lawsuits and inconsistent judicial decisions, requiring still further proceedings to resolve. As succinctly explained by Vice Chancellor Laster of the Delaware Court of Chancery in a recent multi-forum action: "This case really exemplifies the interforum dynamics that have allowed plaintiff's counsel to extract settlements in M&A litigation and that have generated truly absurdly high rates of litigation challenging transactions."[1] Indeed, we have seen Maryland-formed companies subjected to litigation in Maryland and simultaneously in states as far away as California and Arizona arising out of the same corporate actions. As a result, corporations and real estate investment trusts formed in Maryland, Delaware and other jurisdictions have adopted exclusive forum bylaw provisions requiring certain intracorporate disputes to be brought in the courts of the state of incorporation. Over the last few years, Delaware courts have repeatedly addressed the legitimacy and scope of these provisions and, as discussed below, a proposed amendment to the Delaware General Corporation Law (the "DGCL") that would codify the right to adopt an exclusive forum provision is currently under consideration in Delaware.

Now, an important new study demonstrates the beneficial impact of exclusive forum bylaws on reducing multi-forum litigation in large M&A transactions. According to a report by Cornerstone Research released just last month, shareholder lawsuits were filed in 93% of public company M&A transactions valued at over $100 million in 2014, with an average of more than four lawsuits filed per transaction – an increase from 54% in 2008. However, in 2014, only 40% of these transactions were challenged in more than one jurisdiction, and only four percent were challenged in more than two jurisdictions (the lowest number since 2007). This is a dramatic decrease from 2013, when 62% of these transactions were challenged in more than one jurisdiction and an average of over five lawsuits were filed per transaction. The author specifically states that this decline in multi-forum litigation is "likely a result of widespread adoption of forum selection clauses in corporate bylaws."[2]

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[1] *Edgen Group Inc. v. Genoud*, No. 9055-VCL (Del. Ch. Nov. 5, 2013). *See also* LEO E. STRINE, JR., LAWRENCE A. HAMERMESH & MATTHEW C. JENNEJOHN, *Putting Stockholders First, Not the First-Filed Complaint*, 69 BUS. LAW. 1, 8 (2013) ("In recent years, shareholder class actions challenging mergers and acquisitions have become more prevalent, and so have instances in which litigation of this sort has been brought more or less concurrently in multiple forums."). Internal affairs litigation is also common in contexts other than just M&A transactions.
[2] Olga Koumrian, *Shareholder Litigation Involving Acquisitions of Public Companies*, CORNERSTONE RESEARCH (February 2015).

Development under Delaware Law

The scope and enforceability of exclusive forum bylaw provisions have developed through several Delaware cases in the last few years. The seminal opinion was issued on June 25, 2013 in two consolidated cases, *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, Del. Ch. C.A. No. 7220-CS, and *IClub Investment Partnership v. FedEx Corp.*, Del Ch. C.A. No. 7238-CS (together "*Chevron*"). In *Chevron*, Chancellor Strine of the Delaware Court of Chancery (now Chief Justice of the Delaware Supreme Court) held that, with regard to a facial challenge to exclusive forum bylaw provisions enacted by Chevron and FedEx, (1) the venue for stockholder corporate and derivative litigation was a proper subject for regulation by bylaw, (2) exclusive forum bylaw provisions unilaterally adopted by directors are "valid and enforceable" as to stockholders and (3) hypothetical situations in which a particular bylaw *could* prove unreasonable did not make it facially invalid. While the court noted that exclusive forum bylaw provisions are always subject to as-applied challenges, *i.e.*, a board's adoption of the provision is still subject to scrutiny in the context of particular facts and circumstances, Chancellor Strine stated that "[s]uch circumstantial challenges are required to be made based on real-world circumstances by real parties, and are not a proper basis for the survival of the plaintiffs' claims that the bylaws are facially invalid under the DGCL."

As a result of *Chevron*, over 600 public corporations and real estate investment trusts, including over 60 Maryland public companies, have adopted exclusive forum provisions. Indeed, these provisions have become mainstream since the *Chevron* decision.

Following *Chevron*, Chancellor Bouchard in *City of Providence v. First Citizens Bancshares, Inc.*,[3] held that Chancellor Strine's analysis in *Chevron* would apply to exclusive forum bylaw provisions dictating a forum other than the state of incorporation. The bylaw in question was, according to the court "[i]n all but two respects . . . functionally identical to the bylaws . . . challenged in *Chevron*." The two differences concerned (a) language stating that the bylaw is applicable only "to the fullest extent permitted by law" (a difference which was not addressed) and (b) designating North Carolina, the state where the company was headquartered, as the exclusive forum for litigation, rather than Delaware (the state of incorporation).

The *Providence* court upheld the exclusive forum bylaw provision in question, stating that "nothing in the text or reasoning of *Chevron* can be said to prohibit directors of a Delaware corporation from designating an exclusive forum other than Delaware in its bylaws." Further, the court added that the company's decision to designate North Carolina, the "second most obviously reasonable forum given that [the company] is headquartered and has most of its operations there . . . does not . . . call into question the facial validity of the Forum Selection Bylaw." The court went on to hold that it did "not discern an overarching public policy of [Delaware] that prevents boards of directors of Delaware corporations from adopting bylaws [requiring] stockholders to litigate intra-corporate disputes in a foreign jurisdiction."

[3] C.A. No. 9795-CB (Del Ch. Sept. 8, 2014).

Plaintiffs in *Providence* also challenged the timing of the adoption of the exclusive forum bylaw provision at issue. In *Providence*, the board of directors of First Citizens Bancshares, Inc. approved the exclusive forum bylaw provision at the same meeting the board approved a merger with First Citizens Bancorporation, Inc. In addition to the challenges discussed above, the plaintiffs claimed that enforcing the bylaw would be "unjust" and "goes well beyond [plaintiffs'] reasonable expectations" given the timing of adoption. The court disagreed and stated: "That the Board adopted [the exclusive forum bylaw] on an allegedly 'cloudy' day when it entered into the merger agreement . . . rather than on a 'clear' day is immaterial given the lack of any well-pled allegations . . . demonstrating any impropriety in this timing."

Finally, the Delaware Supreme Court, in an opinion by Chief Justice Strine, has recently reaffirmed the validity of board-adopted exclusive forum bylaw provisions.[4]

Enforceability under Maryland Law

Although there is no controlling Maryland case on point, the Court of Appeals of Maryland (our highest state court), the Court of Special Appeals (our intermediate appellate court) and our trial courts, as well as other courts interpreting Maryland law, "have historically found Delaware law in matters involving business law highly persuasive."[5] Thus, we think that *Chevron* and its progeny provide strong authority supporting the validity and enforceability of an exclusive forum bylaw provision in Maryland.

Delaware Statutory Developments

Earlier this month, the Corporation Law Council of the Delaware State Bar Association announced its proposed amendments to the DGCL for 2015, which include a new Section 115 that would, if adopted, codify a corporation's right to include an exclusive forum provision in its certificate of incorporation or bylaws. Any exclusive forum provision would apply only to "intracorporate claims," as defined in the proposed amendment. Further, Delaware corporations would be required to specify Delaware as the exclusive forum for any intracorporate claims, thus overruling *Providence* in part and disallowing a forum other than the state of incorporation. The full text of the proposed amendment to the DGCL is attached hereto as Exhibit A.

* * * *

As always, we and our colleagues are available at any time to discuss these or other matters of Maryland law.

Jim Hanks
Dan Mendelsohn

[4] *See United Tech. Corp. v. Treppel*, No. 127, 2014 (Del. Dec. 23, 2014) (*en banc*).
[5] *In re Nationwide Health Properties, Inc. Shareholder Litigation*, No. 24-C-11-001476, slip op. at 16 (Md. Cir. Ct. May 27, 2011) (opinion of Berger, J., now a judge of the Court of Special Appeals of Maryland).

This memorandum is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations for which Venable LLP has accepted an engagement as counsel.

EXHIBIT A

PROPOSED AMENDMENT TO THE DGCL

§ 115. Forum selection provisions.

The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all intracorporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State. "Intracorporate claims" means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.

Key Drivers Impacting a REIT's Stock Price Meeting

Wednesday, April 1st
9:45am – 11am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Mark Denien, EVP & CFO, Duke Realty Corporation

Panelists:
Scott Eisen, Managing Director, Citi
Lukas Hartwich, Analyst, Green Street Advisors
Douglas Funke, Managing Director, Forum Securities Limited

REIT Valuation
The NAV-based Pricing Model

Green Street Advisors

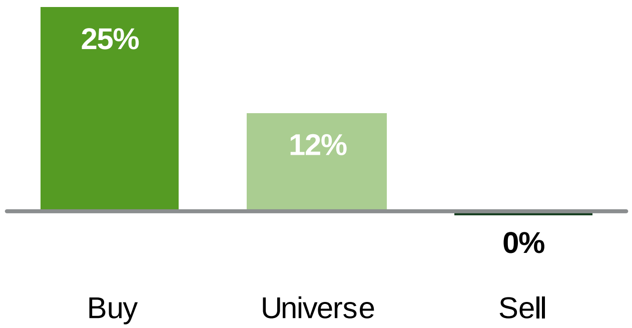
It's All Relative

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.

An Impressive Track Record

20+Yr Annualized Total Return of Green Street's Stock Recommendations*



* Past performance (as of 5/30/14) can not be used to predict future performance. Please see recommendation track record disclosure on page 20

Important disclosure on pages 19-20

660 Newport Center Drive, Suite 800, Newport Beach, CA 92660, USA
+1 949 640 8780

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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Sections

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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

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

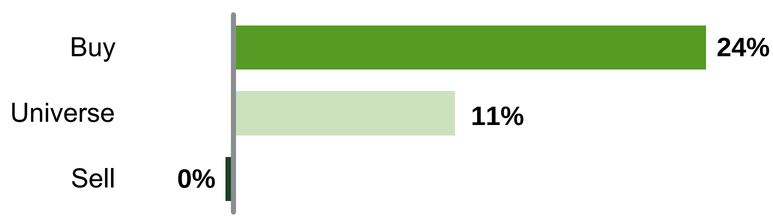
NAV-Based Pricing Model

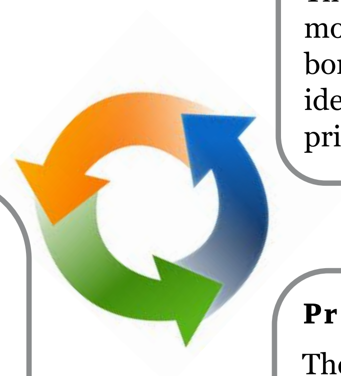
NAV
+ Warranted Premium to NAV
= Warranted Share Price

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

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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)

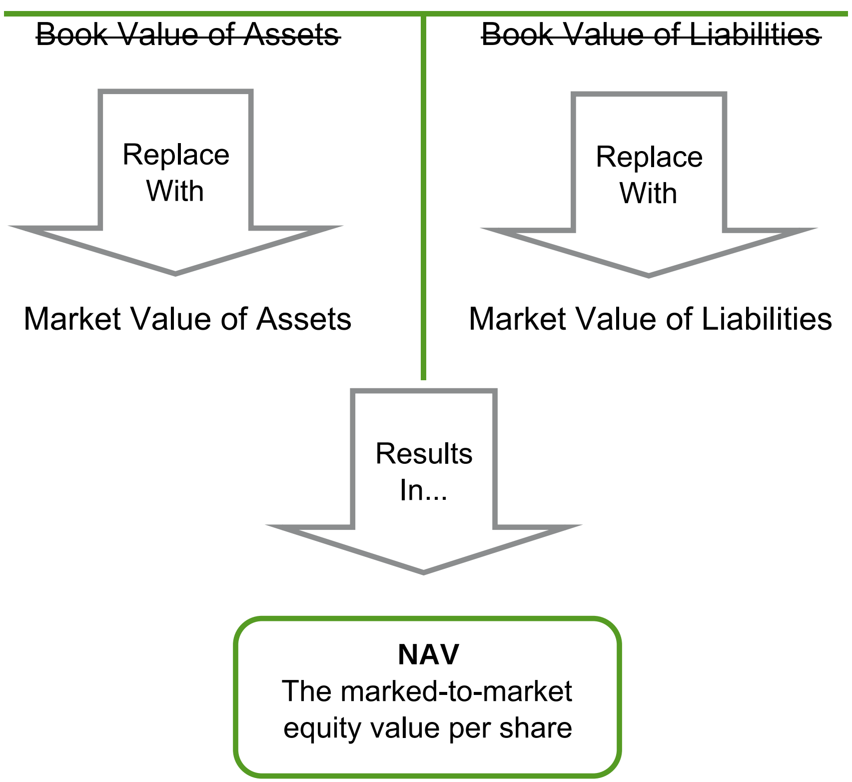
Warranted Share Price

Used to compare valuations *relative* to those of other REITs. It's fair to call it "relative intrinsic value."

Overview: What is NAV?

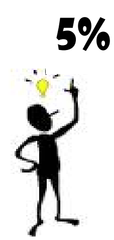
Mark It to Market: An NAV-based valuation methodology is only as good as the underlying estimate of NAV. High-quality estimates of marked-to-market asset value require a great deal of effort and resources, but the estimate can be reasonably precise when done properly. It is also important to mark-to-market 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.

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?

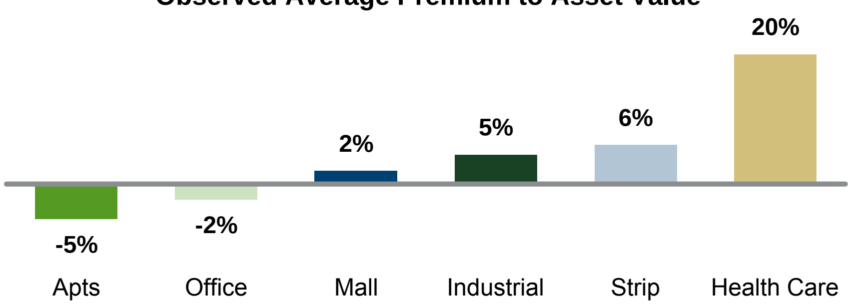
The investment world focuses on premiums to **NAV**, which are impacted by leverage, but the mechanics of our model strip out the distortions leverage can cause by focusing on premiums to **unlevered asset value (UAV)**. Even though the model is UAV-centric, the many references herein to NAV are employed to better speak the language most commonly used in our industry.

Overview: The Influence of Property Sectors

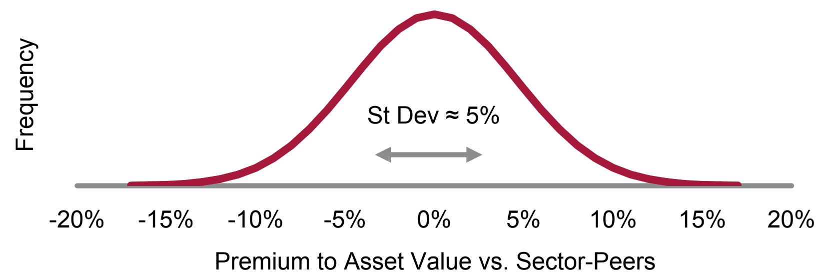
A Normal World: The starting point in calculating the warranted premium for any REIT is the sector-average premium ascribed by the market at current share prices. An assumption is made that the dispersion of observed premiums for the entirety of our coverage universe serves as a good indicator of how 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

Observed Average Premium to Asset Value



Dispersion of Observed Premiums - All REITs



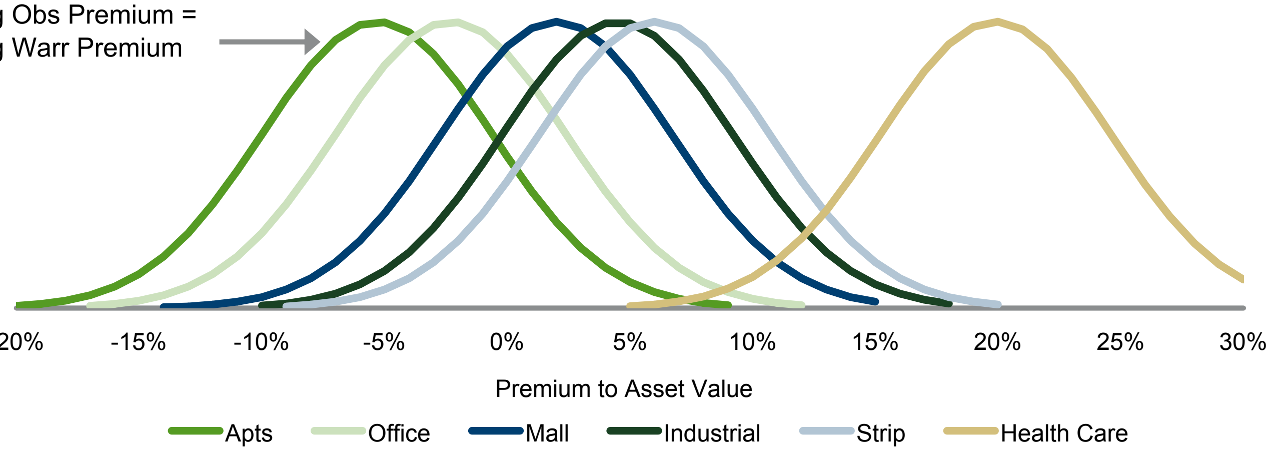
Why Sector Premiums Vary

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

Dispersion of Warranted Premiums Across Sectors



This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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

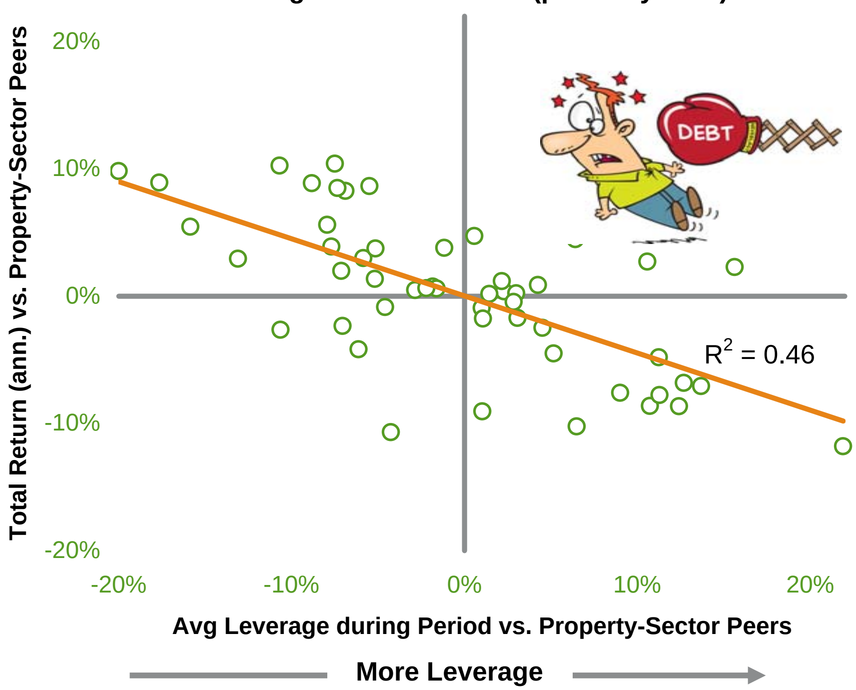
The objective metrics help guide the analyst, but the ultimate score is entirely at his/her discretion.

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.

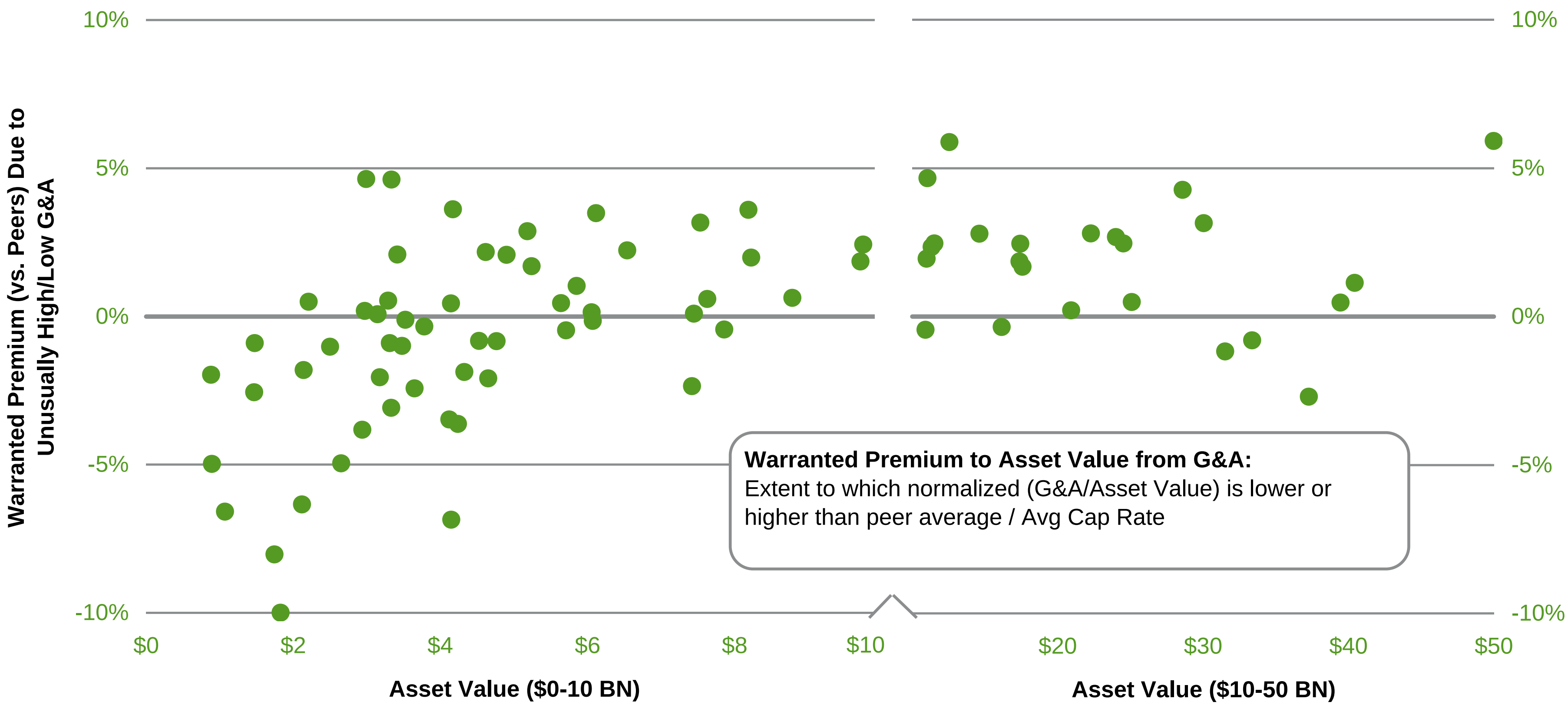
Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders 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 subtracting 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



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.

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

To View the Full Report…

Please contact a member of our Sales team at
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inquiry@greenstreetadvisors.com

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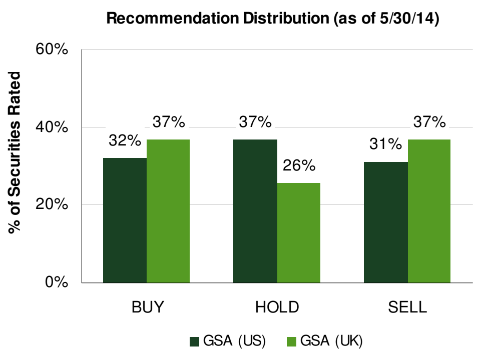
- Unless otherwise indicated, Green Street reviews all investment recommendations on at least a monthly basis.
- The research recommendation contained in this report was first released for distribution on the date identified on the cover of this report.
- Green Street will furnish upon request available 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

REIT Wise®

March 31- April 2
2015

NAREIT's Law, Accounting
& Finance Conference
JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Key Drivers Impacting a REIT's Stock Price

April 1,2015

Session Faculty

- Mark Denien, moderator, EVP & CFO, Duke Realty Corporation
- Scott Eisen, Managing Director, Citi
- Douglas Funke, Managing Director & Global Portfolio Manager, Forum Securities Ltd.
- Lukas Hartwich, Analyst, Green Street Advisors

Topics to be Discussed

- Impact of NAV models
- Importance of FFO and AFFO growth forecasts
- Dividends: Grow versus retain for reinvestment
- Impact of leverage
- “Intangibles” such as management team value add

- Using FFO vs AFFO/FAD vs NAV for REIT Valuations and Target Stock Price
  - Challenges in using forecasts of FFO and AFFO
    - Use of non-NAREIT FFO measures and lack of a standard definition of AFFO
    - Company analysts packages or audited financials or both

- NAV Considerations
  - Debt mark-to-market under a “liquidation methodology” or under a “going concern view”
  - Capitalization rates:
    - Differentiate portfolios based on asset quality factors and specific submarkets
    - Review of recent comparable transactions
    - Current and projected capital expenditure needs
    - Portfolio premiums

- Other Valuation Considerations
  - Franchise value
  - Quality of management team
  - Corporate governance
  - Track record of stock price performance

- Balancing Development as a Value Creator vs. Risk
- Leverage Considerations
  - Rating agency ratings
  - Current levels vs. target levels
  - Optimal leverage levels for REITs and why

Macroeconomic Factors

NOI/FFO as GAAP Metrics – a Possibility? Meeting

Thursday, April 2nd
9:30am – 10:45am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
George Yungmann, SVP-Financial Standards, NAREIT

Panelists:
Marc Siegel, Board Member, Financial Accounting Standards Board
David Smetana, Managing Director, Morgan Stanley

Financial Performance Reporting

Research Project

FINANCIAL ACCOUNTING STANDARDS BOARD

A Research Project on Presentation

FASB directed staff to perform research on a financial statement presentation project in January 2014

Re-scoped from the previous financial statement presentation project, which went inactive in 2011

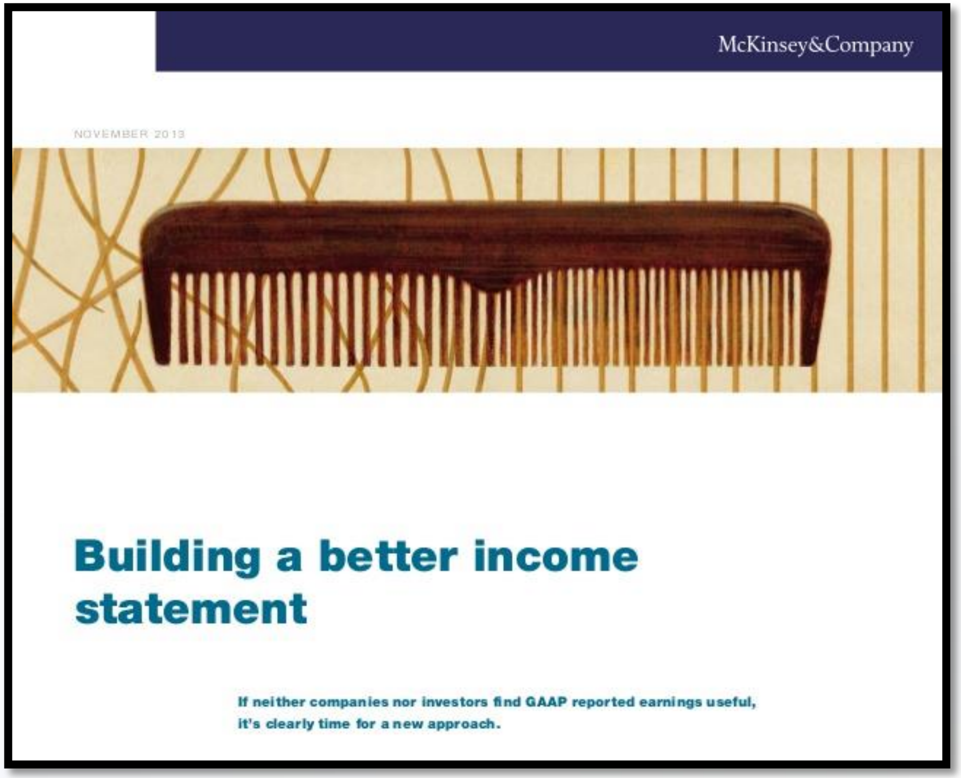
Objective of research is to identify & evaluate alternatives for improving financial statement presentation

Following the research phase, goal is to activate a project on FASB's active agenda

Reasons for undertaking this project

Ranked as a high priority in 2013 agenda survey by FASB Advisory Group

Stakeholders continue to raise concern with usability of income statement – McKinsey


McKinsey&Company

NOVEMBER 2013

Building a better income statement

If neither companies nor investors find GAAP reported earnings useful, it's clearly time for a new approach.

Scope of the Research Project

Primary objective
The primary objective is to evaluate ways the FASB might improve the relevance of information presented in the performance statement.

Two focus areas for the performance statement:

(1) a framework for determining an operating performance metric

(2) distinguishing between recurring & nonrecurring or infrequently occurring items

Scope of the Research Project (cont.)

Improvement areas	Performance reporting
Priority focus areas	
Operating performance metric	✓
Non-recurring or infrequent items	✓
Areas where related improvements may also be considered	
Transparency of remeasurements	✓
Additional disaggregation in the performance statement	✓
Related changes to segment reporting	✓
Linkages across the primary statements	✓

Meaning of a remeasurement

A remeasurement is an income statement item that is:

- a change in (or realization of) a current price of value
- a change in an estimate of a current price or value, or
- a change in an estimate or measurement method

For example:

- Asset impairments such as intangibles & fixed assets
- Change in the method for estimating a warranty obligation
- Changes in the income tax rates

Areas unlikely to be addressed

The following areas are unlikely to be pursued in this project:

- Direct Cash Flow Statement
- COGS
- Earnings Per Share
- Other Comprehensive Income

Previous performance reporting projects

FASB (1979)

- Reporting Earnings Task Force – Discussion Memorandum
- Analysis of Issues Related to Reporting Earnings

FASB (1981)

- Conceptual Framework – Exposure Draft
- Reporting income, Cash Flows & Financial Position

AICPA (1994)

- Jenkins' Committee Report
- Special Committee on Financial Reporting

Previous performance reporting projects

FASB & G4+1 (1998)	• G4+1 – Special Report • Reporting Financial Performance
UK ASB (2000)	• Exposure Draft • Reporting Financial Performance
FASB & IASB (2008)	• Joint Project – Discussion Paper • Preliminary Views on Financial Statement Presentation
FASB & IASB (2010)	• Joint Project – Staff Draft of an Exposure Draft • Financial Statement Presentation

Differences from the Previous FSP Project

Major improvements sought in the 2010 Staff Draft
Core principles
Disaggregation principle (three primary statements by function, nature & measurement)
Cohesiveness principle (three primary statements into operating, investing, financing)
Other major changes proposed
Separate note disclosure of income statement remeasurements
Separate note disclosure of changes in assets & liabilities (rollforwards)
Enhanced disclosures in the segment reporting note
Direct method cash flow statement

Operating Performance Metric

Key premise: Operating performance metric is the net result of a defined set of *operating activities*

Research into ways to define operating activities
- Current practice in presenting operating income
- Previous standard setting attempts
- International practices
- Academic research
- Conceptual framework

Public Board meeting held in February

Disaggregation of line items – Next steps

Ideas considered:
- Infrequency/nonrecurring notion
- Remeasurements notion
- Function/nature

The next public meeting will focus on infrequent/nonrecurring items.

The Board will revisit defining operating activities after it considers disaggregation

Aggregation of line items – Next steps

Potential factors for grouping:

- Characteristics of the recognized items
- Activity from which recognized item resulted
- Measurement method
- Timing & uncertainty of prospects for future cash flows

REIT Wise® March 31- April 2 2015

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

NOI/FFO as GAAP - a possibility

April 2, 2015

Session Faculty

- George Yungmann, moderator, SVP-Financial Standards
- Marc Siegel, Board Member, FASB
- David Smetana, Managing Director, Morgan Stanley

Topics to be Discussed

- FASB Project -- *Financial Performance Reporting*
- An analyst's use of the current GAAP income statement and the importance that non-GAAP metrics and other information be supported by amounts reported in the GAAP income statement
- Might important industry metrics be reported in a statement of operating performance – a management approach to reporting
- The importance of input to the FASB from investors and preparers

Introduction and Context

- Industry non-GAAP metrics, like *net operating income* and *funds from operations* have served the industry well for over 20 years
- The industry has provided investors solid returns over those years using non-GAAP metrics and supplemental information
- Why would the industry like to report industry metrics under GAAP
- The global industry's 2007 consensus for a statement of comprehensive income

An Analyst's Use of the Current GAAP Income Statement and the Importance of Linkage to Audited GAAP Reporting

What We Focus On

- Addition of Net Property Income line-item further solidifies the view that REITs are proxies for real estate
  - We are not a collection of leases or financing arrangements
  - NPI or NOI is a staple in calculating cap-rates and NAV calculations
  - General and Administrative expenses need to be considered
- Revenues
  - Cash vs. Non-cash (straight-line rent and FAS 141)
  - Recurring vs. Non-recurring (lease termination fees and credit losses)
  - TRS activities (billboards, outparcel sales, etc.)
- Expenses
  - Property operating expenses vs. general and administrative
    - Allocations vary widely by company
    - We compare G/A as a % of Assets – 60 bps on average
  - Capitalized expenses

What we would like to see…

- More uniform definition of same-store NOI (SSNOI)
  - Wide-range of definitions
    - Basic description in the financials of the policy; what is in the pool and what is not
    - Treatment of re-developments (compare a center with 120k sf to 100k sf?)
- SSNOI Revenue and Expense line items broken-out separately
  - Best practices to date show each line-items on I/S (Cash and GAAP)
  - Some firms still quote in text a SSNOI number with no tie to audited financial
- Cap-Ex with Same-store NOI
  - How much cap-ex was spent on the properties in each year

Partnership Tax Issues Encountered by REITs Meeting

Wednesday, April 1st
2:45pm – 4pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Kathleen Courtis, SVP, General Growth Properties, Inc.

Panelists:
Steven Adler, VP-Taxation, Acadia Realty Trust
Richard Lipton, Partner, Baker & McKenzie, LLP
Terence Cuff, Counsel, Loeb & Loeb LLP
Craig Schultz, SVP-Strategic Finance & Tax, DDR Corp.

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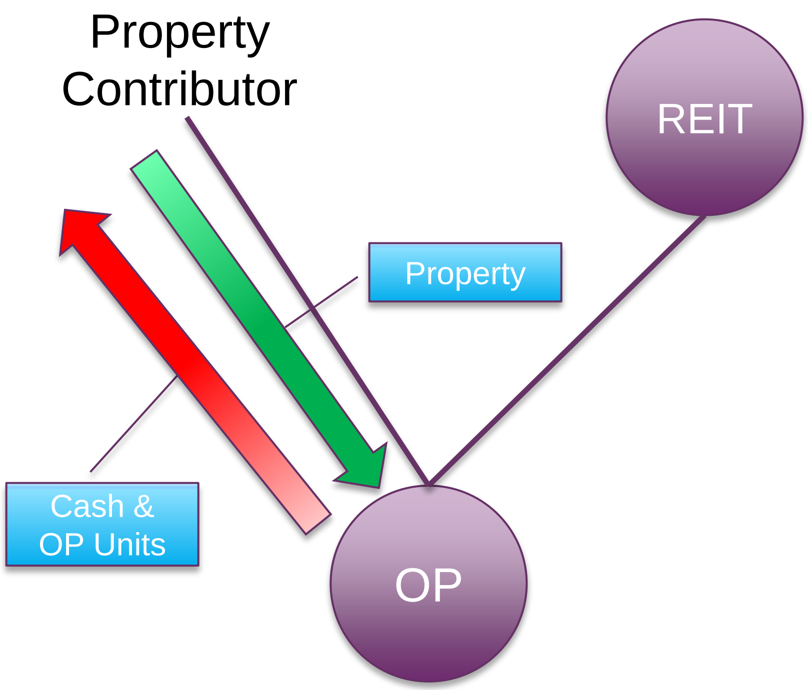
®

Partnership Tax Issues Encountered by REITs

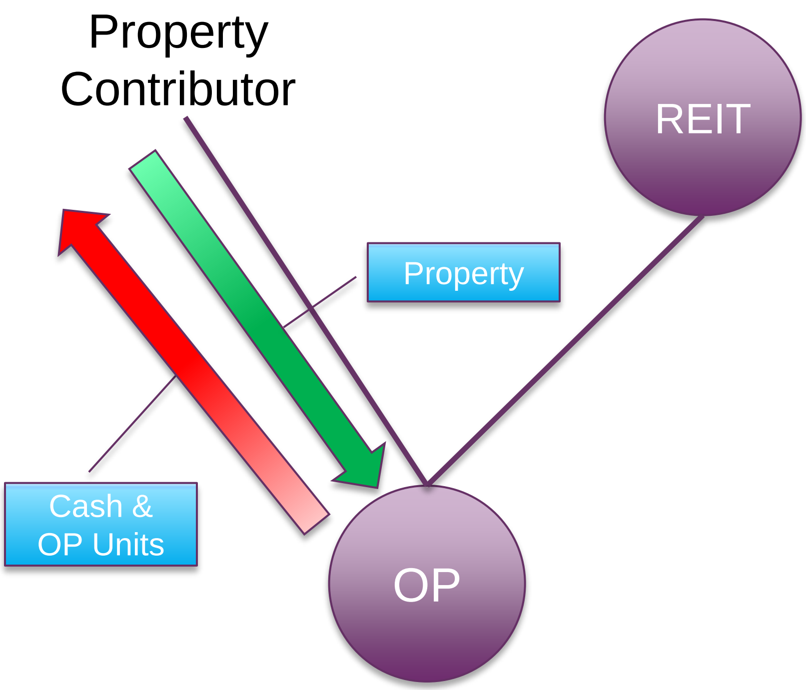
April 1, 2015

Disguised Sales and Liabilities



- Property Contributor contributes real estate to up-REIT OP.
- Receives OP Units and cash.
- Task: avoid gain on contribution & receipt of cash.

Disguised Sales and Liabilities



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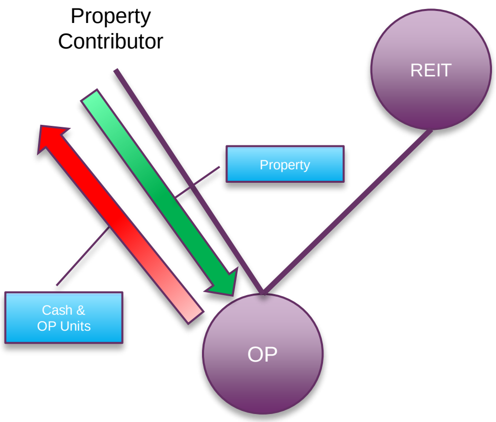
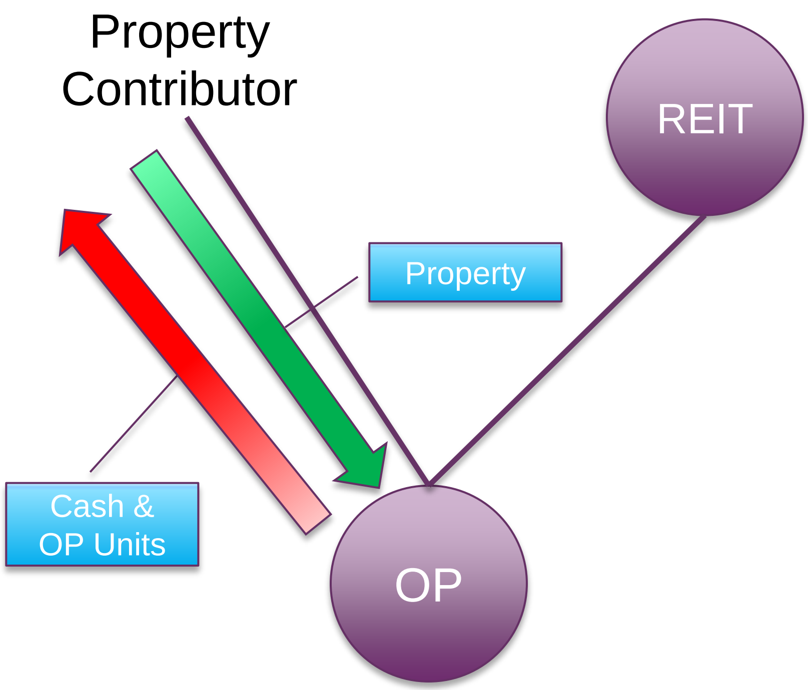


Contributed Property

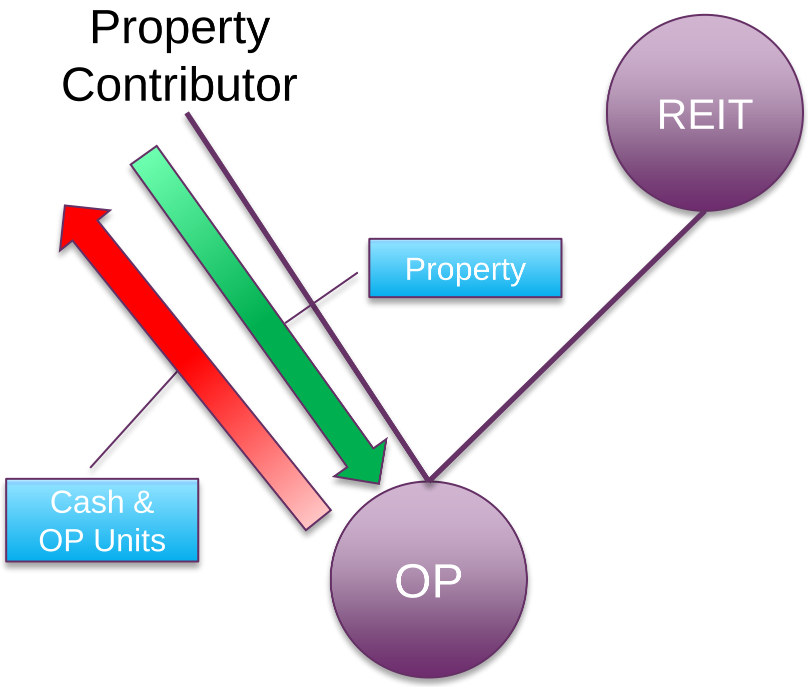
	Adjusted Basis	FMV
Land	\$3,000,000	\$10,000,000
Building	\$3,000,000	\$32,000,000
Total	\$10,000,000	\$42,000,000
Liabilities	\$12,000,000	\$12,000,000
Total	(\$2,000,000)	\$30,000,000

Disguised Sales and Liabilities



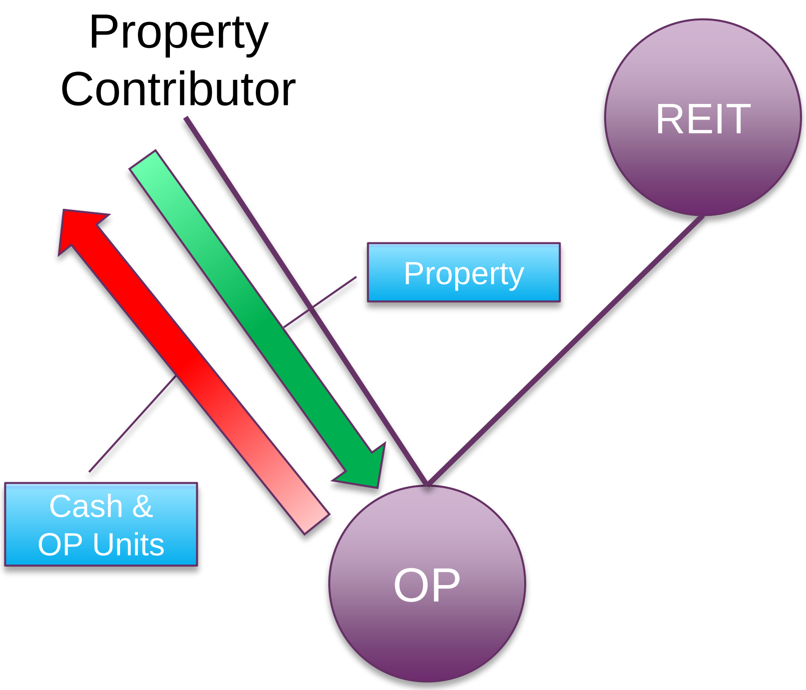
- Considerations:
  - Disguised sale.
  - Liability relief.
  - At risk recapture.

Disguised Sales and Liabilities



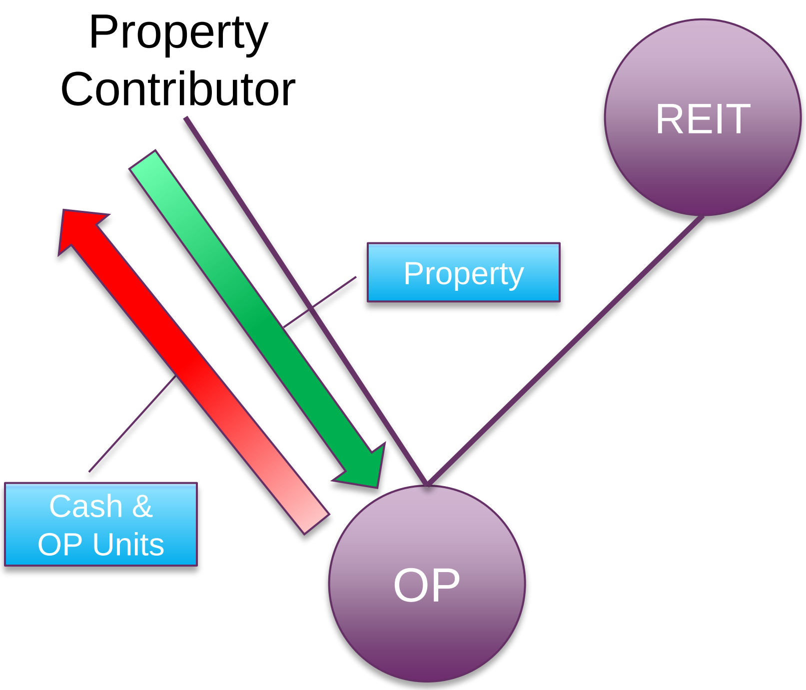
- Disguised sales.
  - Assumption of nonqualified liabilities incurred within 2 years of contribution.
  - Large cash distributions within 2 years of contribution.

Disguised Sales and Liabilities



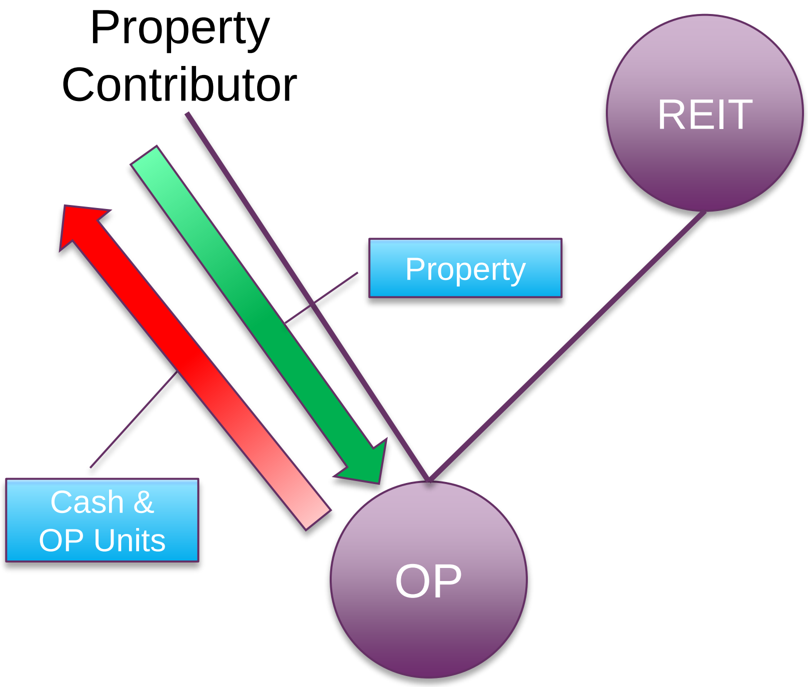
- Liabilities.
  - Relief creating "negative basis" results in gain.
  - Relief of qualifying nonrecourse debt can create at risk recapture.

Disguised Sales and Liabilities



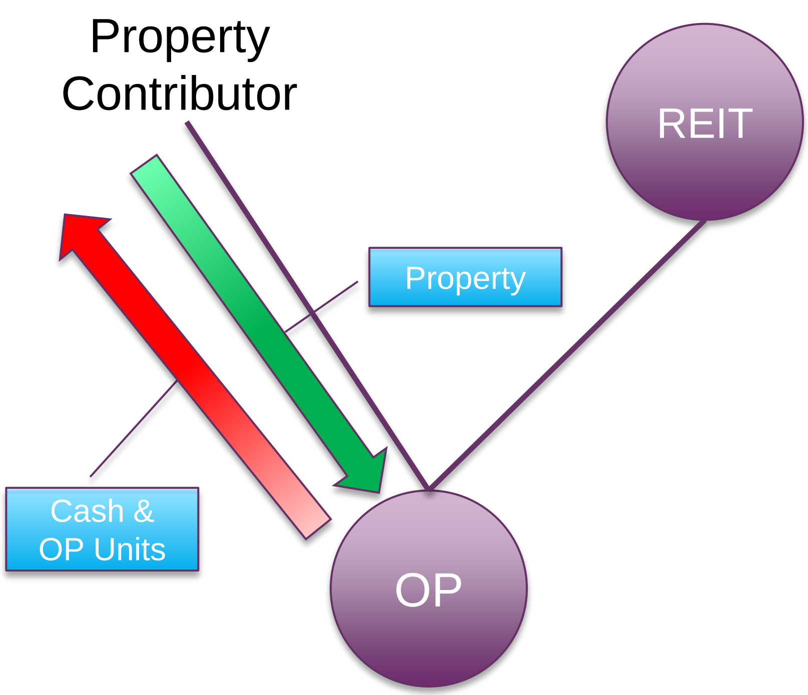
- At risk recapture.
  - Taxpayer going into negative at risk amount triggers recapture.
  - Qualified nonrecourse liabilities. Relief creating “negative basis” results in gain.
  - Relief of qualifying nonrecourse debt can create at risk recapture.

Disguised Sales and Liabilities



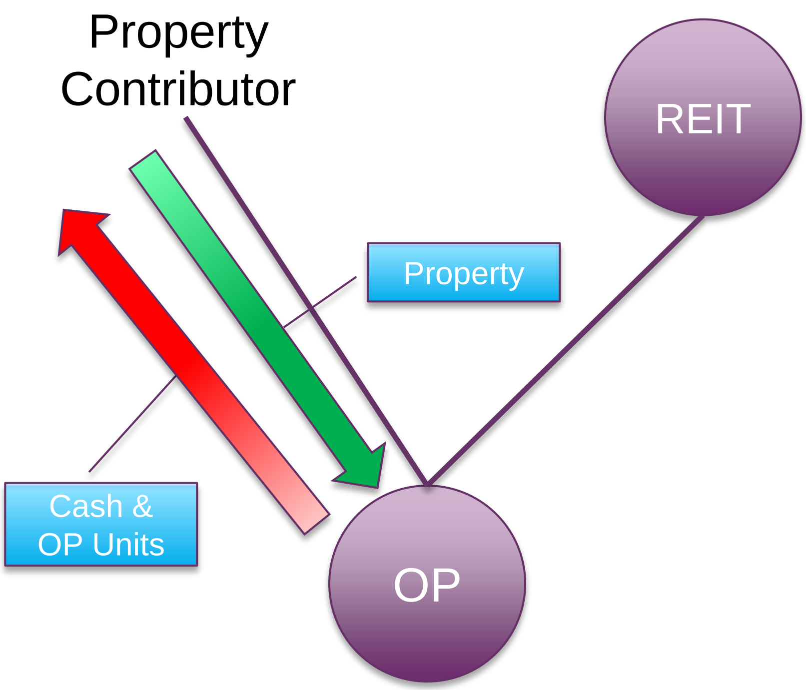
- At risk recapture.
  - Issue: is lender a "qualified person": person actively and regularly engaged in the business of lending money.

Disguised Sales and Liabilities

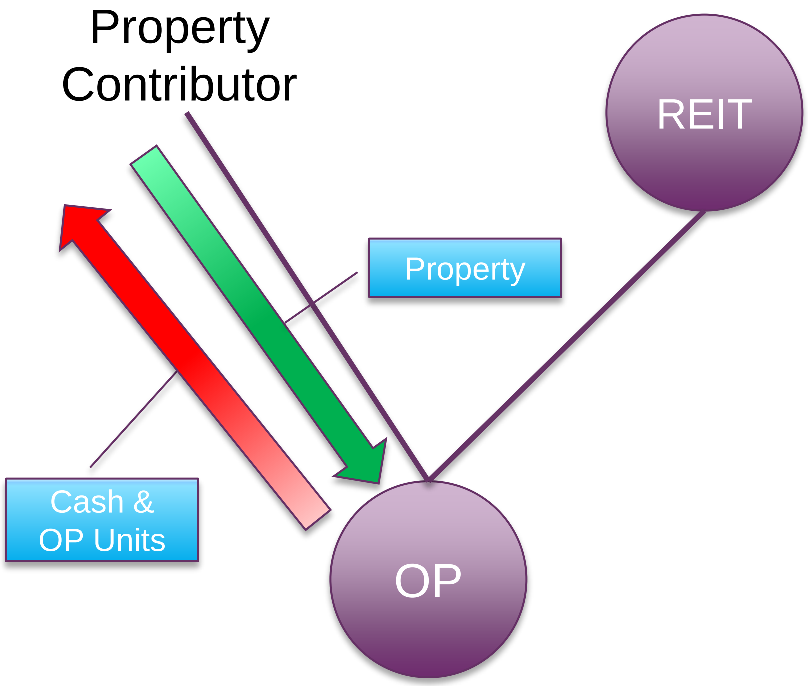


- 2 year rule.
  - Contributions subject to new liabilities (<= 2 years) can create disguised sales.
  - Distributions within two years of contribution can create disguised sales.
  - Distributions outside of two years are presumed not to be disguised sales.

Disguised Sales and Liabilities

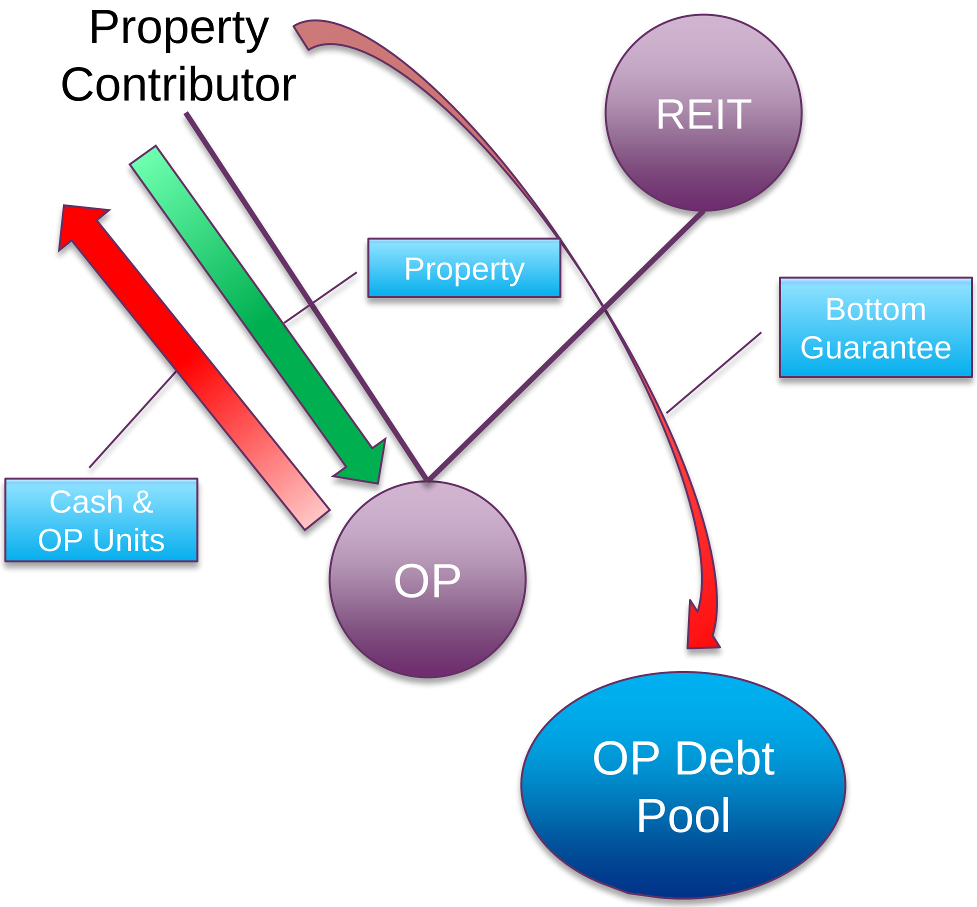


- Disguised Sale exceptions.
  - Contribution subject to qualified liabilities (> 2 yrs).
  - Reasonable preferred returns and guaranteed payments (<= 150% AFR) on unreturned capital.
  - Operating cash flow distributions: percentage of profits during year.
  - Reimbursement of preformation expenditures (<=20% FMV).



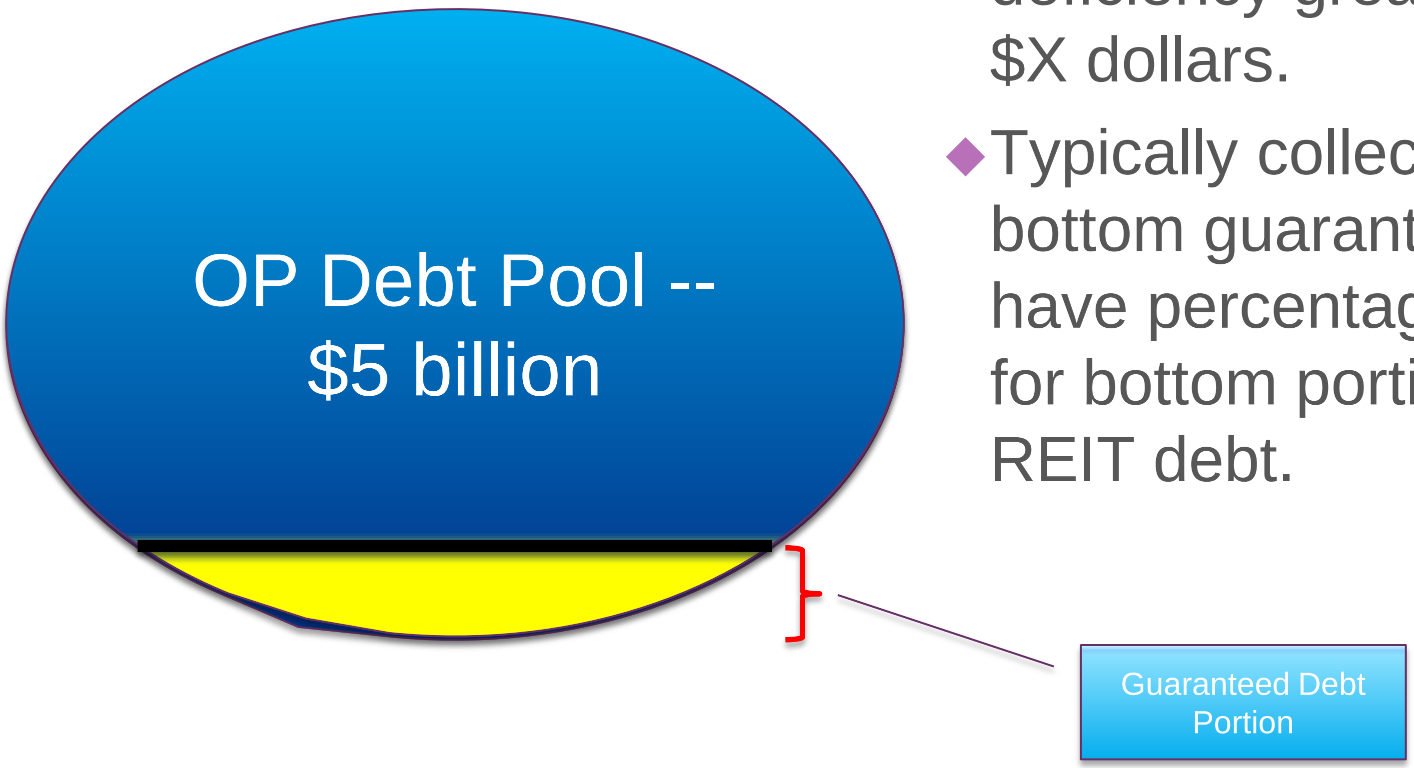
- Leveraged distributions of partner's share of debt.

Disguised Sales and Liabilities



- Classic solution.
  - Property contributor enters into “bottom” guarantee of REIT’s pool of liabilities.

Disguised Sales and Liabilities



- Bottom Guarantee
  - Guarantee kicks in only if lender suffers deficiency greater than $X dollars.
  - Typically collection of bottom guarantors will have percentage liability for bottom portion of Up-REIT debt.

Disguised Sales and Liabilities

- *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010).
  - Indemnitor was thinly capitalized subsidiary with no business operations and no real assets.
  - Treatment for accounting purposes as sale.
  - Distributed money was loaned to parent corporation.

Disguised Sales and Liabilities

- Amount distributed close to value of transferred assets.
- Lender did not ask for the indemnity.
- Indemnity covered only principal, not interest.
- Solvency of guarantor.
- Application of Section 752 antiabuse rules.

Disguised Sales and Liabilities

- Proposed Rules re Recognized Partner Payment Obligations.
  - Net value test for partners other than individuals and estates.
  - Seven recognition factors, except for state law obligations.

Disguised Sales and Liabilities

- Recognition factors:
  - Either:
    - Commercially reasonable net worth throughout the term of the payment obligation; or
    - Commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

Disguised Sales and Liabilities

- Required periodically to provide commercially reasonable documentation regarding financial condition.
- Term of guarantee >= term of the partnership liability.
- Payment obligation does not require that the primary obligor hold money or other liquid assets > reasonable needs of such obligor.

- Arm's length consideration for assuming the payment obligation.
- Guarantor liable up to the full amount of guarantor’s payment obligation to the extent of deficiency.
  - No bottom guarantees.
  - No vertical guarantees.

Disguised Sales and Liabilities

- What do we do?
  - Ensure actual net worth. How much?
  - Covenants not to reduce net worth.
    - If violated?
  - Restrict net worth depleting transfers.
    - If violated?
  - Periodic financial reports (e.g., quarterly or annual).
    - If violated?
  - Guarantee for term of loan.

Disguised Sales and Liabilities

- Bottom guarantees?
- Vertical slice guarantees?

Disguised Sales and Liabilities

- At risk?
  - Is debt qualified nonrecourse financing?
  - Are public holders treated as qualified lenders?

Disguised Sales and Liabilities

- Disguised sale exceptions.
  - Reimburse capital expenditures within two years prior to transfer.
    - 20% FMV limit.
    - Under proposed regulations, cannot double up where expenses financed.

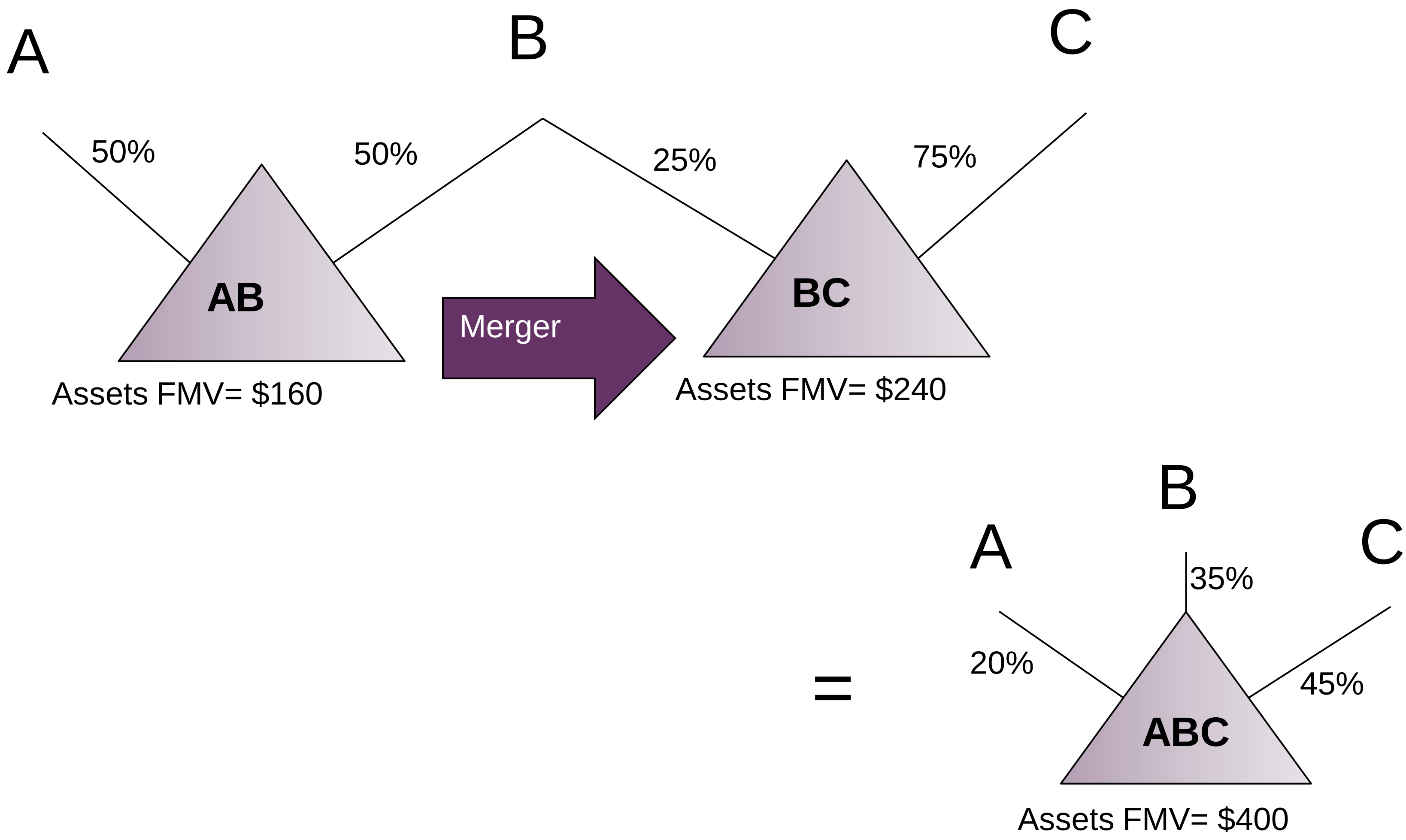
Partnership Mergers – General Rules

- A merger of one partnership into another is generally treated as a continuation of one partnership and the termination of the other merged partnership.

- ***Who Survives?*** In a merger of two or more partnerships, the resulting partnership is the continuation of any merging partnership whose members own a greater than 50% interest in the capital AND profits of the resulting partnership.
    - If the resulting partnership can be a continuation of more than one partnership, the resulting partnership is a continuation of the one credited with contributing the assets with the greatest fair market value (net of liabilities).
    - If none of the merging partnerships' members have an interest of more than 50% in the capital and profits of the resulting partnership, all merged partnerships are deemed terminated and a new partnership results.
    - New Partnerships are subject to a "new" 7-year clock under Sections 704(c)(1)(B) and 737.

Partnership Mergers – General Rules

EXAMPLE OF MERGER OF TWO OR MORE PARTNERSHIPS --



ABC is a continuation of BC

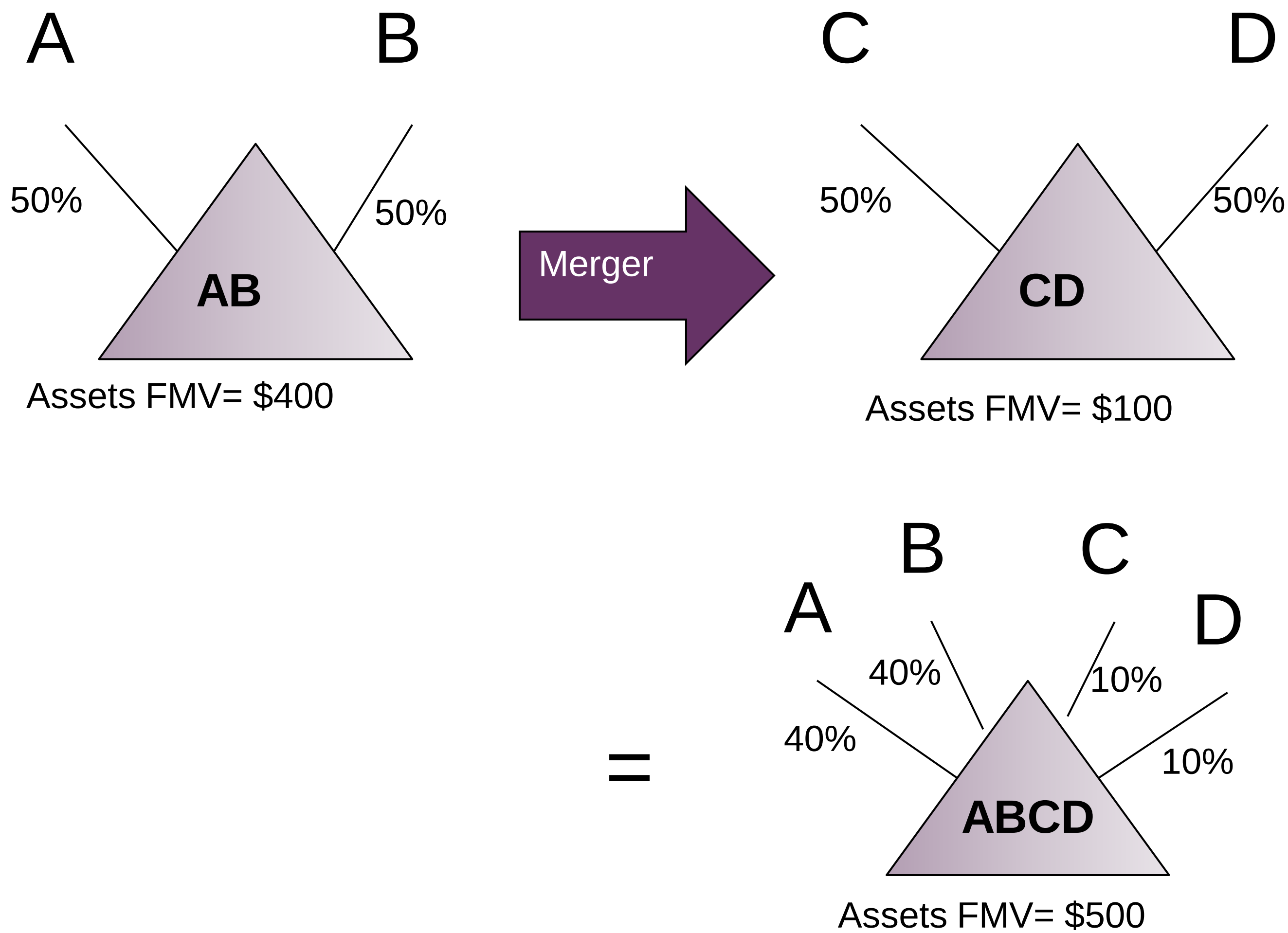
Partnership Mergers – General Rules

- **Form Does Not Override Statute** – If under applicable state law, the rules allow parties the ability to elect which entity legally survives a merger of two partnerships, the merger may be recast for U.S. federal income tax.

- *Example:* Partnership AB hold assets with a net fair market value of $400. Partnership CD holds assets with a net fair market value of $100. Both partnerships are limited liability companies of State X. Partnership AB merges into partnership CD, and under the applicable laws of State X, partnership CD is deemed to survive.
    - The merger is recast as a merger of CD into AB with the resulting partnership, ABCD, considered a continuation of partnership AB for U.S. federal income tax purposes. Partnership CD terminates.

Partnership Mergers – General Rules

EXAMPLE OF PARTNERSHIP MERGERS --

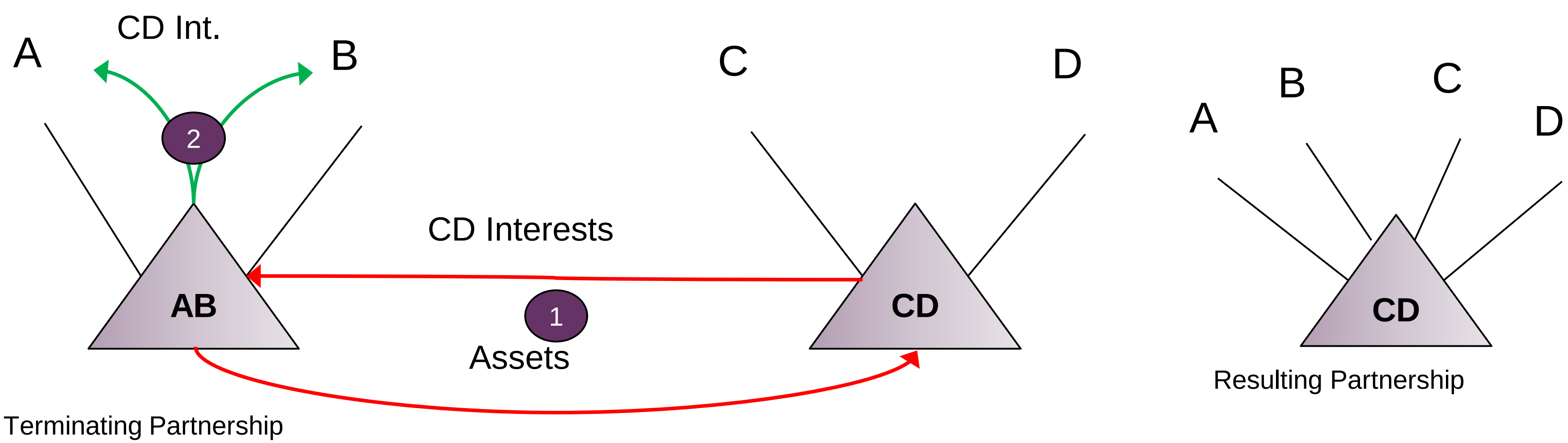


ABCD is a continuation of AB

Constructs of Partnership Mergers

- **Assets-Over Form:** The terminating partnership contributes its assets and liabilities ***over*** to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminating partnership distributes the interests in the resulting partnership to its partners in liquidation.

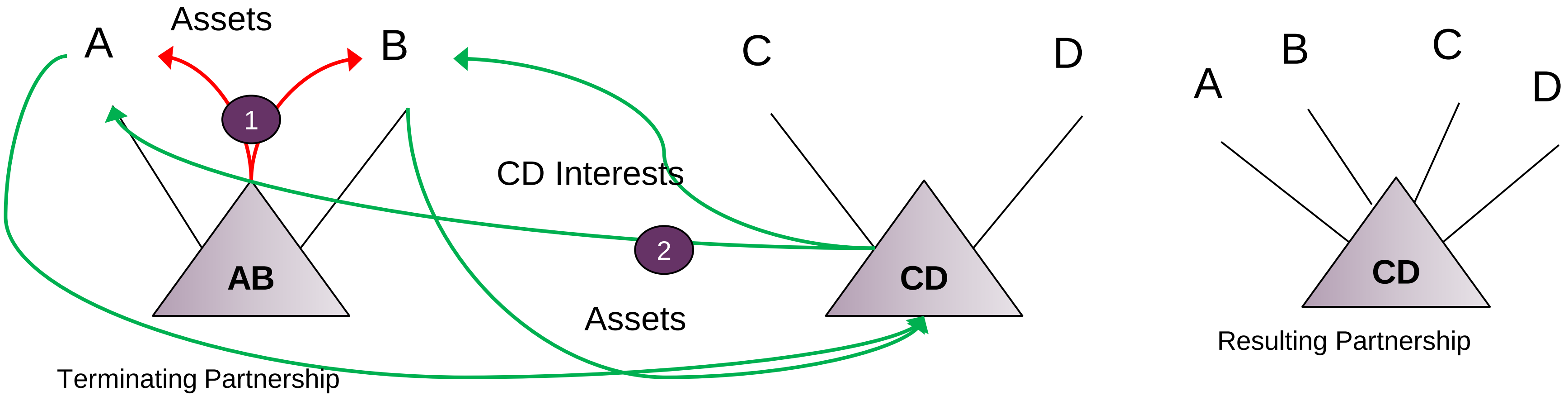
EXAMPLE OF ASSETS-OVER FORM --



Constructs of Partnership Mergers

- **Assets-Up Form:** The terminating partnership distributes all of its assets ***up*** to its partners in liquidation, and immediately thereafter, the partners of the liquidating partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.

EXAMPLE OF ASSETS-UP FORM --



Constructs of Partnership Mergers

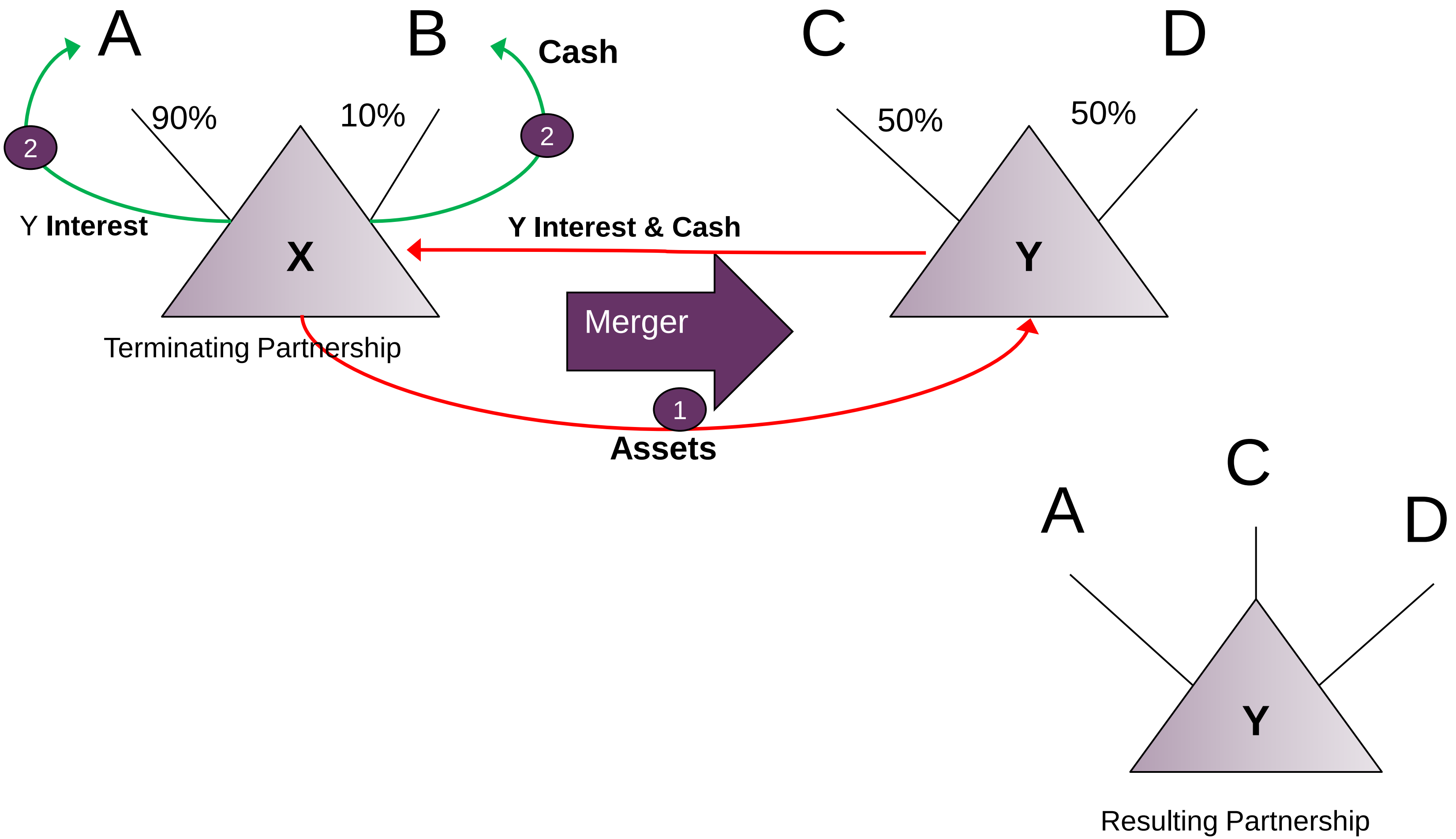
- **Assets-Over Form is the default construct.**
  - **No mixing:** Terminating partnerships using a combination of assets-over and assets-up will be treated as following the assets-over form.
  - **No Interest-Over Form:** Transactions where partners transfer interests in the terminating partnership in exchange for interests in the resulting partnership with the terminating partnership liquidating into the resulting partnership will be recast and characterized under the assets-over form.

Buyouts and Disguised Sales Rules

- *Example:* Partnership X and Partnership Y agree to merge via an assets-over merger with Partnership X terminating. Partner B, a 10% partner in X, does not wish to become a partner in Y and instead wants cash. Partnership X does not have sufficient cash to buyout Partner B prior to the merger.
- Normally, a transfer of assets (i.e., Partnership X assets) to partnership (Y) in exchange for partnership interests and other property could run afoul of the *disguised sale rules.* Could result in gain on the sale of assets to all terminating partners.
- The regulations permit an election to buyout dissenting partner’s interest in a terminating partnership if the dissenting partner consents to treat as a sale of the partner’s terminating partnership interest to the resulting partnership. **No disguised sale.**

Buyouts and Disguised Sales Rules

EXAMPLE OF BUYOUTS --



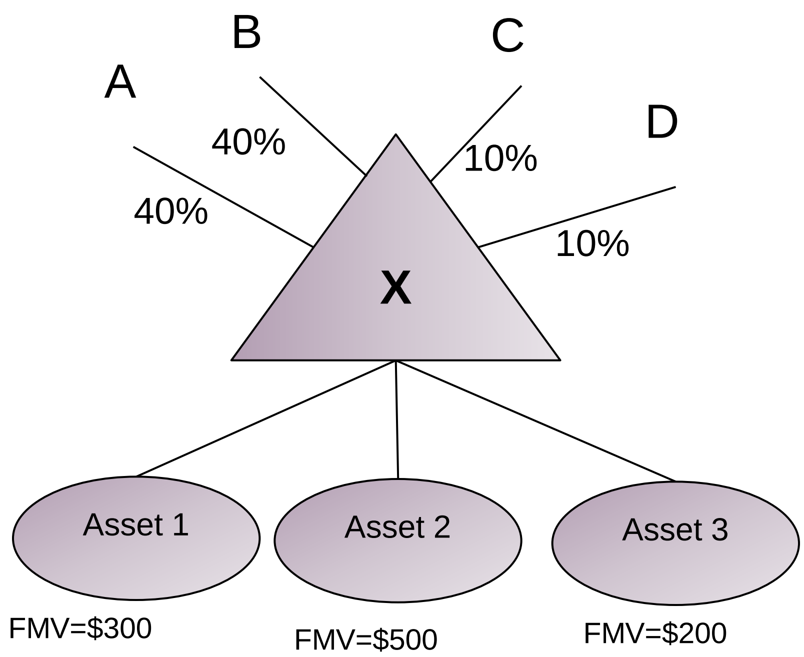
Partnership Divisions

- *General Rule* – Upon the division of a partnership into two or more partnerships, any resulting partnerships with members that had a more than 50% interest in the capital and profits of the prior partnership shall be a considered a continuation of the prior partnership.
    - If more than one resulting partnership can be considered a continuation of the prior partnership, the continuation partnership with the greatest net fair market value of assets is the *divided partnership*.
    - The *divided partnership* files as and retains attributes of prior partnership.
    - All other resulting partnerships deemed new.

- *Partnership Division Considerations –*
  - Mixing Bowl Rules…7 year period
  - Depreciation Recapture
  - Disguised Sale

Partnership Divisions

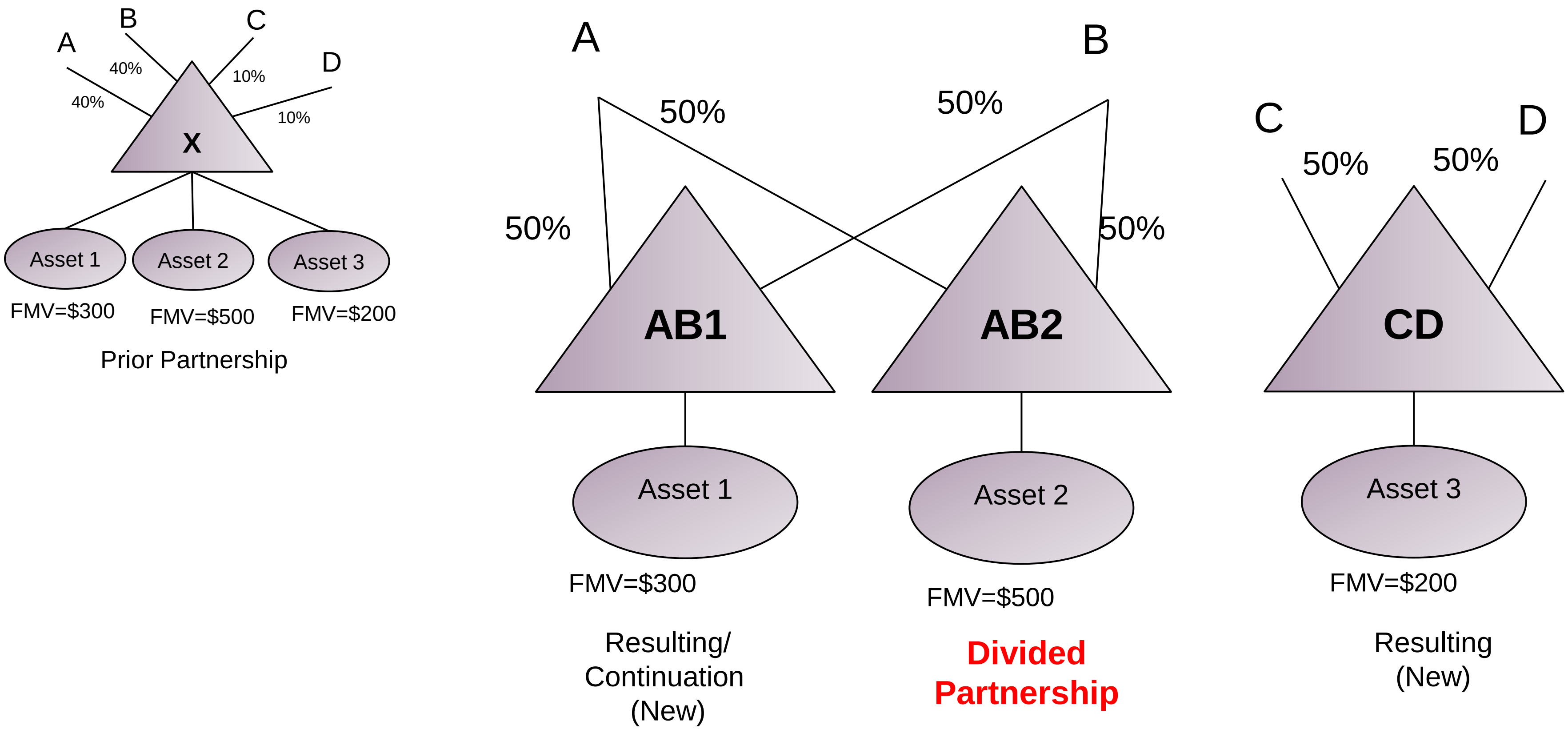
EXAMPLE OF PARTNERSHIP DIVISIONS --



Prior Partnership

Partnership Divisions

EXAMPLE OF PARTNERSHIP DIVISIONS --



LTIPs

LTIP Partnership Units

- Tax saving alternative to restricted stock available to UPREITs
- Issuance of Operating Partnership profits interest units in exchange for services
  - Subsequently booked up under IRC Section 704(b) to receive capital account and liquidity
  - May be exchanged for REIT stock after bookup and vesting
- May be issued to officers, employees and trustees and other service provider

Advantages of LTIPs

- Recipient recognizes no income on issuance or vesting
  - Withholding not required
  - No need to sell newly vested units to pay taxes
  - Avoid potential trap of ordinary income on vesting followed by capital loss on sale if stock price declines
- Gain on ultimate sale generally capital
  - Subject to IRC Section 751
  - May be considered “carried interest” under tax reform proposals

Disadvantages of LTIPs - Recipient

- Units may never be booked up
- Possible post-bookup phantom income
  - Special allocation of 704(c) gain on sales of appreciated property
- Tax return filing in multiple states
  - Composite returns can reduce required filings

Disadvantages of LTIPS - REIT

- Operating partnership ***never*** receives a deduction for issuance of LTIPs (*Rev Proc 2001-43*)
  - Restricted stock is deductible at vesting
  - Operating partnership may receive Section 754 stepup and deductions after exchange of LTIPs for REIT stock

Requirements for Profits Interest Treatment - *Rev Procs 93-27 & 2001-43*

- Units must be profits interest (*93-27*)
  - no ownership in partnership assets until bookup
- Partnership income cannot be substantially certain and predictable (*93-27*)
  - Cannot be from high-quality debt securities
  - Cannot be from high-quality net leases

Requirements for Profits Interest Treatment - *Rev Procs 93-27 & 2001-43*

- Interest must be held for at least two years (*93-27*)
- Cannot be an interest in a "publicly traded partnership" (*93-27*)
- Recipient must be treated as owner from issuance regardless of vesting (*2001-43*)
  - Must receive share of all income and other tax items
  - May receive current distributions

Non-tax Considerations

- May require Board approval or shareholder vote
- REIT can establish vesting schedule
  - Can be any combination of time and performance hurdles
- Similar GAAP treatment to restricted stock
  - Earnings upon vesting
  - May claim lesser charge if value is different from stock
- Greater administrative costs & complexity

Potential Impact of Proposed Carried Interest Legislation

- All distributions could be ordinary, earned income
- All gain on exchange of units could be ordinary, earned income
- No change with respect to tax deferral proposed to date

Examples of LTIP Tax Benefits

- 1. No change in stock price (after bookup)

		Restricted Stock			*LTIPs*		
Event	Value	Income	Cap Gain	Tax	Income	Cap Gain	Tax
Issuance	9,000	--	N/A	--	--	N/A	--
Vesting	10,000	10,000	N	5,000	--	N/A	--
Sale	10,000	--	N/A	--	10,000	Y	3,000
Total Tax				5,000			3,000
Tax Benefit		2,000					

Assumed Tax Rates: Ordinary Income – 50%; Capital Gains – 30%

Examples of LTIP Tax Benefits

- 2. Increase in stock price (after vesting)

		Restricted Stock			*LTIPs*		
Event	Value	Income	Cap Gain	Tax	Income	Cap Gain	Tax
Issuance	9,000	--	N/A	--	--	N/A	--
Vesting	10,000	10,000	N	5,000	--	N/A	--
Sale	15,000	5,000	Y	1,500	15,000	Y	4,500
Total Tax				6,500			4,500
Tax Benefit		2,000					

Examples of LTIP Tax Benefits

- 3. Decrease in stock price (after vesting)

		Restricted Stock			*LTIPs*		
Event	Value	Income	Cap Gain	Tax	Income	Cap Gain	Tax
Issuance	9,000	--	N/A	--	--	N/A	--
Vesting	10,000	10,000	N	5,000	--	N/A	--
Sale	8,000	(2,000)	Y	-- (1)	8,000	Y	2,400
Total Tax				5,000			2,400
Tax Benefit		2,600					

(1) Capital loss – limited deductibility

Example - Capital at LTIP Issuance

	Number of Shares/Units	Value per Share/Unit	704(b) Capital
Outstanding Shares/Units	50,000	30.00	1,500,000
LTIPs	1,000	30.00	--
Total Shares/Units/LTIPs	51,000		1,500,000

Example - 704(b) Gain on Bookup

704(b) Capital after Bookup	52,000 x 31.00	1,612,000
704(b) Capital before Bookup	50,000 x 30.00	1,500,000
Increase in 704(b) Capital		112,000
Less: Cash Received		-31,000
704(b) Gain		81,000

Bookup event is issuance of 1,000 shares for cash @31.00 per share

Example - Allocation of 704(b) Gain

	LTIPs	Outstanding Shares/Units
Original Capital Catchup	30,000	
Pro Rata	1,000	50,000
Total	31,000	50,000

Example - Capital after Bookup

	Number of Shares/Units	Value per Share/Unit	704(b) Gain	704(b) Capital
Outstanding Shares/Units	50,000	31.00	50,000	1,550,000
LTIPs	1,000	31.00	31,000	31,000
New Shares/Units (1)	1,000	31.00	--	31,000
Total Shares/Units/ LTIPs	52,000		81,000	1,612,000
Total 704(b) Gain				81,000

(1) Issued for Cash

Partnership Preferential Interests

Basic Forms

1. Yield on capital (i.e. straight 8% on capital)
2. Timing of distributions and return of capital
3. Pooled asset preferred
4. Catch-up or cumulative
5. Profits interest
6. Any combination of the above

Partnership Preferential Interests

Economic Considerations

1. Timing
   - Cash flow from operations
   - Cash flow from capital transactions
     - Sales and/or refinancing transactions
   - Liquidation
   - Combination of operations, capital transactions & liquidation
     - i.e. yield out of operations and return of capital out of capital events
2. Participation
   - Right to share in partnership profits
   - What's the negotiated return?

Partnership Preferential Interests

Economic Considerations (cont'd)

3. Risk
   - Will the preference be realized

All three factors impact the economics of the preference rights.

- Longer the timing…
- Greater the risk…
- Higher the return.

Common Applications

1. Cash contributors v. Asset contributors (practically either)
2. Additional capital contributions

Partnership Preferential Interests

Examples:

1. Preference solely related to **<u>timing</u>**
   - Partners A and B contribute $100 each
   - Year 1 partnership profits of $10
     - Partner A receives 100% of the cash flows ($10)
   - Year 2 liquidation
     - Partner A receives $95…or $105 cumulatively
     - Partner B receives $105..or $105 cumulatively

Partnership Preferential Interests

Examples:

1. Preference related to **<u>participation</u>**
   - Partners A and B contribute $100 each
   - Year 1 partnership profits of $10
     - Partner A receives 100% of the cash flows ($10)
   - Year 2 liquidation
     - Partner A receives $100…or $110 cumulatively
     - Partner B receives $100..or $100 cumulatively

Partnership Preferential Interests

Participation / Permanent Preference

1. Percentage of profit or percentage return
   - Fixed or variable
   - IRR or on capital with or without cumulative unpaid return
   - Non-preferred partner requirements to fund shortfall
   - Lockouts on the timing of preferred repayment
2. Repayment from operations or capital event
   - Operating = Ordinary / Sales = Capital (potentially)

Partnership Preferential Interests

Tax Distributions

1. Actual partner tax rate v. assumed tax rate
2. Cumulative income or current year income
   - Prior losses taken into account?
   - Capital call for excess distributions? (i.e. later losses)
3. Stand alone or reduction of other distributions
4. Frequency (Annual, quarterly)
5. Recoupment provisions upon liquidation

Partnership Preferential Interests

Is it really a preference?

1. Preferred Interest
   - Risk that profits are insufficient to satisfy the preference
   - Distributions not taxable with sufficient tax basis
   - Tax event upon allocation of profits (ordinary or capital)
2. Guaranteed Payment
   - Payment regardless of whether profits are adequate
   - Taxable in year the partnership deducts (receipt if capitalized)
   - Ordinary income characterization

Partnership Preferential Interests

Repayment risk? Does it make it guaranteed?

1. Preferred partner bears the risk
   - Dilutes benefit of negotiating a preferred interest
   - Satisfaction of return can’t come out of other partners capital
   - At minimum, preference to receive contributed capital first
2. Non-preferred partner bears the risk
   - Capital shift satisfies the preferred return
3. Somewhere in the middle

Partnership Preferential Interests

Other items

1. Disguised sales
   - Reasonable threshold based upon “safe-harbor” rate
   - 150% of the highest Applicable Federal Rate (“AFR”)
2. Management and voting rights
   - Partner rights or lender rights

Partnership Preferential Interests

Debt v. Equity – Re-characterization Risk

1. Form and intent (IRS asserting substance over form)
2. Risk
3. Debt-to-equity ratios (thin capitalization)
4. Participation in management
5. Subordination to general creditors
6. Creditworthiness
7. Other debt-like qualities (maturity, call rights, etc.)

Partnership Preferential Interests

Debt v. Equity – Impact Analysis

1. REIT income and asset tests
   - "Self-charged" – what percentage to use
2. GAAP financial statements
   - Fee recognition
3. Debt Covenants
   - Value "credit" for loan v. equity interest

Partnership Preferential Interests

Technical 704(b) v. Economic Agreement

1. Liquidation by positive capital accounts or by distribution provisions
   - Distribution provisions preserve economic agreement
   - Capital accounts, respected, but may not reflect economics
2. Forced allocations – complex allocations following distributions
3. Curative allocations – “cures” potential distortions
4. Targeted final balance allocations – In liquidation year only

REIT Tax Potpourri Meeting

Wednesday, April 1st
9:45am – 11am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Michael Stauffer, VP-Taxes, Kilroy Realty Corporation

Panelists:
Adam Handler, Principal, PwC
Jennifer Weiss, Partner, Greenberg Traurig, LLP
Nabil Andrawis, EVP & Director-Taxation, Lexington Realty Trust
Ross Wehman, VP-Tax, Camden Property Trust

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NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

REIT Tax Potpourri

March 31-April 2, 2015

REIT Tax Potpourri

Moderator:

Michael Stauffer, VP, Taxes, Kilroy Realty Corporation

Panelists:

Nabil Andrawis, EVP & Director of Taxation, Lexington Realty Trust
Adam Handler, Principal, PwC
Ross Wehman, VP-Tax, Camden Property Trust
Jennifer Weiss, Shareholder, Greenberg Traurig, LLP

Customary Services

Summary of rule

- Regs. 1.856-4(b)(1) Charges for customary services
  - Qualifying rental income includes charges for services customarily furnished or rendered in connection with the rental of real property
  - If a service is not customary, then it generally is impermissible tenant service income (ITSI)

Customary Services

How to determine

- Geographic market
  - Services customarily furnished to tenants of buildings of a similar class in the same geographic area
  - Services that are ordinarily furnished to tenants in connection with the rental of real property and not primarily for the convenience of the occupants.

Customary Services

How to determine (cont.)

- Survey - REIT Status Questionnaire
  - A REIT Questionnaire is generally completed to determine rent structure and types of services provided at the property
- Examples
  1. Car charging stations
  2. Wifi
  3. Fitness Centers
  4. Happy Hour
- Legal Requirements

Customary Services

Use of RR 2002-38

- Applies when a REIT uses a TRS to perform non-customary services in a property.
- Section 857(b)(7)(B)(ii) through (vii) contains exceptions, or safe harbors, from the 100 percent tax on redetermined rents.
- Requirements
  1. Gross income of the TRS from the service must be at least 150 percent of the TRS's direct cost of rendering the service § 857(b)(7)(B)(vi)
  2. Arm's length charge Section 1.482–2(b)(3)
- Limits

Pitfalls of Baby REITs

Uses of baby REITs

- Acquisition of C Corps.
  1. C corp. to REIT conversion
     a. Distribution of C Corp E&P
     b. Section 1374 built in gain tax
- JVs with Foreigners, Pensions, etc.
  1. The sale of stock in a "domestically controlled" REIT is exempt from FIRPTA tax
  2. In general, REIT dividends do not generate UBTI, unless the REIT is a “pension held REIT”

Pitfalls of baby REITs

Uses of baby REITs (cont.)

- State Tax
  1. Alleviate any income taxes at the property level, e.g., TN
  2. Some states provide preferential statutes for REITs on the imposition of franchise taxes or realty transfer taxes as well as other similar taxes.
  3. Some states classify baby REITs as a captive REIT for state purposes -- denying the entity DPD e.g., franchise taxes in a state like New York or New York City.
  4. Increased complexity on the sale of shares due to possible difference in inside and outside basis when dividends paid from baby REIT to parent company are either deferred, eliminated or not allowed (in the case of consent dividends).

Pitfalls of baby REITs

Special Issues

- Personal Holding Company (PHC)
- Closely-held Test
- Related Party Rents
- 100 Shareholders
- TRS Election
- Management Fees
- Independent Contractor

Pitfalls of baby REITs

Special Issues

1. Personal Holding Company (PHC)
   - A REIT is taxed as a personal holding company under section 542 if: at least 60% of its adjusted ordinary gross income for the tax year is largely of investment character, and it is closely held as defined under Code Section 856(h)(1)(A).
2. Closely-held Test
   - At any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. Code Section 856(h)(1)(A). Initial year excluded.

Pitfalls of baby REITs

Special Issues (cont.)

3. Related Party Rents
   - Generally, a REIT is prohibited from leasing property to a tenant in which it directly or indirectly holds a 10 percent or greater interest
   - Broad attribution rules apply to attribute ownership by a 10 percent shareholder of the REIT or a 25 percent partner in a partnership, including the operating partnership of an UPREIT
   - Violating the ownership limitation at any time during the year taints the rents from the lease for the entire year

Pitfalls of baby REITs

Special Issues (cont.)

4. 100 Shareholders
   - Must have at least 100 shareholders (but no minimum value for each shareholder) during at least 335 days of the taxable year. Initial year excluded.
5. TRS Election
   - Must be filed no later than 75 days after effective date.
   - If a timely election is not filed, Section 9100 relief may be requested from the IRS.

Pitfalls of baby REITs

Special Issues (cont.)

6. Independent Contractor (IK)
   - IK cannot own directly or indirectly more than 35% of the interest in the REIT
   - One or more persons owning 35% of the REIT cannot own more than 35% or more of the interest in the IK.
   - A REIT may not derive or receive any income from the independent contractor
7. Management Fees

Transfer Pricing Update

Increased audit activity

1. Desert Capital
    - Bankruptcy Case involving intercompany allocations from REIT to TRS
    - 100% excise tax upheld!
    - Court opined on the interplay between 482 and 857(b)(7)
        - Best method under Section 482 must be applied
        - Reasonable method 857(b)(7) focuses on reasonable results
2. Other transfer pricing audits being disclosed by companies under their SEC Fillings

Transfer Pricing Update

Landscape is changing

- OECD’s Base Erosion & Profit Shifting (BEPS) influencing the way the IRS is conducting audits
- Collateral damage on the REIT industry dealing with common intercompany transactions (loans, leases, cost sharing)

Transfer Pricing Update

Lessons Learned

- Intercompany loans (including leveraged blockers)
  - Need to support principal amount and interest rate
  - Business purpose is key
- Intercompany Leases
  - Supporting leakage is not enough!
  - Watch out for terms imposed by management and lender agreements
  - Lease-by-lease analysis (avoid risk to entire portfolio)
- Shared Services
  - Demonstrate benefit from services
  - Document rationale for a TP methodology (i.e., markup vs markup, allocation key)

Transfer Pricing Update

Lessons Learned (cont.)

- Shared Services
  - Demonstrate benefit from services
  - Document rationale for a TP methodology (i.e., markup vs markup, allocation key)
- Best Practices
  - Good documentation at the beginning of an intercompany arrangement is key
  - Need to monitor transfer pricing policies periodically

Managing Non-Qualifying income from Joint Ventures

Non-Qualifying Fees – REIT is managing member

- On-going Management Fees
  - Usually % of gross income or % of Invested Capital
  - Can be easily forecasted
  - Usually can be Managed within a REIT non-qualifying income basket, depending on the size of the JV.
- Acquisition Fees
  - Usually % of property purchase price
  - Can fluctuate from one year to the other
  - Is usually earned by the TRS.
  - JV agreement needs to entitle the TRS to the fees

Managing Non-Qualifying income from Joint Ventures

Non-Qualifying income from operations – REIT is non- managing member

- Managing member to operate the partnership as a standalone REIT
- The partnership to use only approved Lease form.
- REIT member approve any new entity formation or tax election.
- The partnership shall not engage in the provision of any services that would produce impermissible tenant services income within the meaning of section 856(d)(2)(C).
- The Managing member shall complete, sign and provide to REIT member a property questionnaire, the form of which shall be provided by the REIT partner

Managing Non-Qualifying income from Joint Ventures

- REIT member to approve third party service providers.
- The partnership shall not lease to any person that would cause the REIT member to derive related party rent as defined in section 856(d)(2)(B)
- The Buy/sell provision in the agreement cannot be triggered before 2 years of the date the property is placed in service.
- Partnership shall not dispose of a property in a transaction the would be treated as a “prohibited transaction” unless it qualifies for the safe harbor taking into account the REIT member dispositions.

Managing Non-Qualifying income from Joint Ventures

- The partnership shall use reasonable efforts to make distributions in compliance with the 90% distribution requirement of section 857(a)(1)
- The managing member shall provide such information and additional reports as the REIT member may reasonably request in connection with its REIT compliance.

Working with Outside Tax Advisors

- Best Practices

- Frame the discussion/engagement clearly from the start to manage expected outcome and fees. Set boundaries
- Get to the subject-matter expert quickly rather than general client engagement manager. Have engagement manager get expert up to speed on issue before first discussion
- Follow up frequently with advisor to monitor progress of work. Demand responsiveness
- Make sure advisor is working with you and not against you. If a "bad" answer is coming, have them suggest alternatives

Working with Outside Tax Advisors

- Keep a good relationship going with primary advisor during the year rather than just at tax return time. Quarterly lunches/discussions can shortcut surprises at year end
- Know who to call first—accountants vs. attorneys vs. consultants
- Deal with advisors who are compatible to you, your staff and co-workers. Don't work with condescending or demanding advisors, work with those who are instructive.
- Consider conflicting views of firms on certain issues

Working with Outside Tax Advisors

- If practical, present all the facts and relevant points on the issue at hand to the advisor in writing/email form. This might make you really think through the issue and focus on the technical point of discussion. It might save the advisor time by narrowing the scope of the issue and possibly generate an email response (rather than a phone call) which can be saved for future reference.
- Avoid advisors who push “add on services” beyond those requested
- Avoid advisors who “nickel and dime” you on bills

SEC Financial Reporting Issues Meeting

Thursday, April 2nd
11am – 12:15pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Christopher Dubrowski, Partner, Deloitte LLP

Panelists:
Ian Kaufman, SVP & CAO, Equity Residential
John Gottfried, Partner, PwC
Kirk Rogers, Partner, Grant Thornton LLP
Sonia Barros, Assistant Director-Division of Corporation Finance, Securities and Exchange Commission

Deloitte.

Real Estate
Accounting and Financial Reporting Update

November 24, 2014

Financial Services Industry

Contents

Foreword

November 24, 2014

To our clients and colleagues in the real estate sector:

We are pleased to announce our seventh annual accounting and financial reporting update. Some of the notable standard-setting developments that occurred during 2014 were (1) the issuance of new guidance on the recognition of revenue from contracts with customers and discontinued operations; (2) the continued work of the FASB on accounting for leases, consolidation, and financial instruments; and (3) the SEC's continued focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act.

This publication is divided into three sections: (1) "Updates to Guidance," which highlights changes to accounting and reporting standards that real estate entities need to start preparing for now; (2) "On the Horizon," which discusses standard-setting topics that will affect real estate entities as they plan for the future; and (3) "Other Topics" that may be of interest to entities in the real estate sector.

The 2014 accounting and financial reporting updates for the banking and securities, insurance, and investment management sectors are available (or will be available soon) on US GAAP Plus, Deloitte's Web site for accounting and financial reporting news.

In addition, be sure to check out the eighth edition of our *SEC Comment Letters — Including Industry Insights*, which discusses our perspective on topics that the SEC staff has focused on in comment letters issued to registrants over the past year, including an analysis of comment letter trends in each financial services sector.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

Chris Dubrowski
Real Estate Industry Professional Practice Director
Deloitte LLP

Bob O'Brien
Global Real Estate Leader
Deloitte & Touche LLP

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Jeanine Pagliaro
Sean Prince
Shahid Shah
Scott Streaser
Jiaojiao Tian
Abhinetri Velanand
Andrew Warren
Karen Wiltsie
Ana Zelic

If you have any questions concerning this publication, please contact the following Deloitte industry specialists:

Chris Dubrowski
Real Estate Industry Professional Practice Director
+1 203 708 4718
cdubrowski@deloitte.com

Bob O'Brien
Global Real Estate Leader
+1 312 486 2717
robrien@deloitte.com

Wyn Smith
Real Estate Industry Deputy Professional Practice Director
+1 713 982 2680
gesmith@deloitte.com

Bob Contri
Vice Chairman, U.S. Financial Services Leader
+1 212 436 2043
bcontri@deloitte.com

Susan L. Freshour
Financial Services Industry Professional Practice Director
+1 212 436 4814
sfreshour@deloitte.com

Introduction

The real estate market continued its modest recovery from 2013 into 2014. Through late 2014, the national home price index gained single-digit year-to-date returns compared with double-digit growth in 2013. Factors contributing to the continued increase in home prices include shrinking unemployment, low mortgage rates, and rising income for consumers. The commercial real estate market has also seen tapering price increases over the past year.

Economic Growth by Major Group

Commercial Real Estate

In 2009 and 2010, rental revenues in the commercial real estate industry declined dramatically because of weakened demand for commercial spaces. In 2014, revenues increased marginally, resulting in a five-year compound average revenue growth rate of about 2 percent. However, several factors could constrain long-term increases (e.g., increases in telecommuting, e-commerce).

Growth in REITs

REIT[1] fundraising has been increasing in recent years. REIT IPOs have been at their highest level (in terms of number and value of transactions) since 2005 and have involved both traditional and nontraditional real estate asset classes (e.g., single family rentals, data centers).

Property Management

As a result of the economic downturn, rental vacancy rates have decreased as more consumers have opted to rent a home rather than purchase one. However, this trend may change since the housing market is expected to expand over the next few years. Demand for office and factory space has also declined as firms have either reduced their workforces or closed operations. However, growth in this area was strong in 2014 and is forecasted to remain so.

Accounting Changes

During 2014, the FASB and IASB issued their final standard on revenue from contracts with customers, which supersedes most of the current revenue recognition guidance, including the guidance on real estate derecognition for most real estate disposals. The new standard is one of the most significant releases of guidance affecting the real estate industry since the issuance of FASB Statement 66 in October 1982. See the Revenue Recognition section for a discussion of key accounting issues and potential challenges related to real estate disposals.

The FASB also issued ASU 2014-08,[2] which amends the definition of a discontinued operation in ASC 205-20. The revised guidance will change how entities identify disposal transactions that are required to be accounted for as a discontinued operation under U.S. GAAP. The FASB issued the ASU to elevate the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance). The ASU also requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued operations criteria. See the Discontinued Operations Reporting section for a discussion of key accounting issues and potential challenges related to real estate.

For additional information about industry issues and trends, see Deloitte's 2014 Financial Services Industry Outlooks.

[1] For a list of abbreviations used in this publication, see Appendix B.

[2] For the full titles of standards, topics, and regulations used in this publication, see Appendix A.

Updates to Guidance

Revenue Recognition

Background

On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued by the FASB as ASU 2014-09, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including the guidance on real estate derecognition for most transactions.

The ASU's model is based on a core principle under which an entity "shall 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" and includes five steps to recognizing revenue:

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.

Thinking It Through

The ASU will have a significant effect on the accounting for real estate sales. The ASU eliminates the bright-line guidance that entities currently apply under ASC 360-20 when evaluating when to derecognize real estate assets and how to measure the profit on the disposal. It will change the accounting for both real estate sales that are part of an entity's ordinary activities (i.e., real estate transactions with customers) and real estate sales that are not part of the entity's ordinary activities. While the ASU eliminates the guidance in ASC 360-20 on real estate sales, entities will still need to apply ASC 360-20 to sales of real estate that are part of sale-leaseback transactions, at least until the FASB has completed its project on leasing.

Key Accounting Issues

Some of the key accounting issues and potential challenges related to real estate disposals are discussed below.

Financing Arrangements (Existence of a Contract)

Under current guidance, when the seller of real estate also provides financing to the buyer, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

Under the ASU, collectibility of the sales price affects the evaluation of whether a contract "exists." That is, the ASU requires an entity to determine whether a contract exists by assessing whether it is probable that the entity will collect the consideration to which it will be entitled (the collectibility threshold). However, the ASU does not include specific initial and continuing investment thresholds for performing this evaluation. If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under the ASU's criteria. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would evaluate the arrangement under the derecognition criteria in the ASU. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received as a gain.

Identifying Performance Obligations

Often, a seller remains involved with property that has been sold. Under current guidance, profit is generally deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under the ASU, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a "separate performance obligation," constitutes a guarantee, or prevents the transfer of control.[1] If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized as revenue when (or as) the entity transfers the related good or service to the customer.

Thinking It Through

Views are evolving on how real estate developers should account for contracts that may contain multiple performance obligations. For example, views differ on how a community developer that agrees to provide common areas (e.g., a community center, parks, or a golf course) as part of the development would evaluate whether the promise to provide these additional amenities represents separate performance obligations (to which a portion of the transaction price would be allocated and potentially deferred until the separate performance obligations were satisfied).

Determining the Transaction Price

A sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. Any additional revenue would be recorded only when the contingent revenue is realized. Under the ASU, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (the "constraint").

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price, which may be recognized up front. As a result, revenue may be recognized earlier under the ASU than under current requirements.

The ASU also requires entities to adjust the transaction price for the time value of money when the arrangement provides either the customer or the entity with a significant benefit of financing the transfer of real estate to the customer. In such instances, the entity will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the customer had paid cash for the promised property at the time control was transferred to the customer. In calculating the amount of consideration attributable to the significant financing component, the entity should use an interest rate that reflects a hypothetical financing-only transaction between the entity and the customer. As a practical expedient, the ASU does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all of the payments and the transfer of the promised goods and services is one year or less.

Accordingly, if an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the customer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the customer or the entity a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the entity or the customer).

[1] Certain forms of continuing involvement would not constitute a separate performance obligation. For example, an option or obligation to repurchase a property is specifically addressed by the ASU and would preclude derecognition of the property. Further, a seller obligation that qualifies as a guarantee under ASC 460 would be outside the scope of the ASU.

Recognizing Revenue When (or as) Performance Obligations Are Satisfied

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer.

Under the ASU, a seller of real estate would evaluate whether a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying assets is transferred to the purchaser.[2] An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred to the customer. If control is transferred at a point in time, revenue is recognized when the good or service is transferred to the customer.

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is 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 . . . 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."

Thinking It Through

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. The ASU contains an example[3] in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete. In one scenario in this example, the seller does recognize revenue over time; however, the example indicates that this conclusion is based on legal precedent in the particular jurisdiction where the contract is enforceable.

If a performance obligation does not meet any of the three criteria for recognition over time, the performance obligation is deemed satisfied at a point in time. Under the ASU, entities would consider the following indicators in evaluating the point in time at which control of real estate has been transferred to the buyer and when revenue should be recognized:

- "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."

[2] ASC 606-10-25-25 (added by the ASU) states that "[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

[3] ASC 606-10-55-173 through 55-182.

While entities will be required to determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP, the FASB decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under the ASU.[4]

Effective Date and Transition

For public entities, the ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the ASU's guidance. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (transactions in periods presented in the financial statements before that date are reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those that are not completed) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date. Entities that elect the modified approach must disclose the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

For additional information, see Deloitte's May 28, 2014, and July 2, 2014, *Heads Up* newsletters and Deloitte's September 22, 2014, *Real Estate Spotlight*.

Thinking It Through

Real estate entities will need to reassess their historical accounting for all real estate disposals to determine whether any changes are necessary. In addition to the issues discussed above, real estate entities will need to consider the ASU's guidance when accounting for (1) repurchase agreements (the seller may be required to account for the transaction as a lease, a financing, or a sale with a right of return) and (2) partial sales (entities that enter into partial sales will need to determine whether control of the real estate is transferred to the customer).

The ASU also requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, entities used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer. To comply with the ASU's new accounting and disclosure requirements, real estate entities may want to consider whether they need to modify their systems, processes, and controls to gather and review information that may not have previously been monitored.

4 An entity would not consider parts of a contract that are accounted for under guidance outside the ASU (e.g., guarantees within the scope of ASC 460) when determining whether control of the remaining goods and services in the contract has been transferred to a customer.

Discontinued Operations Reporting

Background

On April 10, 2014, the FASB issued ASU 2014-08, which amends the definition of a discontinued operation in ASC 205-20 and requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued-operations criteria. The revised guidance will change how entities identify and disclose information about disposal transactions under U.S. GAAP. The FASB issued the ASU to provide more decision-useful information to users and to elevate the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance). Under the previous guidance in ASC 205-20-45-1, the results of operations of a component of an entity were classified as a discontinued operation if all of the following conditions were met:

- The component "has been disposed of or is classified as held for sale."
- "The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction."
- "The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."

The new guidance eliminates the second and third criteria above and instead requires discontinued-operations treatment for disposals of a component or group of components that represents a strategic shift that has or will have a major impact on an entity's operations or financial results. The ASU also expands the scope of ASC 205-20 to disposals of equity method investments and acquired businesses held for sale.

Further, the ASU (1) expands the disclosure requirements for transactions that meet the definition of a discontinued operation and (2) requires entities to disclose information about individually significant components that are disposed of or held for sale and do not qualify as discontinued operations.

The ASU also requires entities to reclassify assets and liabilities of a discontinued operation for all comparative periods presented in the statement of financial position. Before these amendments, ASC 205-20 neither required nor prohibited such presentation.

Regarding the statement of cash flows, an entity must disclose, in all periods presented, either (1) operating and investing cash flows or (2) depreciation and amortization, capital expenditures, and significant operating and investing noncash items related to the discontinued operation. This presentation requirement represents a significant change from previous guidance.

The new guidance is likely to have the greatest impact on entities that enter into routine disposal transactions, such as those in the real estate or retail industries.

Scope

Previously, investments in equity securities accounted for under the equity method were outside the scope of ASC 205-20. The ASU eliminates that scope exception. In addition, the ASU notes that a "business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale is reported in discontinued operations." Further, the ASU removed the discontinued-operations scope exceptions in ASC 360-10-15-5 but retained the exception for oil and gas properties accounted for under the full-cost method.

Recognition Criteria

Under the revised guidance, the unit of account for evaluating disposals (other than an acquired business or nonprofit activity) continues to be a component of an entity or a group of components of an entity; the ASU retains the existing definition of a component of an entity.

Discontinued Operation

ASU 2014-08 defines a discontinued operation as a component or group of components of an entity that (1) has been disposed of by sale or other than by sale in accordance with ASC 360-10-45-15, or is classified as held for sale, and (2) "represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results." According to the ASU, a strategic shift that has (or will have) a major effect on an entity's operations and results includes the disposal of any of the following:

- A major geographical area.
- A major line of business.
- A major equity method investment.
- Other major parts of an entity.

The ASU does not define the terms "major," "line of business," or "geographical area." It does, however, provide examples illustrating the evaluation of whether a disposal qualifies as a discontinued operation. These examples illustrate the quantitative thresholds of various metrics (e.g., assets, revenue, net income) — ranging from 15 percent to 20 percent as of the disposal date and 30 percent to 40 percent in historical periods — in various scenarios in which there was a strategic shift in an entity's operations that has (or will have) a major effect on the entity's financial results.

Thinking It Through

Entities will need to use judgment in determining what constitutes "major." Some may interpret the illustrative guidance in ASC 205-20-55-83 through 55-101 as implying that breaching quantitative thresholds in the range of 15 percent to 20 percent indicates that a disposal is major. However, note that the FASB intentionally avoided creating a bright-line quantitative threshold because qualitative factors may also affect this assessment.

Entities may also find it challenging to define the terms "line of business" and "geographical area." For example, some entities may define a geographical area as a county, state, country, or continent, while others may base this definition on how management determines its regions. Further, there may be differences in how entities define a major line of business: some may weight quantitative considerations more heavily, while others may stress qualitative factors.

Example

A publicly traded REIT in the United States has a regional mall division, a shopping center division, and an other commercial property division. The REIT's regional mall division consists of shopping malls in cities across the United States. In October, the REIT decides to sell two shopping malls in Washington because of declining operations. The two malls in Washington comprise 2 percent of the REIT's total net income and 5 percent of its total assets. Because the sale of the malls in Washington does not represent a strategic shift in the REIT's operations and because the quantitative thresholds are not significant, the sale does not meet the criteria for presentation as a discontinued operation, although disclosures may be required (as discussed below).

Disclosures

The ASU introduces several new disclosure requirements for both (1) disposals that meet the criteria for a discontinued operation and (2) individually significant disposals that do not meet these criteria.

The following are some of the noteworthy new disclosure requirements:

- Major line items constituting the pretax profit or loss for all periods for which the discontinued operation's results of operations are reported in the income statement. Some examples of major line items are (1) revenue, (2) cost of sales, (3) depreciation and amortization, and (4) interest expense.

- For most discontinued operations, an entity must disclose either of the following in the statement of cash flows or the notes to the financial statements:

  - Operating and investing cash flows for the periods for which the discontinued operation's results of operations are reported in the income statement.

  - Depreciation and amortization, capital expenditures, and significant operating and investing noncash items for the periods for which the discontinued operation's results of operations are reported in the income statement.

- "For the initial period in which the disposal group is classified as held for sale and for all prior periods presented in the statement of financial position, a reconciliation of" (1) total assets and total liabilities of the discontinued operation that are classified as held for sale in the notes to the financial statements to (2) "[t]otal assets and total liabilities of the disposal group classified as held for sale that are presented separately on the face of the [balance sheet]."

- For disposal of an individually significant component that does not meet the definition of a discontinued operation, all entities must disclose pretax profit or loss reported in the income statement for the period in which the disposal group is sold or is classified as held for sale. In addition, public entities must also disclose pretax profit or loss for all prior periods presented in the income statement.

These disclosures are required for both interim and annual reporting periods.

Transition Guidance

The ASU is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) or components initially classified as held for sale in periods beginning on or after December 15, 2014, with early adoption permitted.

See Deloitte's April 22, 2014, *Heads Up* for further discussion of ASU 2014-08.

Going Concern

Background

In August 2014, the FASB issued ASU 2014-15, which provides guidance on determining when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued.[5] An entity must provide certain disclosures if "conditions or events raise substantial doubt about [the] entity's ability to continue as a going concern."

Under U.S. GAAP, an entity's financial reports reflect its assumption that it will continue as a going concern until liquidation is imminent.[6] However, before liquidation is deemed imminent, an entity may have uncertainties about its ability to continue as a going concern. Because there are no specific requirements under current U.S. GAAP related to disclosing such uncertainties, auditors have used applicable auditing standards[7] to assess the nature, timing, and extent of an entity's disclosures. Consequently, there has been diversity in practice. The ASU is intended to alleviate that diversity.

[5] An entity that is neither an SEC filer nor a conduit bond obligor for debt securities that are traded in a public market would use the date the financial statements are available to be issued (in a manner consistent with the ASU's definition of "issued").

[6] In accordance with ASC 205-30, an entity must apply the liquidation basis of accounting once liquidation is deemed imminent.

[7] PCAOB AU Section 341.

The ASU extends the responsibility for performing the going-concern assessment to management and contains guidance on (1) how to perform a going-concern assessment and (2) when going-concern disclosures would be required under U.S. GAAP.

Key Provisions of the ASU

Disclosure Thresholds

An entity would be required to disclose information about its potential inability to continue as a going concern when there is "substantial doubt" about its ability to continue as a going concern, which the ASU defines as follows:

> Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued . . . . The term probable is used consistently with its use in Topic 450 on contingencies.

In applying this disclosure threshold, entities would be required to evaluate "relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued." Reasonably knowable conditions or events are those that an entity may not readily know of but can be identified without undue cost and effort.

Time Horizon

In each reporting period (including interim periods), an entity would be required to assess its ability to meet its obligations as they become due for one year after the date the financial statements are issued.

Disclosure Content

The disclosure requirements in the ASU closely align with those under current auditing literature. If an entity triggers the substantial-doubt threshold, its footnote disclosures must contain the following information, as applicable:

Substantial Doubt Is Raised but Is Alleviated by Management's Plans	Substantial Doubt Is Raised and Is Not Alleviated
• Principal conditions or events.	• Principal conditions or events.
• Management's evaluation.	• Management's evaluation.
• Management's plans.	• Management's plans.
	• Statement that there is "substantial doubt about the entity's ability to continue as a going concern."

The ASU explains that these disclosures may change over time as new information becomes available.

Effective Date

The guidance in the ASU is "effective for annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016." Early application is permitted.

For additional information, see Deloitte's August 28, 2014, *Heads Up*.

Accounting for Investments in Qualified Affordable Housing Projects

Background

In January 2014, the FASB issued ASU 2014-01, which is based on the final consensus reached by the EITF on Issue 13-B. This ASU amends the criteria that must be met to qualify for an alternative method of accounting for low income housing tax credit (LIHTC) investments. It also replaces the previous alternative accounting method — the effective yield method — with the proportional amortization method. Lastly, it introduces new disclosures that all entities must provide about their LIHTC investments.

ASU 2014-01 is effective for public business entities for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. For entities that are not public business entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted for all entities.

Scope

Before the issuance of ASU 2014-01, few entities were able to apply the effective yield method of accounting to their LIHTC investments because of the restrictive nature of the previous scope requirements. ASU 2014-01 amends the scope requirements so that more LIHTC investments will qualify for an alternative method of accounting. Specifically, ASU 2014-01 eliminates the requirement that the tax credits from the LIHTC investment must be "guaranteed by a creditworthy entity" and also allows entities to consider both the tax credits and other tax benefits (e.g., depreciation expense) when determining whether the projected yield of the investment is positive.

As a result of these and other changes to the scope requirements, more LIHTC investments are likely to qualify for the alternative method of accounting.

New Alternative Approach

As noted above, ASU 2014-01 replaces the effective yield method with the proportional amortization method. The new approach, however, retains the effective yield method's presentation method, under which an entity presents the amortization of the LIHTC investment as "a component of income tax expense (benefit)."

Under the proportional amortization method, an entity would amortize the initial carrying amount of the LIHTC investment "in proportion to the tax credits and other tax benefits allocated to the investor." Specifically, the amortization amount for each period would be equal to the product of (1) the initial carrying amount of the investment and (2) the "percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment."

The proportional amortization approach also requires entities to test their LIHTC investments for impairment "when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized." If the investment is impaired, an impairment loss would be recognized equal to the amount by which the carrying amount of the investment exceeds its fair value.

New Disclosures

ASU 2014-01 also introduces new disclosure requirements for all entities that hold LIHTC investments, irrespective of whether they have elected to apply the proportional amortization approach. The objective of these new disclosure requirements is to help financial statement users understand the "nature of [the entity's] investments in qualified affordable housing projects" and "the effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations."

Thinking It Through

ASU 2014-01 significantly changes both the scope requirements and measurement method for the alternative measurement approach for investments in LIHTC partnerships. As a result, to qualify for the generally preferred accounting method, investors in LIHTC partnerships may seek to modify the terms of the partnership agreements.

Definition of a Public Business Entity

In December 2013, the FASB issued ASU 2013-12, which defines the term "public business entity" (PBE). The definition establishes the scope of accounting alternatives developed by the Private Company Council (PCC).[8] Specifically, entities that do not qualify as PBEs are generally eligible for private-company accounting alternatives. In addition, the term PBE will be incorporated by the FASB into future standard setting. Under the recently issued revenue standard, for example, an entity would refer to the definition of a PBE to determine whether it qualifies for effective date and disclosure relief. Therefore, even if an entity has no plans to elect a private-company accounting alternative, it should consider whether it meets the definition of a PBE and therefore would qualify for such relief under future standards. An entity would apply the definition of a PBE in connection with its adoption of the first ASU that uses the term.

The ASU defines a PBE as a business entity that meets any one of the following criteria:

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It 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.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

Although these criteria are largely drawn from similar definitions under other standards (e.g., ASC 280 defines a "public entity"), some are new. For example, criterion (a) is not in certain definitions and criterion (e) is not in any. Further, an entity would meet criterion (a) if its financial statements are included in another entity's SEC filing (e.g., as a significant investee or an acquiree of an SEC registrant). As a result, there may be some cases in which an entity that would have been considered nonpublic under previous guidance will now qualify as a PBE. Conversely, because a subsidiary of a public entity is not by extension automatically a PBE under the ASU, there may be instances in which an entity that would have been considered public will not qualify as a PBE for stand-alone financial statement purposes.

[8] The PCC was established by the Financial Accounting Foundation in 2012 to improve the accounting standard-setting process for private companies.

Thinking It Through

An entity that determines it is not a PBE and can therefore elect the private-company accounting alternatives should remain cognizant of the following:

- *The mandates, if any, of its financial statement users* — The ASU's basis for conclusions acknowledges that "decisions about whether an entity may apply permitted differences within U.S. GAAP ultimately may be determined by regulators (for example, the SEC and financial institution regulators), lenders and other creditors, or other financial statement users that may not accept financial statements that reflect accounting or reporting alternatives for private companies." Therefore, entities should seek to understand the views of their regulators and other users about the acceptability of the accounting alternatives before making an election.

- *The absence of transition guidance* — The ASU does not provide guidance on situations in which an entity subsequently meets the definition of a PBE as a result of changed circumstances. Entities should assume that they would be required to eliminate any private-company accounting alternatives from their historical financial statements if they later meet the definition of a PBE (e.g., in connection with an IPO). Therefore, from a practical perspective, entities considering electing a private-company accounting alternative should consider the likelihood that they may later meet the definition of a PBE — and the potential effort associated with unwinding the accounting alternative — before making an election.

For more information on ASU 2013-12, see Deloitte's January 27, 2014, *Heads Up*.

Accounting Alternatives for Private Companies

During 2014, the PCC finalized alternative accounting guidance on the following (early adoption of each ASU is permitted):

- *Goodwill* — ASU 2014-02 allows private companies to use a simplified approach to account for goodwill after an acquisition. Under this alternative, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. In addition, the ASU eliminates "step 2" of the goodwill impairment test; as a result, entities would measure goodwill impairment as the excess of the entity's (or reporting unit's) carrying amount over its fair value. Entities would adopt the ASU prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions). See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Hedge accounting* — ASU 2014-03 gives private companies a simplified method of accounting for interest rate swaps used to hedge variable rate debt. An entity that elects to apply simplified hedge accounting to a qualifying hedging relationship continues to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, it would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement effects as if it had issued fixed-rate debt. An entity that applies the simplified hedge accounting approach also may elect to measure the related swap at its settlement value rather than fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. Entities would adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Consolidation* — ASU 2014-07 gives private-company lessees an exemption from having to apply the consolidation guidance on variable interest entities to a related-party lessor when the entity and the lessor are under common control. The entity must evaluate additional criteria about the relationship between the lessee and lessor before applying this exception. If it applies the ASU, the entity may no longer be required to consolidate a related-party lessor entity. The ASU would be adopted retrospectively. See the March 21, 2014, *Deloitte Accounting Journal* entry for more information.

- *Intangible assets* — The upcoming ASU on this alternative is expected to give private companies an exemption from having to recognize certain intangible assets in a business combination. Specifically, an entity would not be required to recognize intangible assets for noncompete agreements and certain customer-related intangible assets. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to elect the goodwill accounting alternative, resulting in the amortization of goodwill. Entities would adopt the ASU prospectively and apply it to new business combinations occurring after its adoption. The FASB expects to issue the ASU by the end of this year.

Throughout 2014, the PCC has discussed aspects of financial reporting that are complex and costly for private companies. The accounting for stock-based compensation was a significant focus of these discussions. In a recent meeting, the PCC and FASB Board members agreed that the PCC would incorporate its views on this topic into the separate stock-based compensation project that the FASB is undertaking as part of its simplification initiative.

Thinking It Through

While entities in the industry may be particularly interested in the goodwill alternative, some may want to wait until the FASB completes its overall goodwill project before committing to the private-company alternative.

Pushdown Accounting

Background

On November 18, 2014, the FASB issued ASU 2014-17, which represents the final consensus reached by the EITF on Issue 12-F at its September 2014 meeting. The ASU provides guidance on determining when an acquired entity can establish a new accounting and reporting basis in its stand-alone financial statements (commonly referred to as "pushdown" accounting).

Also, in connection with the FASB's issuance of ASU 2014-17, the SEC rescinded SAB Topic 5.J, which contained the SEC staff's views on the application of pushdown accounting for SEC registrants. As a result of the SEC's actions, all entities — regardless of whether they are SEC registrants — will apply ASU 2014-17 for guidance on the use of pushdown accounting.

ASU 2014-17 reaffirms the EITF's consensus-for-exposure to provide an acquired entity[9] with the option of applying pushdown accounting in its stand-alone financial statements upon a change- in-control event. An acquired entity that elects pushdown accounting would apply the measurement principles in ASC 805 to push down the measurement basis of its acquirer to its stand-alone financial statements. In addition, the acquired entity would be required to provide disclosures that enable "users of [its] financial statements to evaluate the nature and effect of the pushdown accounting."[10] Under ASU 2014-17, when an acquired entity elects to apply pushdown accounting, it would be:

- Prohibited from recognizing acquisition-related debt incurred by the acquirer unless the acquired entity is required to do so in accordance with other applicable U.S. GAAP (e.g., because the acquired entity is legally obligated).

- Required to recognize the acquirer's goodwill.

- Prohibited from recognizing bargain purchase gains that resulted from the change-in-control transaction or event.

However, the acquired entity would treat the bargain purchase gain as an adjustment to equity (i.e., additional paid-in capital). ASU 2014-17 also clarifies that the subsidiary of an acquired entity would have the option of applying pushdown accounting to its stand-alone financial statements even if the acquired entity (i.e., the direct subsidiary of the acquirer) elected not to apply pushdown accounting.

[9] The scope of the final consensus will include both public and nonpublic acquired entities, whether a business or a nonprofit activity.
[10] Entities would achieve that disclosure objective by providing the relevant disclosures required by ASC 805.

ASU 2014-17 departs from the guidance in the proposed ASU in two notable ways:

- Rather than limiting the election of pushdown accounting to change-in-control events occurring after the effective date of the final consensus, the ASU permits entities to elect to apply pushdown accounting as a result of the most recent change-in-control event in periods after the event as long as it was preferable to do so. Entities would not be permitted to unwind a previous application of pushdown accounting (i.e., an acquired entity can change its election for the most recent change in control from not applying pushdown accounting to applying pushdown accounting, if preferable, but not vice versa).

- An entity is **not** required to disclose that a change-in-control event had occurred for which the entity had elected not to apply pushdown accounting.

Effective Date and Transition

ASU 2014-17 applies to all pushdown elections occurring after November 18, 2014. At transition, an acquired entity is permitted to elect to apply pushdown accounting arising as a result of change-in-control events occurring before the standard's effective date as long as (1) the change in-control event is the most recent change-in-control event for the acquired entity and (2) the election is preferable. Pushdown accounting applied in issued (or available-to-be issued) financial statements by an acquiree before the effective date of the guidance is irrevocable.

On the Horizon

Leases

Background

The FASB has been working with the IASB for almost a decade to address concerns related to the off-balance-sheet treatment of certain lease arrangements by lessees. The boards' proposed model would require lessees to adopt a right-of-use (ROU) asset approach that would bring substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability.

Thinking It Through

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor would continue to account for initial direct costs in a manner consistent with the current requirements. However, the boards decided to amend the definition of initial direct costs. In May 2014, the boards tentatively decided that the definition of initial direct costs for both lessees and lessors should include only those costs that are incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. This definition would be consistent with the definition of incremental cost in the recently issued revenue recognition standard. Under this definition, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. In 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) would be excluded from this definition.

Lessee and Nonlease Components

Lessees and lessors would be 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 forthcoming 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, the boards have noted that lessees would be permitted "to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract . . . as a single lease component." For more information, see the May 23, 2014, *Deloitte Accounting Journal* entry.

Thinking It Through

The boards agreed that an activity should be considered a separate nonlease component when 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 lessee would have been required to otherwise contract for these services separately. However, the boards have not addressed whether payments for property taxes would be considered a nonlease component.

Lessee Accounting

While the boards agree that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, the FASB and the IASB support different approaches for the lessee's subsequent measurement of the ROU asset. The FASB decided on a dual-model approach under which a lessee would classify a lease by using criteria that are similar to the lease classification criteria currently in IAS 17. For leases that are considered Type A leases (many current capital leases are expected to qualify as Type A), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would separately recognize interest expense and amortization of the ROU asset, which typically would result in a greater total expense during the early years of the lease. For leases that are considered Type B leases (many current operating leases are expected to qualify as Type B), the lessee would recognize a straight-line total lease expense.

While the FASB tentatively decided on a dual-model approach, the IASB decided on a single-model approach under which lessees would account for all leases similar to a financed purchase arrangement.

Thinking It Through

Under the FASB's dual-model approach, a lease would be classified as Type A 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."
- It is reasonably certain that a lessee will "exercise an option to purchase the underlying asset."
- "The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease."

These criteria are essentially the same as the existing lease classification criteria in IAS 17 but are not identical to the requirements in ASC 840. For example, under the proposed criteria, a lessee would be required to assess land and other elements separately unless the land element is clearly immaterial,[1] whereas under ASC 840 the land would only be evaluated separately if its fair value at lease inception was 25 percent or more of the fair value of the leased property. This change may result in more bifurcation of real estate leases into separate land and building elements that would be evaluated separately for lease classification purposes.

In addition, the FASB's tentative decision effectively eliminates the bright-line rules under the ASC 840 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. The decision could also affect the lease classification.

Lessor Accounting

Earlier this year, the boards discussed constituent feedback on the ED and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are similar to current sales-type leases, the lessor would only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

Thinking It Through

The inability to recognize profit on a transaction if it would not have qualified as a sale under the new revenue recognition guidance will probably not have a significant impact on real estate lessors since they typically do not enter into sales-type leases. However, the effect of the proposed changes to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. In addition, the proposed guidance would require real estate lessors to disclose more information.

[1] "Clearly immaterial" is not a defined term or threshold under U.S. GAAP. It is expected, however, that this threshold will be extremely low. We anticipate that, once adopted, an acceptable level for "clearly immaterial" will evolve based on industry practice and the profession.

Next Steps

The FASB and IASB are expected to complete their redeliberations during the first half of 2015 and, although they have not indicated a release date, are likely to issue final guidance during the second half of 2015. In addition, while the boards have not indicated when the final guidance would be effective, a date as early as January 1, 2018, is possible. See Deloitte's March 27, 2014, *Heads Up* for additional information about the boards' tentative decisions in connection with the proposed lessee and lessor accounting models.

Consolidation

Introduction

The FASB is currently finalizing its forthcoming ASU on consolidation. While the Board's deliberations have largely focused on the investment management industry, its decisions could have a significant impact on the consolidation conclusions for reporting entities in the real estate industry. Specifically, the amended guidance could affect a real estate entity's evaluation of whether (1) limited partnerships and similar entities should be consolidated, (2) variable interests held by the real estate entity's related parties or de facto agents affect its consolidation conclusion, and (3) fees it receives for decision-making services result in the consolidation of a variable interest entity (VIE).

Accordingly, real estate entities will need to reevaluate their previous consolidation conclusions in light of their involvement with current VIEs, limited partnerships not previously considered VIEs, and entities previously subject to the deferral in ASU 2010-10.

For additional information, see Deloitte's October 7, 2014, *Heads Up*.

Determining Whether Fees Paid to Decision Makers or Service Providers Are Variable Interests

One of the first steps in assessing whether a fund manager or property manager is required to consolidate a real estate fund or real estate operating entity is to determine whether the fund manager or property manager holds a variable interest in the entity. While the ASU will retain the current definition of a variable interest, it modifies the criteria for determining whether a decision-making arrangement is a variable interest.

Under current U.S. GAAP, six criteria must be met for an entity to conclude that its fee does not represent a variable interest. The ASU will eliminate the criteria focused on the subordination of the fees (ASC 810-10-55-37(b)) and the significance of the fees (ASC 810-10-55-37(e) and (f)). Under the ASU, the evaluation of whether fees are a variable interest would focus on whether (1) the fees "are commensurate with the level of effort" (ASC 810-10-55-37(a)), (2) the decision maker has any other direct or indirect interests (including indirect interests through its related parties) that absorb more than an insignificant amount of the VIE's variability (ASC 810-10-55-37(c)), and (3) the arrangement includes only customary terms (ASC 810-10-55-37(d)).

It is expected that with the elimination of three of the criteria in ASC 810-10-55-37, fewer fee arrangements would be considered variable interests.

Limited Partnerships (and Similar Entities)

Determining Whether a Limited Partnership Is a VIE

The ASU will amend the definition of a VIE only for limited partnerships and similar entities. Under the ASU, a limited partnership would be considered a VIE regardless of whether it has sufficient equity or meets the other requirements to qualify as a voting interest entity unless a single limited partner (LP) or a simple majority of all partners (including interests held by the general partner (GP) and its related parties) has substantive kick-out rights (including liquidation rights) or participating rights. As a result of the proposed amendments to the definition of a VIE for limited partnerships and similar entities, partnerships that historically were not considered VIEs may need to be evaluated under the new VIE consolidation model. Although the consolidation conclusion may not change, an updated analysis on the basis of the revised guidance would be required. In addition, even if a reporting entity determines that it does not need to consolidate a VIE, it would have to provide the existing extensive disclosures for any VIEs in which it holds a variable interest.

Example

A limited partnership is formed to acquire a real estate property. The partnership has a GP that holds a nominal interest in the partnership; five unrelated LPs hold the remaining equity interests. Profits and losses of the partnership (after payment of the GP's fees, which represent a variable interest in the entity) are distributed in accordance with the partners' ownership interests. There are no other arrangements between the partnership and the GP/LPs.

The GP is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing. In addition, the GP can be removed without cause by a simple majority of all of the LPs.

Under the Proposed Guidance

Although the GP has power over the activities that most significantly affect the limited partnership, a simple majority of all LPs can remove the GP. Accordingly, the equity holders as a group do not lack the criteria in ASC 810-10-15-14(b),and therefore, the partnership would not be considered a VIE provided that the conditions in ASC 810-10-15-14(a)[2] and ASC 810-10-15-14(c)[3] are not met. However, if kick-out rights did not exist, the limited partnership would be a VIE.

Consolidation of a Limited Partnership

Under current U.S. GAAP, a GP is required to perform an evaluation under ASC 810-20 to determine whether it controls a limited partnership that is not considered a VIE. This evaluation focuses on whether certain rights held by the unrelated LPs are substantive and overcome the presumption that the GP controls (and therefore is required to consolidate) the partnership. To overcome the presumption that the GP controls the partnership, the LPs (excluding interests held by the GP, by entities under common control of the GP, and by other entities acting on behalf of the GP) must have either (1) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the GP without cause (as distinguished from with cause) or (2) substantive participating rights.

Like an entity's analysis under the current guidance in ASC 810-20, its analysis under the proposed guidance on determining whether the GP should consolidate a partnership that is not considered a VIE would focus on an evaluation of whether the kick-out, liquidation, or participating rights held by the other partners are considered substantive. Unlike current guidance, however, the FASB's tentative approach requires entities to assess interests held by the GP, by entities under common control of the GP, and by other entities acting on behalf of the GP. That is, the rights would be considered substantive if they can be exercised by a simple majority of all of the partners, including the GP.

Partnerships would be VIEs when a single partner or a simple majority (or a lower threshold) of all partners do not have a substantive kick-out right or participating rights. The evaluation of whether the GP should consolidate a limited partnership (or similar entity) that is considered a VIE is consistent with how all other VIEs would be analyzed (i.e., the GP's economic exposure to the VIE would be considered). Accordingly, the GP would generally not be required to consolidate a limited partnership if the partners do not have substantive kick-out or participating rights unless the GP (or an entity under common control of the GP) has an interest in the partnership that could potentially be significant.

[2] ASC 810-10-15-14(a) states that an entity is a VIE if the "total equity investment . . . at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support."

[3] ASC 810-10-15-14(c) states that an entity is a VIE if (1) "voting rights of some investors are not proportional to their obligation to absorb the expected losses [or] their rights to receive the expected residual returns" and (2) substantially all of the potential VIE's activities "either involve or are conducted on behalf of an investor that has disproportionately few voting rights."

Real Estate Funds That Are Not Limited Partnerships (or Similar Entities)

The ASU will eliminate the deferral of ASU 2010-10 for investment funds. Accordingly, while kick-out and participating rights may have been considered for entities that qualified for the deferral, for real estate funds that are not limited partnerships (or similar entities), kick-out and participating rights will not be considered in the determination of whether the equity-at-risk group controls the fund unless the rights are held by a single party (including its related parties and de facto agents). As a result, an entity other than a partnership that qualified for the deferral and was not a VIE because its board of directors, as a group, held simple majority kick-out or participating rights may become a VIE if the equity holders as a group are no longer considered to have "power" over the entity through their kick-out rights. Accordingly, more funds could become VIEs under the ASU (particularly if the fund manager has other potentially significant interests in the fund).

Under current guidance, a real estate fund manager's assessment of whether it is the primary beneficiary of a VIE (and therefore must consolidate the VIE) that qualifies for the deferral would focus on whether the fund manager absorbs the majority of the VIE's variability as determined through quantitative analysis. Under the ASU, the reporting entity would be required to consolidate a VIE if it has both (1) the power to direct the activities of the VIE that most significantly affect the entity's economic performance ("power") and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. Accordingly, a fund manager that has power over a VIE, but did not previously consolidate the VIE because it did not absorb a majority of the VIE's variability, may be required to consolidate the VIE if it holds an economic interest that could potentially be significant to the VIE (e.g., a 15 percent economic interest in the VIE).

Effective Date and Transition

Modified retrospective application (including a practicability exception) would be required, with an option for full retrospective application. For public business entities, the ASU's guidance would be effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the ASU's guidance would be effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. The ASU would allow early adoption for all entities but would require entities to apply its guidance as of the beginning of the annual period containing the adoption date.

Thinking It Through

More entities are likely to qualify as VIEs under the ASU than under current guidance, and real estate entities would be required to provide additional disclosures regardless of whether they consolidate the VIE. Specifically, any real estate venture or fund that is formed as a limited partnership would automatically be a VIE unless the partners hold simple majority kick-out or participating rights. However, as a result of the ASU's changes to the guidance on (1) how to evaluate partnerships for consolidation, (2) how a reporting entity's related parties' interests in the VIE affect the consolidation analysis, and (3) whether a decision maker's fees represent a variable interest, fewer VIEs are likely to be consolidated. Accordingly, real estate entities will need to reevaluate their previous consolidation conclusions.

Real estate fund managers and property managers should start considering the extent to which they may need to change their processes and controls to apply the revised guidance, including those related to obtaining additional information that may have to be provided under the disclosure requirements. Changing such processes and controls may be particularly challenging for entities that intend to early adopt the proposed guidance. In addition, companies should consider the effect of the revised guidance as they enter into new transactions.

Financial Instrument Impairment

Background

In late 2012, the FASB issued a proposed ASU to obtain feedback on its current expected credit loss (CECL) model. Under the CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce complexity of U.S. GAAP by decreasing the number of different credit impairment models for debt instruments.[4]

Under the existing impairment models (often referred to as incurred loss models), an impairment allowance is recognized only after a loss event (e.g., default) has occurred or its occurrence is probable. In assessing whether to recognize an impairment allowance, an entity may only consider current conditions and past events; it may not consider forward-looking information.

The CECL Model

Scope

The CECL model[5] would apply to most[6] debt instruments (other than those measured at fair value through net income (FVTNI)), lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts, and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320.

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. An entity would, however, write off the carrying amount of a financial asset when it is deemed uncollectible, which is consistent with existing U.S. GAAP.

Thinking It Through

Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided at its September 17, 2013, meeting that an "entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero." U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

[4] Although impairment began as a joint FASB and IASB project, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of its July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

[5] This discussion of the CECL model reflects the FASB's redeliberations to date, including tentative decisions made at the October 29, 2014, Board meeting.

[6] The CECL model would not apply to the following debt instruments:

- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

Measurement of Expected Credit Losses

An entity's estimate of expected credit losses represents all contractual cash flows it does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it "reasonably expects" that it will execute a troubled debt restructuring.

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period that the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets that are within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

The FASB tentatively decided to permit the use of practical expedients in measuring expected credit losses for two types of financial assets:

1. *Collateral-dependent financial assets* — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value.

2. *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — The estimate of expected credit losses would be measured consistently with other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value (adjusted for selling costs, when applicable).

Thinking It Through

The FASB's tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined "similar risk characteristics." As a result, it remains to be seen whether the FASB expects an aggregation based on "similar risk characteristics" to be consistent with the existing practice of pooling purchased credit-impaired (PCI) assets on the basis of "common risk characteristics." Entities may need to make systems and process changes to capture loss data at more granular levels than they do now, depending on the expectations of market participants such as standard setters, regulators, and auditors.

Available-for-Sale Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, in August 2014, the FASB tentatively decided that AFS debt securities would not be included within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security's cost basis).

- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.

- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Thinking It Through

The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in OCI. However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write down of the AFS security's cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

1. If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.

2. If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The requirement to use an allowance approach for AFS debt securities may affect how a REIT communicates to its investors changes in cash flow expectations and their impact on the effective yield of the security. For example, under the proposed approach, the REIT would recognize any increase in cash flow expectations as a reversal of credit losses through earnings and a corresponding adjustment to its allowance. To the extent that the expected cash flows exceed the cash flows originally expected at acquisition of the asset, the REIT would recognize the excess as an income statement gain in the current period (as opposed to a prospective yield adjustment).

Purchased Credit-Impaired Assets

For PCI assets, as defined[7] in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of *contractual* cash flows not expected to be collected. After initial recognition of the PCI asset and its related allowance, a reporting entity would continue to apply the CECL model to the asset. Consequently, any subsequent changes to its estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change.

[7] The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

Thinking It Through

Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. In addition, under the CECL model, the discount embedded in the purchase price attributable to expected credit losses as of the date of acquisition must not be recognized as interest income, which is consistent with current practice.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows due to deterioration in the asset's credit quality since origination. Under the FASB's tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

Beneficial Interests Whose Credit Quality Is Not High or That Have Significant Prepayment Risk (Within the Scope of ASC 325-40)

The FASB tentatively decided at its June 11, 2014, meeting that an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of *contractual* cash flows not expected to be collected). In addition, the FASB indicated that "changes in expected cash flows due to factors other than credit would be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would never be included in interest income)."[8]

Thinking It Through

Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Disclosures

Many of the disclosures required under the proposal are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities would be required to disclose information related to:

- Credit quality.[9]
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

[8] Quoted text is from a handout for the June 11, 2014, FASB meeting.

[9] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

The Board plans to discuss at a future meeting rollforward disclosures of an entity's allowance and amortized cost balances and whether all of the tentative disclosure requirements should also apply to AFS debt securities.

Next Steps

At a future meeting, the Board plans to discuss additional matters related to disclosures, transition, and effective date.

Thinking It Through

Measuring expected credit losses will most likely be a significant challenge for real estate entities with lending activities. As a result of moving to an expected loss model, such entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

Today, financial institutions use various methods to estimate credit losses. Some apply simple approaches that take into account average historical loss experience over a fixed time horizon. Others use more sophisticated "migration" analyses and forecast modeling techniques. Under the CECL model, for any approach that is based solely on historical loss experience, an entity would need to consider the effect of forward-looking information over the remaining contractual life of a financial asset. In addition, the FASB tentatively decided at its August 13, 2014, meeting that when an entity is "developing its estimate of expected credit losses . . . for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts, [the] entity is allowed to revert to its [unadjusted] historical credit loss experience."

For instance, assume that an entity uses annualized loss rates to determine the amount of probable unconfirmed losses on its homogeneous pools of loans as of the reporting date. When moving to the CECL model, the entity may need to revise its allowance method by adjusting the fixed time horizon (i.e., annualized loss rates) to equal a period that represents the full contractual life of the instrument. Entities using a probability-of-default (PD) approach may need to revise their PD and loss-given-default (LGD) statistics to incorporate the notion of lifetime expected losses. Today, an entity's PD approach might be an estimate of the probability that default will occur over a fixed assessment horizon, which is less than the full contractual life of the instrument (often one year). Similarly, an entity would need to revise its LGD statistic to incorporate the notion of lifetime expected losses (i.e., the percentage of loss over the total exposure if default were to occur during the full contractual life of the instrument).

Classification and Measurement

Recent Redeliberations

The FASB is no longer pursuing a converged approach to the classification and measurement of financial instruments. Instead, the Board has decided to retain existing requirements related to (1) the classification and measurement categories for financial instruments other than equity investments, (2) the method for classifying financial instruments, (3) bifurcation of embedded derivatives in hybrid financial assets, and (4) accounting for equity method investments (including impairment of such investments). However, the Board has discussed targeted improvements to the requirements related to accounting for equity investments and presentation of certain fair value changes for fair value option liabilities.

Classification and Measurement of Equity Investments

Under the FASB's tentative approach, entities will be required to carry all investments in equity securities that do not qualify for the equity method or a practicability exception at FVTNI. For equity investments that do not have a readily determinable fair value, the FASB would permit entities to elect the practicability exception to fair value measurement under which the investment would be measured at cost less impairment plus or minus observable price changes. This exception would not be available to reporting entities that are investment companies or broker-dealers.

Impairment Assessment of Equity Investments That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the FASB has tentatively decided to eliminate the requirement to assess whether an impairment of such an investment is other than temporary. In each reporting period, an entity would qualitatively consider certain indicators to determine whether the investment is impaired, including:

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

b. A significant adverse change in the regulatory, economic, or technological environment of the investee

c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates

d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment

e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

An entity that determines that the equity security is impaired on the basis of an assessment of the above indicators would recognize an impairment loss equal to the difference between the security's fair value and carrying amount. In contrast, the existing guidance in ASC 320-10-35-30 requires entities to perform a two-step assessment under which an entity first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.

Thinking It Through

Under existing U.S. GAAP, marketable equity securities other than equity-method investments (those for which the investor has significant influence over the investee) are classified as either held for trading (FVTNI) or available for sale (FVTOCI). For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity-method investments are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities can no longer be accounted for as AFS securities or by using the cost method, REITs that hold such equity investments could see more volatility in earnings under the proposed guidance.

Presentation of Fair Value Changes Attributable to Instrument-Specific Credit Risk for Fair Value Option Liabilities

The FASB has tentatively decided to introduce a new requirement related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this tentative decision, an entity would be required to separately recognize in OCI the portion of the total fair value change attributable to instrument-specific credit risk. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income.

Under the FASB's tentative approach, an entity would measure the portion of the change in fair value attributable to instrument-specific credit risk as the excess of total change in fair value over the change in fair value "resulting from a change in a base market risk, such as a risk-free interest rate . . . . Alternatively, an entity may use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk." In either case, the entity would be required to disclose the method it "used to determine the gains and losses attributable to instrument-specific credit risk and [to] apply the method consistently from period to period."[10]

See Appendix A in Deloitte's August 8, 2014, *Heads Up* for a comparison of classification and measurement models under current U.S. GAAP and the FASB's tentative approach.

[10] Quoted text is from a handout for the April 23, 2014, FASB meeting.

Next Steps

Additional matters that the Board plans to discuss at future meetings include disclosures (e.g., core deposits), transition, effective date, and cost/benefit considerations.

Hedging

At its meeting on November 5, 2014, the FASB voted to move its current research project on hedge accounting to its active agenda. In deliberating the project, the FASB will discuss the following issues:

- Hedge effectiveness requirements.
- Whether the shortcut and critical-terms-match methods should be eliminated.
- Voluntary dedesignations of hedging relationships.
- Recognition of ineffectiveness for cash flow underhedges.
- Hedging components of nonfinancial items.
- Benchmark interest rates.
- Simplification of hedge documentation requirements.
- Presentation and disclosure matters.

Formal deliberations in the hedging project will continue on a future date.

Thinking It Through

The FASB's hedging project may lead to welcome simplification of the existing guidance. For example, on the basis of constituent feedback received on the FASB's initial proposals, the criteria to qualify for applying hedge accounting are expected to be easier for entities to satisfy (e.g., from "highly effective" to a lower threshold). It is also expected that the guidance resulting from the project will simplify the actual application of hedge accounting for eligible entities by, for example, only requiring qualitative (rather than quantitative) ongoing assessments of hedge effectiveness.

Accounting for Goodwill by Public Business Entities and Not-for-Profit Entities

Overview

In November 2013, the FASB endorsed a decision by the PCC to allow nonpublic business enterprises to amortize goodwill and perform a simplified impairment test. The Board has received feedback indicating that many public business entities and not-for-profit entities have similar concerns about the cost and complexity of the annual goodwill impairment test. Thus, the Board added this project to its agenda for 2014 and has asked the staff to analyze the views below.

Current Status

The Board is considering the following alternatives for the accounting for goodwill by public business entities and not-for-profit entities:[11]

> View A — Goodwill would be amortized "over 10 years or less than 10 years if an entity demonstrates that another useful life is more appropriate." Goodwill would be tested for impairment "only when a triggering event occurs."
>
> *View B* — Goodwill would be amortized over its expected useful life, which would not exceed a specified number of years; the current impairment test would be retained.
>
> *View C* — An entity would write off goodwill directly at initial recognition or transition and would reflect the charge in net income or equity and provide additional disclosures for each acquisition. Under this alternative, there would be no subsequent goodwill accounting considerations.
>
> *View D* — An entity would not amortize goodwill but would perform a simplified impairment test. Such a model would most likely eliminate step 2 of the goodwill impairment test in ASC 350 and would potentially simplify the unit of account (i.e., raise it to a level above the reporting unit). In addition, "[a]n entity would make an accounting policy election to test goodwill for impairment at the entity level or at the reporting unit level. It would test goodwill for impairment only when a triggering event occurs."

Next Steps

At its November 5, 2014, meeting, the FASB discussed the results of the IASB's post-implementation review (PIR) of IFRS 3. The Board also discussed findings of a study on how the qualitative assessment has been used since the issuance of ASU 2011-09. On the basis of discussions during the meeting, the Board decided to add a project to its agenda on the accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities. The purpose of this project will be to evaluate whether certain intangibles assets could be subsumed into goodwill.

Clarifying the Definition of a Business

Background

The FASB currently has a project on its agenda to clarify the definition of a business. According to the FASB's project update page, the objective of the project is to address "whether transactions involving in-substance nonfinancial assets (held directly or in a subsidiary) should be accounted for as acquisitions (or disposals) of nonfinancial assets or as acquisitions (or disposals) of businesses." The project will also include clarifying the guidance on partial sales of nonfinancial assets. The FASB has not yet made any technical decisions in connection with the project.

Thinking It Through

Accounting for real estate acquisitions as a business combination (rather than as an asset acquisition) affects whether (1) the real estate is initially measured at fair value or on an allocated cost basis, (2) acquisition related costs are capitalized or expensed, and (3) contingent consideration should be recorded as of the acquisition date. In addition, the differences between the asset-based or business-based derecognition requirements could affect when to derecognize real estate assets sold and how to measure any retained interests if a company sells a partial interest in an asset.

[11] Quoted text is from the FASB's tentative decisions at its March 26, 2014, meeting.

Other Topics

Disclosure Framework

Background

In July 2012, the FASB issued a discussion paper as part of its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. See Deloitte's July 17, 2012, *Heads Up* for additional information. The FASB subsequently decided to distinguish between the "Board's decision process" and the "entity's decision process" for evaluating disclosure requirements.

FASB Decision Process

Overview

On March 4, 2014, the FASB released for public comment an ED of a proposed concepts statement that would add a new chapter to the Board's conceptual framework for financial reporting. The ED proposes a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FASB's objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte's March 6, 2014, *Heads Up* for additional information.

Summary of Comment-Letter Feedback

Comments on the FASB's ED were due by July 14, 2014. The FASB received over 50 comment letters from various respondents, including preparers, professional and trade organizations, and accounting firms. Respondents generally expressed support for the development of a conceptual framework for use in evaluating disclosure requirements that would apply to existing and future standards.

However, many respondents were concerned that the ED's "intentionally broad" proposed decision questions may result in excessive disclosure (which respondents had also noted in their comments on the discussion paper). Accordingly, many respondents suggested that the FASB use a filtering mechanism (e.g., based on cost and decision usefulness) to further narrow disclosure requirements.

Respondents also suggested that the FASB clarify the difference between relevance and materiality and align the definition of materiality in the FASB's concepts statement with that established by the Supreme Court.[1]

Further, many respondents encouraged the Board to work with regulatory bodies, such as the SEC, to develop requirements that result in disclosures that are more effective and less redundant in the overall financial reporting package.

Next Steps

The FASB will continue its redeliberations related to concerns raised in comment letters and will review feedback received as a result of its outreach activities, which included testing the entity's decision process against various Codification topics (see the Entity's Decision Process section). A final concepts statement is expected to be issued after the outreach process is complete.

[1] Paragraph QC11 in Chapter 3 of FASB Statement of Financial Accounting Concepts No. 8 states that "[i]nformation is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity." Further, PCAOB AS 11 explains that "[i]n interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is 'a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' As the Supreme Court has noted, determinations of materiality require 'delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him'" (footnotes omitted).

Entity's Decision Process

Topic-Specific Disclosure Reviews

The FASB staff is currently analyzing ways to "further promote [entities'] appropriate use of discretion" in determining proper financial statement disclosures. This process will take into account "section-specific modifications" to the following Codification topics:

ASC Topic	Status
820 (fair value measurement)	Testing in progress. Results discussed with Board.
330 (inventory)	Not started.
715 (defined benefit plans)	Testing in progress. Results discussed with Board.
740 (income taxes)	Not started.

A proposed ASU could be issued as a result of this process. No tentative decisions have been made on this matter to date.

Thinking It Through

The financial statements of real estate entities often contain lengthy fair value measurement disclosures. The FASB is currently using the ED's conceptual framework to test ASC 820 and expects that disclosures will ultimately be reduced as a result (i.e., by identifying disclosures that are beyond the scope of the conceptual framework).

During deliberations, the FASB discussed the Level 3 rollforward. The ED's decision question L7 contains information to be considered for disclosure, including "the causes of changes from the prior period (such as major inflows and outflows summarized by type or a detailed roll forward)," which may imply that a rollforward (or similar information) is required for each significant balance sheet line item.

In addition, the February 2014 post-implementation review report on FASB Statement 157 stated that "preparers and practitioners are concerned with the decision-usefulness of the Statement 157 disclosures. They cited concerns about disclosure overload, particularly as it relates to Level 3 disclosures, including the Level 3 rollforward."

At its September 2014 meeting, the Board discussed the following:

- Adding disclosures about:
  - Alternative measures.
  - Gains and losses.
- Modifying disclosures about:
  - The Level 3 rollforward. During deliberations, it was acknowledged that performing the rollforward every quarter was difficult for entities (see the Interim Reporting section).
  - Transfers between Level 1 and Level 2.
  - The policy for timing of transfers between levels.
  - Valuation process for Level 3 fair value measurements.
  - Sensitivity information.
  - Estimates of timing of future events.

No decisions were made, and the views of Board members were mixed. Board members also indicated that they would need to assess whether users would prefer (1) the application of materiality on a company basis or (2) uniform disclosures among all companies (including immaterial items).

Interim Reporting

The FASB deliberated modifications to the guidance on interim reporting. The Board tentatively decided that an update to an annual footnote disclosure is warranted as of an interim period if the update would alter the "total mix" of information available to investors. This is consistent with the guidance in SAB 99, which is based on a Supreme Court ruling.[2]

During future redeliberations on interim reporting, the Board will continue reviewing comment-letter feedback on the ED.

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

As part of its simplification initiative, the FASB issued a proposed ASU that would remove from U.S. GAAP the concept of extraordinary items and therefore eliminate the requirement for entities to separately present such items on the income statement and disclose them in the footnotes. Currently, extraordinary items (1) are unusual in nature and (2) occur infrequently. The proposed ASU retains the reporting and disclosure requirements for an event that demonstrates either of those characteristics. Accordingly, users of financial statements would continue to be informed about unusual or infrequent events after the concept of extraordinary items is eliminated.

The FASB believes that eliminating the concept would also improve the efficiency of the financial reporting process since it would relieve entities from having to identify extraordinary items and comply with associated presentation and disclosure requirements.

In October, 2014, the FASB voted to issue final guidance in an ASU. The Board tentatively decided to allow either prospective or retrospective application of the guidance. For all entities, the ASU will be effective for periods beginning after December 15, 2015. Early adoption is permitted when the guidance is applied from the beginning of the reporting period in the year of adoption.

Debt Issuance Costs

On October 14, 2014, the FASB issued a proposed ASU that would change the presentation of debt issuance costs in the financial statements. Under the proposal, an entity would be required to present such costs in the balance sheet as a direct deduction from the debt liability in a manner consistent with its accounting treatment of debt discounts. Amortization of the issuance costs would be reported as interest expense.

The proposed guidance would replace the guidance in ASC 835-30 that requires an entity to report debt issuance costs in the balance sheet as deferred charges (i.e., as an asset). It would also align U.S. GAAP on this topic with IFRSs, under which transaction costs that are directly attributable to the issuance of the liability are treated as an adjustment to the initial carrying amount of the financial liability.

Comments on the proposal are due by December 15, 2014. For more information about the proposed ASU, see Deloitte's October 14, 2014, *Heads Up*.

Liabilities and Equity — Short-Term Improvements

In November 2014, the FASB voted to move part of its current research project on liabilities and equity to its active agenda. Specifically, the FASB decided to add a project addressing (1) practice issues related to ASC 815-40 and (2) targeted improvements to the organization of the related Codification topics.

To date, no technical decisions have been made in the project.

[2] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

COSO Framework

Background

Since the Committee of Sponsoring Organizations of the Treadway Commission issued an updated version of its *Internal Control — Integrated Framework* (the "2013 Framework") in May, 2013,[3] companies have been taking steps to implement it by December 15, 2014. While the internal control components[4] in the 2013 Framework are the same as those in the original framework issued in 1992, the updated framework requires companies to assess whether 17 principles underlying five components are present and functioning in determining whether their system of internal control is effective. Further, the 17 principles are supported by points of focus, which are important considerations in a company's evaluation of the design and operating effectiveness of controls to address the principles.

These changes will result in the need for entities to develop a different deficiency evaluation process. From an ICFR perspective, when one or more of the 2013 Framework's 17 principles are not present and functioning, a major deficiency exists, which equates to a material weakness under Section 404 of the Sarbanes-Oxley Act.[5]

See Deloitte's September 5, 2014, *Heads Up* for additional discussion of challenges and leading practices related to implementing the new framework, including observations and perspectives regarding its application for operational and regulatory compliance purposes.

SEC Rules

Background

The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

SEC Issues Proposed Rule Related to Treatment of Certain Communications Involving Security-Based Swaps

On September 8, 2014, the SEC issued a proposed rule under which "the publication or distribution of price quotes relating to security-based swaps that may be purchased only by persons who are eligible contract participants and are traded or processed on or through a facility that either is registered as a national securities exchange or as a security-based swap execution facility, or is exempt from registration as a security-based swap execution facility pursuant to a rule, regulation, or order of the Commission, would not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase such security-based swaps or any guarantees of such security-based swaps that are securities for purposes of Section 5 of the Securities Act."

Comments on the proposed rule were due by November 10, 2014.

[3] See Deloitte's June 10, 2013, *Heads Up* for an overview of the 2013 Framework.

[4] Control environment, risk assessment, control activities, information and communication, and monitoring activities.

[5] The 2013 Framework contains the following new guidance on a major deficiency in internal control:

> "When a major deficiency exists, the organization cannot conclude that it has met the requirements for an effective system of internal control. A major deficiency exists in the system of internal control when management determines that a component and one or more relevant principles are not present or functioning or that components are not operating together. A major deficiency in one component cannot be mitigated to an acceptable level by the presence and functioning of another component. Similarly, a major deficiency in a relevant principle cannot be mitigated to an acceptable level by the presence and functioning of other principles."

SEC Issues Final Rule on Asset-Backed Securities

On September 4, 2014, the SEC issued a final rule that is intended to enhance the disclosure requirements for ABSs. Specifically, the final rule requires "loan-level disclosure for certain assets, such as residential and commercial mortgages and automobile loans" and gives investors more time "to review and consider a securitization offering, revise[s] the eligibility criteria for using an expedited offering process known as 'shelf offerings,' and make[s] important revisions to reporting requirements."

The final rule will become effective on November 24, 2014.

For more information, see the September 3, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final Rule on Nationally Recognized Statistical Rating Organizations

On August 27, 2014, the SEC issued a final rule that revises the requirements for NRSROs in response to a mandate of the Dodd-Frank Act. The amendments "address internal controls, conflicts of interest, disclosure of credit rating performance statistics, procedures to protect the integrity and transparency of rating methodologies, disclosures to promote the transparency of credit ratings, and standards for training, experience, and competence of credit analysts." The ultimate objective of these new requirements is "to enhance governance, protect against conflicts of interest, and increase transparency to improve the quality of credit ratings and increase credit rating agency accountability."

The final rule became effective on November 14, 2014.

For more information, see the September 3, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final and Proposed Rules Related to Money Market Funds

On July 23, 2014, the SEC issued a final rule that amends the way money market funds (MMFs) are regulated. The rule eliminates the use of penny rounding for institutional nongovernment MMFs and establishes a current NAV — or floating NAV — like that used in other mutual funds. Government and retail MMFs may continue using amortized cost to value a fund´s investments instead of calculating the fund´s value by using a floating NAV (i.e., they may continue to use a stable NAV, which is typically $1).

The final rule notes that MMFs with floating NAVs will be permitted to "continue to use amortized cost to value debt securities with remaining maturities of 60 days or less if fund directors, in good faith, determine that the fair value of the debt securities is their amortized cost value, unless the particular circumstances warrant otherwise." The final rule also includes provisions related to redemption gates and liquidity fees.

The SEC has also issued a reproposed rule related to (1) MMF communications to investors and (2) the replacement of credit rating references in Rule 2a-7 and Form N-MFP with other factors a fund would use to assess liquidity and creditworthiness of investments to comply with Section 939A of the Dodd-Frank Act.

The final rule became effective on October 14, 2014. Comments on the proposed rule were also due by October 14, 2014.

For more information, see the July 24, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final Rule on Cross-Border Security-Based Swaps

On June 26, 2014, the SEC issued a final rule that explains "when a cross-border transaction must be counted toward the requirement to register as a security-based swap dealer or major security-based swap participant." In addition, the rule addresses "the scope of the SEC's cross-border anti-fraud authority."

The final rule became effective September 8, 2014.

For more information, see the press release on the SEC's Web site.

SEC Proposes Rule for Covered Clearing Agencies

On March 12, 2014, the SEC issued a proposed rule that would amend the Exchange Act to establish additional regulations for "covered clearing agencies" (i.e., certain types of SEC-registered clearing agencies) that (1) the Financial Stability Oversight Council deems "systemically important" or (2) participate in "more complex transactions" (e.g., securities-based swaps). The new requirements would affect such agencies' financial risk management, operations, governance, and disclosures.

Comments on the proposed rule were due by May 27, 2014.

For more information, see the press release on the SEC's Web site.

SEC Extends Exemptions Related to Security-Based Swaps

On February 7, 2014, the SEC published amendments extending the expiration date for "interim final rules that provide exemptions under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939 for those security-based swaps that [1] prior to July 16, 2011 were security-based swap agreements and [2] are defined as 'securities' under the Securities Act and the Exchange Act as of July 16, 2011 due solely to the provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act." The amendments affect the following interim final rules:

- Rule 240 of the Securities Act.
- Rules 12a-11 and 12h-1(i) of the Exchange Act.
- Rule 4d-12 of the Trust Indenture Act.

The new expiration date for the interim final rules is February 11, 2017.

SEC Issues Risk Alert on Investment Advisers' Use of Due Diligence

On January 28, 2014, the SEC's Office of Compliance Inspections and Examinations issued a risk alert summarizing its observations regarding the due-diligence procedures investment advisers follow when "recommending alternative investments to their clients." The SEC staff's observations fall into two main categories: (1) trends in investment advisers' due-diligence processes and (2) the extent to which the advisers have complied with applicable rules and regulations, including the Investment Advisers Act and the advisers' own codes of ethics that the Commission mandates for SEC-registered advisers.

For more information, see the press release on the SEC's Web site.

SEC Issues Interim Final Rule Related to Certain Collateralized Debt Obligations

On January 17, 2014, the SEC, in conjunction with the OCC, the Federal Reserve, the FDIC, and the CFTC, issued an interim final rule that "would permit banking entities to retain investments in certain pooled investment vehicles that invested their offering proceeds primarily in certain securities issued by community banking organizations of the type grandfathered under Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

The interim final rule became effective on April 1, 2014.

For more information, see the press release on the SEC's Web site.

SEC Issues Final Rule and Interpretive Guidance Related to Rules for Registration of Municipal Advisers

On January 13, 2014, the SEC issued a final rule granting a temporary stay on the Commission's rules for registration of municipal advisers, which "require municipal advisors to register with the Commission if they provide advice to municipal entities or certain other persons on the issuance of municipal securities, or about certain investment strategies or municipal derivatives." The new date by which municipal advisers must comply with the rules is July 1, 2014. The temporary stay is effective as of January 13, 2014.

In addition, on January 10, 2014, the SEC issued a series of FAQs in response to questions the Commission has received from market participants about the municipal adviser registration rules. Topics covered in the FAQs include:

- Content that entities are permitted to provide to a municipal entity to avoid having to register as a municipal adviser.
- How to provide a request for proposals or request for qualifications that is consistent with the exemption to the definition of a municipal adviser.
- Requirements for the independent registered municipal adviser exemption.
- Exclusions related to underwriters and registered investment advisers.
- Whether a broker-dealer that served as underwriter for an issuance of municipal securities can continue to rely on the underwriter exemption after the issuance and the underwriting period.
- Whether advice provided by remarketing agents is within the scope of the underwriter exclusion.
- Opinions offered by public officials and citizens.
- Effective and compliance dates of the final rules.

For more information, see the January 10, 2014, and January 13, 2014, press releases on the SEC's Web site.

SEC Releases Examination Priorities for 2014

On January 9, 2014, the SEC's Office of Compliance Inspections and Examinations published a document highlighting the Commission's examination priorities for 2014. The objective of the document is to inform SEC registrants and investors about issues that the Commission is planning to focus on for the remainder of the year. These issues include fraud detection and prevention, corporate governance and conflicts of interest, new laws and regulations, and the Commission's programs for investment advisers and broker-dealers.

For more information, see the press release on the SEC's Web site.

SEC Implements Volcker Rule

On December 10, 2013, the SEC, OCC, FDIC, and Federal Reserve jointly issued a final rule to implement Section 619 of the Dodd-Frank Act (also known as the "Volcker Rule"). The final rule "contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the [Federal Reserve] to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund."

For more information, see the press release on the SEC's Web site.

Appendixes

Appendix A — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

FASB Accounting Standards Updates and Other FASB Literature

See the FASB's Web site for the titles of:

- Accounting Standards Updates.
- Proposed Accounting Standards Updates (exposure drafts and public comment documents).
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

PCAOB Literature

PCAOB AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*

SEC Final Rules

33-9616, *Money Market Fund Reform; Amendments to Form PF*

33-9638, *Asset-Backed Securities Disclosure and Registration*

34-71288, *Registration of Municipal Advisors; Temporary Stay of Final Rule*

34-72472, *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant Definitions to Cross-Border Security-Based Swap Activities"*

34-72936, *Nationally Recognized Statistical Rating Organizations*

SEC Interim Rules

33-9545, *Extension of Exemptions for Security-Based Swaps*

BHCA-2, *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*

SEC Proposed Rules

33-9643, *Treatment of Certain Communications Involving Security-Based Swaps That May Be Purchased Only by Eligible Contract Participants*

34-71699, *Standards for Covered Clearing Agencies*

IC-31184, *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*

SEC Staff Accounting Bulletins

SAB 99, codified as SAB Topic 1.M, "Materiality"

SAB Topic 5.J, "New Basis of Accounting Required in Certain Circumstances" (rescinded)

SAB Topic 13, "Revenue Recognition"

International Standards

See Deloitte's IAS Plus Web site for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- Exposure documents.

Appendix B — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
CECL	current expected credit loss
CFTC	U.S. Commodity Futures Trading Commission
COSO	The Committee of Sponsoring Organizations of the Treadway Commission
ED	exposure draft
EITF	Emerging Issues Task Force
FAQs	frequently asked questions
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FVTNI	fair value through net income
FVTOCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
GP	general partner
HTM	held to maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting

Abbreviation	Description
IFRS	International Financial Reporting Standard
IPO	initial public offering
LGD	loss given default
LIHTC	low income housing tax credit
LP	limited partner
MMF	money market fund
NAV	net asset value
NRSROs	nationally recognized statistical rating organizations
OCC	Office of the Comptroller of the Currency (U.S. Department of the Treasury)
OCI	other comprehensive income
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCI	purchased credit-impaired
PD	probability of default
PIR	post-implementation review
REIT	real estate investment trust
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
Investment Advisers Act	Investment Advisers Act of 1940
Sarbanes-Oxley Act	The Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933
Trust Indenture Act	Trust Indenture Act of 1939

Appendix C — Other Resources

Deloitte Publications

Register to receive other Deloitte industry-related publications by going to www.deloitte.com/us/subscriptions, choosing the Industry Interests category, and checking the boxes next to your particular interests. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

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Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, the AICPA, the SEC, the IASB, and the IFRS Interpretations Committee. Check it out today!

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SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends

Eighth Edition
November 20, 2014

Deloitte.

To our clients, colleagues, and other friends:

We are frequently asked to provide our perspective on the topics the SEC staff focuses on in its comment letters to registrants. The eighth edition of *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends* offers such perspective. In addition to extracts of letters and links to relevant related resources, it contains analysis of staff comments to help registrants understand trends and improve their financial statements and disclosures.

Over the past year, the staff has continued to address virtually all topics discussed in our seventh edition, and it remains focused on the clarity of registrants' disclosures. Sections in the eighth edition have been updated to reflect newer comments on registrants' financial statements and other areas of their filings. In addition, the appendixes in the eighth edition offer further insights. For example, Appendix A gives a glimpse into the SEC staff's review and comment letter process. Appendix B discusses best practices for managing unresolved SEC comments, and Appendix C provides helpful tips on searching the SEC's EDGAR database for comment letters. In addition, Appendix D lists the titles (or links to titles) of the standards referred to in this publication, and Appendix E defines the abbreviations we used.

Our eighth edition captures developments on relevant financial reporting topics through the date of publication. The SEC and its staff will continue to provide registrants with information that is pertinent to their filings by means of rulemaking and written interpretive guidance as well as speeches delivered at various forums, of which the AICPA Conference is a prime example. Deloitte's US GAAP Plus Web site is a resource you can use to keep current on the SEC's latest activities related to financial reporting matters — including the SEC staff's participation at the next AICPA Conference, which is scheduled for December 8–10, 2014, and will be discussed in an upcoming issue of our *Heads Up* newsletter.

We hope you find our eighth edition of this publication — and other publications on US GAAP Plus — useful resources as you prepare your annual reports and plan for the upcoming year.

In keeping with recent SEC staff remarks about how registrants can make their disclosures more effective, we encourage you to consider materiality, relevance, and redundancy as you assess whether to provide additional disclosures or enhance existing ones.

As always, we encourage you to contact us for additional information and assistance, and we welcome your feedback.

Sincerely,

Bob	Christine
Bob Uhl Accounting Standards and Communications	Christine Davine SEC Services

Contents

Acknowledgments

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Executive Summary

In October 2014, a new chief accountant, James Schnurr, assumed leadership of the SEC's Office of the Chief Accountant (OCA). In early November, Mr. Schnurr gave a glimpse of his priorities and noted that the OCA would place heavy emphasis on monitoring the implementation of the FASB's and IASB's new converged revenue standard, which introduces a new contract-based model that is designed to replace all current revenue accounting literature. While the standard will not be effective until 2017, Mr. Schnurr noted that a significant number of implementation issues have been identified and that the OCA is considering what additional steps it may take. He also said that he would work with his staff to provide some clarity about whether and, if so, how, to incorporate IFRSs in the U.S. financial reporting system. So it is likely that we will hear more about these topics in the coming months.

Another priority, the aggressive pursuit of investor protections, has been the focus of the SEC's Division of Enforcement and Office of the Whistleblower. Recently, the SEC announced that in fiscal year 2014, the Division of Enforcement filed approximately 755 enforcement actions and levied penalties in excess of $4 billion — both record highs. Further, in September 2014, the Office of the Whistleblower announced that it expected to award a whistleblower approximately $30 million, the highest sum it has paid to date.

The Division of Corporation Finance (the "Division") has been equally busy undertaking its own priorities, devoting much of 2014 to fulfilling the SEC's mandated rulemaking activities under the Dodd-Frank and JOBS Acts. In December 2013, in a report provided under the JOBS Act, the Division's staff indicated that the SEC would commence a broad effort to modernize and streamline its rules and regulations (also called its "disclosure effectiveness project").[1] In addition, the Division's staff has remarked on how, in the absence of rule changes, registrants can improve their disclosure documents in the near term — most notably by focusing their disclosures on matters that are material and relevant to their operations, liquidity, and financial condition.[2]

Further, the Division continues to meet its responsibilities under the Sarbanes-Oxley Act to review registrants at least once every three years. MD&A is again the leading source of SEC staff comments, and the staff has encouraged registrants to "tell their story" in MD&A to allow investors to see the company "through the eyes of management." Comments often focus on enhancing the executive overview to provide an investor with a balanced summary of key drivers, challenges, and risks that affect the registrant's liquidity and results of operations. In results of operations, the staff has continued to focus on encouraging registrants to disclose known trends or uncertainties, quantify components of overall changes in financial statement line items, and enhance their analysis of the underlying factors that cause such changes.

In addition to MD&A, the SEC staff has commented on all sections of a registrant's filings, including the financial statements. Among the questions it frequently asks registrants are those related to:

- *Segment reporting* — This remains a perennial topic of SEC staff inquiry. Historically, the staff has asked registrants about the identification of the chief operating decision maker (CODM), the identification of operating segments, and the analysis supporting the aggregation of operating segments. While the prominence of these themes has continued over the past year, the SEC staff recently remarked that its views are evolving and that it will renew its focus on these topics. In particular, the staff (1) will continue to ask questions to obtain a better understanding of a registrant's management structure and whether that structure supports the person or group identified as the CODM and (2) is rethinking the importance placed on the information package provided to, and regularly reviewed by, the CODM (the "CODM package"). That is, it is likely that the staff will no longer regard the CODM package as the determinative factor supporting the identification of a registrant's operating segments but will treat the CODM package as one of many factors to be considered.

1 For additional information, see Deloitte's August 26, 2014, *Heads Up*.

2 The SEC staff has discussed this topic in various speeches over the past year. For more information about the staff's remarks, see Deloitte's October 16, 2014, March 20, 2014, and December 16, 2013, *Heads Up* newsletters.

- *Revenue recognition* — Comments continue to include those that address the completeness and consistency of disclosures about revenue recognition policies, accounting for multiple-element arrangements, and principal-versus-agent analysis (i.e., gross or net reporting).
- *Income taxes* — The SEC staff remains focused on (1) the valuation and sufficiency of deferred tax assets, (2) appropriate breakout (and descriptions of) adjustments in a registrant's rate reconciliation, and (3) disclosures about liquidity in MD&A when registrants assert that they have indefinitely reinvested foreign earnings.
- *Internal control over financial reporting (ICFR)* — The SEC staff has concentrated on a registrant's evaluation of the severity of deficiencies in ICFR when there are immaterial error corrections disclosed in the filing. The severity of a deficiency depends on whether there is a reasonable possibility that the deficiency could result in a material misstatement. Accordingly, the staff may question whether there is a material weakness in ICFR even though the actual magnitude of the error was not material in amount. In addition, the staff has asked registrants (1) how they assessed the effect of control deficiencies on other components of the COSO framework and (2) to disclose which COSO framework they used to evaluate their ICFR if they have not already made such disclosure.
- *Cash flow statement* — Like past SEC staff comments, recent ones have centered on the appropriate classification of items in the cash flow statement (i.e., the determination of whether particular items should be classified as operating, investing, or financing activities). The process and internal controls related to the preparation of this statement are likely to be topics of future comments given an increase in classification errors. At a recent conference, the SEC staff noted that the errors were generally not attributable to complex fact patterns and cautioned registrants to revisit their processes and related internal controls.

Industry-specific comments to registrants have also been substantial. For example, comments related to the oil and gas industry have focused on (1) understanding how registrants accounted for master limited partnerships, (2) the amount and classification of proved undeveloped reserves, and (3) separate disclosure of natural gas liquid reserves. Registrants in the technology and investment management industries have received comments on how they recognize revenue related to multiple-element arrangements and performance fees, respectively. The SEC staff has asked registrants in the banking industry about disclosures related to the credit quality of their assets, including the sufficiency of their loan loss allowances. Comments to registrants in the retail industry have centered on the need for separate disclosure and analysis of online sales in MD&A.

Financial Statement Accounting and Disclosure Topics

Business Combinations

Purchase Price Allocation

> **Example of an SEC Comment**
>
> Please expand the adjustment notes to disclose, in tabular form, how the purchase price was determined and allocated. . . . Please [also] expand the disclosure to show the allocation of the purchase price to the tangible and intangible assets acquired. Also, for each class of intangibles acquired disclose the related amortization period. Further, disclose the nature of the intangible assets acquired and the factors that make up the goodwill acquired in the [X] acquisition.

The SEC staff frequently asks registrants how they have assigned amounts to assets acquired and liabilities assumed in business combinations. In particular, the staff asks registrants that have recorded a significant amount of goodwill why they have not attributed value to identifiable intangible assets. The staff also compares disclosures provided in press releases, the business section, and MD&A to the purchase price allocation in the financial statements. For example, the SEC staff may ask why a registrant did not recognize a customer-related intangible asset if it discloses in MD&A that it acquired customers in a business combination. In addition, the SEC staff may ask detailed questions about (1) how a registrant determined that intangible assets would have a finite or indefinite useful life; (2) the useful life of identified intangible assets determined to have a finite useful life; and (3) material revisions to the initial accounting for a business combination, including what significant assumptions have changed that support a revision to the value of intangible assets.

Contingent Consideration

> **Example of an SEC Comment**
>
> We note that you agreed to pay an additional $[X] of contingent consideration for earn-out payments based upon performance and milestones. We further note that you determined the fair value of this contingent consideration to be $[Y]. Please revise your filing to clearly explain how you determined the $[Y] fair value for this contingent consideration. Disclose the significant assumptions and how the significant assumptions were determined.

The SEC staff often asks registrants to provide additional disclosures about the nature and terms of a contingent consideration arrangement and the conditions that must be met for the arrangement to become payable. Since ASC 805 requires entities to recognize contingent consideration at fair value as of the acquisition date, the staff may ask registrants to disclose how they determined the fair value of the contingent consideration. In addition, the staff may ask whether the change in the fair value of contingent consideration should be reflected as a retrospective adjustment to the amount of goodwill (i.e., if the adjustment is due to new information identified during the measurement period about facts or circumstances that existed as of the acquisition date) or in current earnings under ASC 805-10-25-13 through 25-19 and ASC 805-10-30-3. The staff may also ask for disclosure of the total amount of contingent consideration that could become payable under the terms of the arrangement.

Bargain Purchases

> **Example of an SEC Comment**
>
> We note your disclosure that you recognized a bargain purchase gain that represents the excess of the fair value of the property and equipment over the amount used to determine the original purchase consideration. Tell us what consideration you gave to discussing the reasons why the transaction resulted in a gain. Refer to ASC 805-30-50-1.f.2. In this regard, further explain to us how the purchase price was determined and why you believe the consideration was acceptable to the seller. Describe the methodology and assumptions used in the valuation of the property and equipment. In addition, please tell us how you considered the guidance in ASC 805-30-25-2 through 25-4.

When a registrant recognizes a gain related to a bargain purchase, the SEC staff will typically comment on how the registrant determined and reassessed the purchase price allocation. A gain from a bargain purchase occurs when the acquisition-date fair value of the identifiable assets acquired and liabilities assumed is greater than the sum of the acquisition-date fair value of (1) the consideration transferred, (2) the noncontrolling interest in the acquiree, and (3) any equity interests previously held by the acquirer. Before recognizing the gain, a registrant is required to perform a reassessment of the bargain purchase gain by verifying that all assets acquired and liabilities assumed were properly identified. The SEC staff has asked registrants to (1) explain their process, (2) provide the results of the reassessment, and (3) disclose that a reassessment was performed.

Disclosures

> **Example of an SEC Comment**
>
> Please revise [your filing] to include all of the disclosures required by ASC 805-10-50 as applicable. For example, it does not appear that you disclosed the revenue and earnings of the combined entity for the comparable prior period as though the acquisition date for all business combination that occurred during [the year indicated] had occurred as of the beginning of the comparable prior annual period (supplemental pro forma information.)

The SEC staff has commented when a registrant fails to provide pro forma disclosures under ASC 805-10-50 about the effects of an acquisition as of the beginning of a reporting period. ASC 805-10-50-2(h)(3) states that the disclosure requirements for comparative financial statements are as follows:

> [F]or a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

In accordance with ASC 805-10-50, registrants must also disclose the nature and amount of material, nonrecurring pro forma adjustments related to the business combinations that are recognized in the reported pro forma information.

If certain criteria are met (e.g., if a significant business combination has occurred or is probable), registrants may also be required to provide pro forma financial information that complies with Regulation S-X, Article 11, in a registration statement, proxy statement, or Form 8-K. For additional information, see the SEC Reporting section.

The SEC staff has also asked registrants:

- Whether an acquisition meets the definition of a business under ASC 805-10-20.
- To indicate which specific elements related to their use of the acquisition method of accounting are not yet complete and why they have not been finalized.
- To identify and disclose the income statement classification of acquisition-related costs they incurred (e.g., due diligence fees, legal fees).
- Whether individually immaterial acquisitions are collectively material, which would require them to disclose certain information.

Consolidation

ASC 810 provides guidance on entities that are subject to consolidation under either the voting interest entity model or the VIE model. Recent SEC comments have focused primarily on the consolidation conclusions reached under the VIE model, including those related to (1) the determination of whether an entity is a VIE, (2) the determination of whether the reporting entity is the primary beneficiary of a VIE, and (3) VIEs in foreign jurisdictions.

Determining Whether an Entity Is a VIE and Whether the Reporting Entity Is a VIE's Primary Beneficiary

Example of an SEC Comment

We note you consolidate the [partnership] and its subsidiaries. Please explain to us in detail your basis for consolidating these entities. If you are within the scope of the Variable Interest Subsections of ASC 810-10-15, please tell us in detail: (i) the basis for your conclusion that the [partnership], by design, is a variable interest entity based on the conditions in ASC 810-15-15-14; (ii) the basis for your conclusion that you have the power to direct the activities of the [partnership] that most significantly impact its economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the [partnership] based on the provisions of ASC 810-10-25-38A through 25-38G; and (iii) your consideration of the disclosure requirements in ASC 810-10-50 related to variable interest entities.

To determine whether it is required to consolidate another entity, a reporting entity must evaluate whether the other entity is a VIE under ASC 810-10 and, if so, whether the reporting entity is the VIE's primary beneficiary. To be the primary beneficiary of a VIE and, therefore, the party that is required to consolidate it, the reporting entity must have (1) the power to direct the activities of the VIE that most significantly affect the VIE's economic performance and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE.[1] The SEC staff continues to focus on consolidation conclusions under ASC 810-10 and often asks registrants to (1) explain their involvement with, and the structure of, VIEs; (2) provide detailed support for their conclusions about whether a structure is a VIE (including the consolidation model they ultimately used); and (3) discuss the basis for their determination of whether they are the primary beneficiary of a VIE.

VIEs in Foreign Jurisdictions

Examples of SEC Comments

- To provide balance and context, please disclose that the registrant is a holding company and clarify that your operational consolidated affiliated entity in the [People's Republic of China (PRC)] includes a variable interest entity holding the [Internet content provider (ICP)] license, material to your business operations and financial results. Disclose that it is through the contractual arrangements that you have effective control, which allows you to consolidate the financial results of the VIE in your financial statements. Disclose that, if your PRC VIE and its shareholders fail to perform their obligations under the contractual arrangements, you could be limited in your ability to enforce the contractual arrangements that give you effective control. Further, if you are unable to maintain effective control, you would not be able to continue to use the material ICP license to operate your business and that you are not eligible as a [foreign investment enterprise] to hold an ICP. Disclose the percentage of revenues in your consolidated financial statements that are derived from your use of the ICP held by the VIE.
- Please disclose all the terms of the various contractual agreements between [Entity A], the trustees, the [wholly foreign-owned enterprise], [Entity B] and [Entity C] such as duration, mutual consent provisions, validity and enforceability of the contracts and any revocability clause. Disclose how these terms convey to you through [Entity A] the power to control [Entity B] and [Entity C] and how the economics are flowing to you before the deconsolidation date. Include any provisions that might limit the ability to exercise power and or whether there are any restrictions on your contractual rights.

[1] Registrants should consider whether consolidating a VIE meets the significance thresholds for reporting under Item 2.01 of Form 8-K and Rule 3-05 of Regulation S-X.

The SEC staff also continues to focus on the consolidation conclusions for overseas VIE arrangements (particularly wholly foreign-owned entities used to invest in China). The SEC staff expects registrants to disclose the critical judgments they made about their involvement with overseas VIEs, such as the validity and enforceability of contracts with the parties involved and whether there are any restrictions on the registrants' contractual rights. Accordingly, the staff may ask registrants to disclose the terms of their significant contractual agreements (e.g., contract duration, mutual consent provisions, renewal rights, or revocability clauses) and how these terms enhance or limit the registrants' ability to exercise power over the foreign VIEs. Further, the staff has indicated that registrants should disclose details about such VIEs, such as their nature, purpose, size, and activities. The SEC staff has also pointed out that registrants' MD&A should (1) describe the economic effects of their involvement with a foreign VIE (e.g., whether material service fees under contractual arrangements are not being settled) and (2) allow investors to assess how registrants would be affected by their deconsolidation of foreign VIEs.[2] At the 2013 AICPA Conference, the SEC staff indicated that it would expect registrants to disclose risk factors related to these structures (e.g., the registrants may have only limited legal protection in China, or there may be restrictions on cash transfers from foreign VIEs).

These expectations overlap significantly with the disclosure requirements in ASC 810-10-50-2AA, under which reporting entities' audited financial statements must provide information about the following:

> a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:
>
> 1. Consolidate a [VIE.]
> 2. Disclose information about its involvement in a VIE.
>
> b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.
>
> c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE.
>
> d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

For additional information, see the Disclosures About Risk section.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

[2] Paragraph 2110.1 of the FRM clarifies that upon deconsolidation of a VIE, registrants should evaluate whether they need to file a Form 8-K for a significant disposition.

Contingencies

Because registrants' contingency disclosures have improved, the SEC staff has commented on this topic less frequently than in prior years. However, the staff continues to monitor registrants' contingency disclosures, and it comments when such disclosures do not comply with U.S. GAAP or SEC rules and regulations.

The staff has continued to comment on the following:

- Lack of specificity regarding the nature of the matter.
- Lack of quantification of amounts accrued, if any, and possible loss or range of loss (or disclosure about why such an estimate cannot be made).
- Lack of disclosure or insufficient detail about what triggered a significant current-period accrual for a contingency when no loss or a significantly lower amount was accrued in prior periods.
- Insufficient detail about judgments and assumptions underlying significant accruals.
- Insufficient detail about (and untimely reporting of) new developments related to loss contingencies and the effect of such developments on current and future periods.
- Inconsistency among disclosures in the footnotes, in other sections of the filing (e.g., risk factors and legal proceedings), and outside the filing (e.g., in press releases and earnings calls). In addition, if different registrants are parties to a claim, the SEC may also review the counterparty's filings and comment if the information is not consistent.
- Use of unclear language in disclosures (e.g., not using terms that are consistent with accounting literature, such as "probable" or "reasonably possible") and failure to consider the disclosure requirements in ASC 450, SAB Topic 5.Y, and Regulation S-K, Item 103.
- Lack of disclosure of an accounting policy related to accounting for legal costs (when material) and uncertainties in loss contingency recoveries, including (1) whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties, (2) risks regarding the collectibility of anticipated recoveries, and (3) the accounting policy for uncertain recoveries.

Loss Contingencies

Example of an SEC Comment

For multiple matters you state that the impact of the final resolution on your results of operations in a particular reporting period is not known. It is not clear for these matters whether there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred. If so, please either disclose an estimate (or, if true, state that the estimate is immaterial in lieu of providing quantified amounts) of the additional loss or range of loss, or state that such an estimate cannot be made. Please refer to ASC 450-20-50.

If you conclude that you cannot estimate the reasonably possible additional loss or range of loss, please supplementally: (1) explain to us the procedures you undertake on a quarterly basis to attempt to develop a range of reasonably possible loss for disclosure and (2) for each material matter, what specific factors are causing the inability to estimate and when you expect those factors to be alleviated. We recognize that there are a number of uncertainties and potential outcomes associated with loss contingencies. Nonetheless, an effort should be made to develop estimates for purposes of disclosure, including determining which of the potential outcomes are reasonably possible and what the reasonably possible range of losses would be for those reasonably possible outcomes.

You may provide your disclosures on an aggregated basis. Please show us in your supplemental response what the revisions in future filings will look like.

Many comments from the SEC staff have focused on comparing current-year disclosures with those in prior-year filings. If a registrant's filing includes disclosures related to a potential contingency, or if the registrant discusses a potential contingency in its earnings calls, the SEC staff is likely to seek more information about the contingency and to inquire about whether the related disclosures are appropriate. The SEC staff encourages registrants to clearly disclose the "full story" regarding their loss contingencies because recognition of such contingencies requires a high degree of professional judgment. Further, the staff has noted that disclosures related to loss contingencies should be continually evaluated over time as facts and circumstances change.

The SEC staff often asks about estimates of potential losses. Questions commonly include whether additional reasonably possible losses have been incurred since the initial disclosure, why the accrual amount for the current year is different from that reported in previous filings, and whether there are any changes in facts and circumstances that may affect the accrual amount. In addition, the SEC staff often comments when a registrant omits disclosure of a loss or range of losses because its estimates lack "precision and confidence." If an estimate of the loss or range of losses cannot be made, the staff expects registrants to demonstrate that they at least attempted to estimate the loss or range of losses before concluding that an estimate could not be made. The staff has also indicated that in such cases, registrants should disclose the specific factors that limited their ability to reasonably estimate the loss and has asked about registrants' quarterly procedures related to such estimates. These factors should be specific to the loss contingency in question and could include representations that (1) claims do not specify an amount of damages, (2) there are a large number of plaintiffs, or (3) the case is in its early stages.

Further, the SEC staff may ask about (1) the basis of a registrant's accrual (e.g., factors supporting an accrual, such as trends in claims received and rejected), (2) the timing of a loss contingency's recognition, and (3) disclosure of a loss contingency. In addition, when a material settlement is disclosed during the period, the staff may review prior-period disclosures to determine whether such disclosures were appropriate (i.e., whether the registrant should have provided early-warning disclosures about the possibility of incurring or settling a loss in future periods to help users understand these risks and how they could potentially affect the financial statements). See the Management's Discussion and Analysis section for additional information about early-warning disclosures.

Litigation Contingencies

Example of an SEC Comment

Although your disclosures . . . indicate that you do not believe you have material potential liability in connection with litigation proceedings, you also disclose that they "could have a material adverse effect." Consistent with ASC 450-20-50-4(b), please disclose the aggregate estimated loss or range of reasonably possible losses in excess of amounts accrued or state that such an estimate cannot be made. If an estimate of reasonably possible additional losses can be made and that amount, both for each individual matter and in the aggregate, is not material to your consolidated financial position, results of operations or cash flows, we will not object to a statement to that effect.

The SEC staff often asks registrants to expand their disclosures about litigation contingencies. If a registrant discloses that the impact of pending or threatened litigation is not expected to be material to its financial statements, the staff is likely to request that the registrant disclose the estimated loss or range of reasonably possible losses in excess of amounts accrued in accordance with ASC 450-20-50-4(b) and SAB Topic 5.Y.[1]

[1] Specifically, the interpretive response to Question 2 of SAB Topic 5.Y indicates that "a statement that the contingency is not expected to be material does not satisfy the requirements of FASB ASC Topic 450 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (a) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (b) state that such an estimate cannot be made."

In addition to complying with ASC 450, public entities must separately meet the requirements of Regulation S-K, Item 103, when disclosing litigation matters because while those requirements are similar to the requirements of ASC 450, they are not identical. Also, to address concerns related to a registrant's contention that providing too much information may be detrimental to efforts to litigate or settle matters, the SEC staff has indicated that registrants do not need to separately disclose each asserted claim; rather, they may aggregate asserted claims in a logical manner as long as the disclosure complies with ASC 450.

Debt

Restrictions

Example of an SEC Comment

We note you disclose that your Senior Notes and European Senior Notes include covenants that limit the Company's ability to cause its restricted subsidiaries to pay dividends or make other payments to the Company. Please tell us if the restricted net assets of the applicable restricted entities exceed 25% of consolidated net assets as of [the end of the most recently completed fiscal year]. If so please tell us how you have complied with the requirement to provide the disclosures required by Rule 4-08(e)(3)(i) and (ii) of Regulation S-X.

When the transfer of assets (cash or other funds) to the parent company/registrant from its subsidiary (or subsidiaries) or equity method investee is materially restricted, limited, or in need of a third party's approval, Regulation S-X, Rules 4-08(e), 5-04, and 12-04, may require:

- Footnote disclosure of the restriction or limitation (Rule 4-08(e)).
- Presentation of condensed parent-company financial data in a financial statement schedule (i.e., Schedule I).
- Both footnote and Schedule I disclosures.

Rule 4-08(e) disclosures are intended to inform investors of restrictions on a registrant's ability to pay dividends or transfer funds within a consolidated group. Such restrictions may result from a contractual agreement (e.g., a debt agreement) or a regulatory body. Without appropriate disclosures of such restrictions, an investor may presume that the registrant (at the parent or subsidiary level) may have more discretion to transfer funds or pay cash dividends than is actually the case.

If Rule 4-08(e) applies, registrants must disclose in the notes to the financial statements a description of "the most significant restrictions, other than as reported under [Rule 4-08(d)], on the payment of dividends by the registrant, indicating their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of restrictions."

Disclosure is also required under Rule 4-08(e)(3) if the total restricted net assets of subsidiaries, plus the parent's equity in the undistributed earnings of 50 percent or less owned entities, exceed 25 percent of consolidated net assets. SAB Topic 6.K provides further guidance on determining the restricted net assets of subsidiaries. Disclosures required under Rule 4-08(e)(3) include:

- The "nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances."
- Separate disclosure of "the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year."

In addition, to give investors separate information about the parent company, registrants are required under Rule 5-04 to file Schedule I "when the restricted net assets [of the registrant's] consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year."

The calculations under Rule 4-08(e) are different from those under Rule 5-04, which governs Schedule I, so registrants must perform both tests to determine what is required. If Schedule I is required, footnote disclosures under Rule 4-08(e) are also required. However, if Rule 4-08(e) disclosures are required, Schedule I may not be required. In addition, a registrant's filing of Schedule I does not necessarily mean that the registrant has satisfied the disclosure requirements of Rule 4-08(e), which are separate and distinct.

Refinancing

> **Example of an SEC Comment**
>
> We note you refinanced your credit facility [on two occasions]. Please tell us how you considered ASC 470-50, Modifications and Extinguishment, for these transactions and provide us with your analysis to determine if the transactions were a modification or extinguishment.

The SEC staff's comments on this topic have focused on registrants' (1) conclusions about whether debt refinancing transactions should be accounted for as debt extinguishments under ASC 470-50 and (2) disclosures about the significant components of the gains or losses recorded on a debt extinguishment and how registrants calculated the components.

Financial Covenant Disclosures

> **Example of an SEC Comment**
>
> Regarding your obtaining a limited waiver of the debt covenants subsequent to [the end of the fiscal quarter], pertaining to limitations on capital expenditures and the Debt Service Coverage (DSC) Ratio, please revise future filings to disclose the specific terms of the covenants, including the actual amounts for each period and the required amounts before and after any revisions or waivers. This will allow readers to understand how much cushion there is between the required and the actual ratios and amounts. Please show the specific computations used to arrive at the actual ratios with corresponding reconciliations to US GAAP amounts, if necessary. Your disclosure should also address the risks and potential consequences of not complying with your debt covenants.

It is important for a registrant to consider providing disclosures about covenant compliance in MD&A to illustrate its financial condition and liquidity. These disclosures may include a discussion of the terms of the most severe covenants and how a registrant has complied with those covenants. In addition, a registrant may present a table that compares its most material actual debt covenant ratios as of the latest balance sheet date with the minimum and maximum amounts permitted under debt agreements. Such transparent disclosures will enable investors to better understand the risk of future covenant noncompliance by the registrant.

For additional discussion on liquidity, see the Management's Discussion and Analysis section.

Classification as Debt or Equity

Under ASC 480, certain financial instruments that embody an obligation of the issuer should be accounted for as liabilities even if their legal form is that of equity or they involve obligations to repurchase or issue the entity's equity shares.

In addition, the guidance in ASC 480-10-S99-3A states that "ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer." ASC 480-10-S99-3A also notes the SEC staff's belief that ASR 268 can be applied analogously to other redeemable instruments.

For additional information on redeemable noncontrolling interests, see the Noncontrolling Interests section.

Consequently, the SEC staff frequently asks registrants with redeemable securities — including registrants undergoing IPO transactions — to support the basis for their classification of such securities as either debt or equity. (See the Initial Public Offerings section for additional considerations for entities undergoing IPO transactions.) In addition, the SEC staff frequently asks registrants about the accounting for conversion features in convertible instruments, including convertible preferred securities. See the Financial Instruments section for considerations regarding embedded conversion features.

Discontinued Operations, Assets Held for Sale, and Restructuring Charges

Discontinued Operations and Assets Held for Sale

Examples of SEC Comments

- Please tell us and disclose the gain or loss recorded upon the sale of your ownership interest in [Component A].
- We note your disclosure that business operations to be divested include the revenues and operating expenses from the recently acquired [Component A] and [Component B] business, both of which were acquired during the year ended September 30, 2013, and which [Company A] intends to divest. Tell us what consideration you gave to classifying these operations as held for sale and presenting as discontinued operations in your financial statements for the year end September 30, 2013, in accordance with ASC 360-10-45-9 and ASC 205-20-45. As part of your response, tell us how you considered the provisions of ASC 350-20-40-4 and 5 in determining the carrying value of any goodwill to be included in the disposal group.

The SEC staff continues to ask registrants whether the operations they have disposed of should be accounted for as discontinued operations. The staff may challenge whether the operations are a "component of an entity" under ASC 205-20. Specifically, it may ask whether the "operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."

Whether components qualify as discontinued operations must be carefully considered, especially when the registrant has cash flows from, or continuing involvement with, the disposed-of operations.[1] In addition, the staff has asked registrants to discuss whether assets meet the held-for-sale criteria in ASC 360 and to explain how they considered the related required disclosures. The staff may inquire about items such as:

- The timeline of events leading to an asset sale.
- The factors used to determine whether to present assets held for sale separately on the balance sheet.
- Sales agreements and how they affected the determination of whether particular assets should be classified as held for sale.

The SEC staff may also question the appropriateness and timeliness of a registrant's impairment tests when assets or components (1) are disposed of, (2) are discontinued, or (3) appear misclassified on the basis of other information in the filing. For example, the staff may ask whether assets that the registrant was expected to sell or dispose of were tested for impairment in prior periods or subject to an impairment charge in the current period (i.e., classified as held for use and thus not recorded at net realizable value). See the Impairments of Goodwill and Other Long-Lived Assets and Management's Discussion and Analysis sections for further discussion of comments on long-lived-asset impairment testing and early-warning disclosures.

The SEC staff has also asked registrants about why they did not disclose the gain or loss on a sale after disposition.[2]

[1] Under ASC 205-20-45-1, when a component has been disposed of or is classified as held for sale, the results of the component's operations must be reported in discontinued operations if (1) the "operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction" and (2) the "entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."

[2] In accordance with ASC 205-20-45-3, gains or losses on disposal transactions "shall be disclosed either on the face of the income statement or in the notes to financial statements."

Restructuring Charges

Example of an SEC Comment

Please revise future filings to more fully disclose and discuss the specific nature of your restructuring activities and their impact and expected impact on future operations. In regard to your 2013 restructuring activities, please revise MD&A in future filings to address these activities and to disclose: the number and nature of the employees to be terminated; the actual number of employees terminated at the most recent balance sheet date; the nature of the other costs; the amount of any annual savings anticipated and when they are expected to be realized; and the amount of any savings actually achieved during the periods presented. Refer to SAB Topic [5.P]. Please show us your proposed revisions in your response.

The SEC staff has inquired about corporate reorganizations and restructurings and registrants' disclosures about such activities. Comments primarily stem from workforce reductions and facility closures. In accordance with ASC 420-10-50-1, registrants should disclose specific information in "notes to financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed." Such information would include a description of the exit or disposal activity, its expected completion date, where in the income statement the amounts are presented, and quantitative information about each major type of cost associated with the activity and about each reportable segment. In addition, under ASC 420-10-50-1(e), when "a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated," registrants should disclose "that fact and the reasons why." The SEC staff has also directed registrants to comply with the guidance in SAB Topic 5.P.4 on disclosures related to material restructuring activities.

Earnings per Share

Two-Class Method

Example of an SEC Comment

We note that you have both Class A and Class B Common Stock outstanding. Tell us what consideration you have given to the two-class method for computing basic and diluted earnings per share for each class of your common stock. We refer you to ASC 260-10-45-60B(d). To the extent that earnings per share would not differ under the two-class method, please revise your disclosures in future filings to indicate as such.

Under ASC 260-10-45-59A, the two-class method applies to the following securities:

a. Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share)

b. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

When a filing indicates that the registrant has two classes of common stock (or has other participating securities) that are treated as one class in the calculation of EPS, the SEC staff often asks whether the registrant considered the two-class method in computing EPS under ASC 260-10-45-59A through 45-70.

The SEC staff may ask a registrant to substantiate the method used to calculate EPS (e.g., the two-class method or the if-converted method). Further, the staff may request additional information or disclosures about each of the registrant's classes of common stock, preferred stock, and common-stock equivalents (such as convertible securities, warrants, or options).

Regarding the treatment of convertible instruments, the SEC staff expects that a registrant with two classes of common stock will present both basic and diluted EPS for each class regardless of conversion rights. See the Debt and Financial Instruments sections for more information about conversion features.

The SEC staff has focused on understanding the terms of registrants' arrangements regarding (1) classes and types of common (or preferred) stock, (2) such stock's dividend rates, and (3) the rights and privileges associated with each class (or type) of stock. When the registrant has preferred shares, the SEC staff may seek to determine whether the preferred stockholders have contractual rights to share in profits and losses of the registrant beyond the stated dividend rate. Similarly, the SEC staff may ask registrants about the dividend rights of restricted stock unit awards or other share-based payment awards and how they are considered with regard to the EPS calculation.

EPS Disclosures

Example of an SEC Comment

Please revise [your footnote] to disclose the number of stock options, restricted shares and other securities that could potentially dilute your basic earnings per share in the future that were not included in the computation of diluted earnings per share for the periods presented because to do so would have been antidilutive for the periods presented. If there were no such securities outstanding during the periods presented, please state this in [your footnote]. Refer to the guidance outlined in ASC [260-10-50].

The SEC staff may also comment on whether a registrant has met the requirements of ASC 260-10-50-1, under which an entity must disclose all of the following for each period in which an income statement is presented:

> a. A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations. . . .
>
> b. The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
>
> c. Securities . . . that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented.

In addition, the SEC staff may ask registrants to elaborate on their calculation of EPS by disclosing:

- How unvested shares, unvested share units, unvested restricted share units, and performance shares are treated in basic and diluted EPS.
- Whether unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (paid or unpaid) are treated as participating securities and factored into the calculation of EPS.
- The nature of incentive distribution rights.

Fair Value

The SEC staff continues to ask registrants about the sufficiency of disclosures for fair value measurements that rely on unobservable inputs and on the use of third-party pricing services.

Disclosures Related to Unobservable Inputs

Quantitative and Qualitative Information

Example of an SEC Comment

You disclose the range of significant unobservable inputs used in developing the fair value of your Level 3 positions. Given the wide range of the forward market price assumptions, please tell us your consideration of disclosing the weighted average of the forward market prices, similar to the illustration provided in ASC 820-10-55-103, and your basis for calculating the weighted average. Please also tell us what consideration was given to providing a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. Please refer to ASC 820-10-50-2(bbb) and (g).

Although ASC 820 requires entities to disclose the significant unobservable inputs used in Level 3 fair value measurements, it contains no explicit guidance on the types of quantitative information an entity should disclose to meet such a requirement. However, the example in ASC 820-10-55-103 illustrates quantitative information an entity "might disclose" to meet the requirement under ASC 820-10-50-2(bbb). According to the example, such information includes the entity's valuation technique, its significant unobservable inputs, and the range and weighted average of those inputs.

Some may have interpreted from the example in ASC 820-10-55-103 that an entity is not required to disclose the weighted average of significant unobservable inputs used in a Level 3 fair value measurement. However, the SEC staff may inquire about weighted averages when registrants do not disclose them.[1] The SEC staff has suggested that a registrant could instead present qualitative information about the distribution of the range of values if a weighted average would not be meaningful. Ideally, such qualitative disclosures would address each significant input and describe the reason for the wide range, the drivers of dispersion (e.g., a particular position or instrument type), and data point concentrations within the range. For additional information about unobservable inputs used to determine fair value, see the Investment Management section.

Sensitivity of Level 3 Measurements

Example of an SEC Comment

[T]here is no information about the sensitivity of a fair value measurement of Level 3 assets to changes in unobservable inputs and any interrelationships between those unobservable inputs. See ASU 2011-04.

The SEC staff continues to comment when a registrant omits disclosures about the sensitivity of Level 3 measurements and may ask for disclosures about changes in significant unobservable inputs to be more granular and transparent. In addition, the staff has noted that it may be helpful for registrants to discuss the specific inputs that changed in the sensitivity analysis and the effect of changing those significant unobservable inputs.

[1] Such inquiries are consistent with SEC staff remarks at the 2012 AICPA Conference. For more information about the conference, see Deloitte's December 11, 2012, *Heads Up*.

Use of Third-Party Pricing Services

Example of an SEC Comment

We note you use third party pricing services and broker quotes to price your securities. Please tell us and revise MD&A disclosures in future filings to address the following areas:

- The number of quotes or prices you generally obtain per instrument, and if you obtain multiple prices, how you determine the ultimate value you use within your financial statements.
- Whether and if so, how and why, you adjusted prices or quotes you obtained from pricing services and brokers.
- The extent to which the brokers or pricing services are gathering observable market information as opposed to using unobservable inputs and/or proprietary models in making valuation judgments and determinations.
- Whether the broker quotes are binding or non-binding
- Describe any procedures you perform to validate the prices you obtain to ensure the fair value determination and its categorization within the fair value hierarchy is consistent with Topic 820 of the Accounting Standards Codification.

The SEC staff continues to ask registrants to describe the procedures they perform to validate fair value measurements obtained from third-party pricing services. The staff has also asked registrants to clarify when and how often they use adjusted rather than unadjusted quoted market prices and to disclose why prices obtained from pricing services and securities dealers were adjusted. If multiple quotes were obtained, the SEC staff may request information about how the registrant determined the ultimate value used in the financial statements.

Financial Instruments

Because of the complexity associated with determining whether certain financial instruments should be accounted for as derivatives, debt instruments, or equity, SEC staff comments related to financial instruments have focused on (1) accounting for embedded derivatives in hybrid instruments,[1] (2) classification of warrants, and (3) calculation of beneficial conversion features (BCFs).

Embedded Derivatives in Hybrid Financial Instruments

Examples of SEC Comments

- We note . . . that the company has performed analysis of [convertible preferred stock] and concluded that the embedded conversion feature does not need to be bifurcated and separately accounted for as a derivative as the conversion option is clearly and closely related to the economic characteristics of common equity and in turn, the host contract. . . . Please provide your analysis of the evaluation of the economic characteristics, risks and terms of the conversion option and the host contract to support your conclusion that the host contract is more akin to an equity host.
- Certain corporate bonds carry a make whole call provision and a par call provision. Please expand your disclosures to discuss the key terms of each of these provisions and any impact of these provisions on your accounting for the corporate bonds. Please also tell us what consideration you gave to the accounting impact of these provisions, including your consideration of ASC 815 in regards to the make whole call provision.

The SEC staff continues to focus on whether registrants have reached appropriate accounting conclusions regarding whether embedded features in hybrid instruments should be bifurcated from the host contract. ASC 815-15-25 provides guidance on whether an embedded feature (e.g., a purchased put option embedded in a company’s preferred stock) should be separated from the host contract and accounted for as a stand-alone derivative instrument in accordance with ASC 815-10. If it is determined that an embedded feature is not clearly and closely related to the host contract, the embedded feature may need to be bifurcated from the host contract depending on whether certain other criteria are met and whether the embedded feature qualifies for any scope exceptions. For example, if the features in a hybrid instrument are predominantly debt-like, the entity would conclude that the host contract is more akin to debt; in such a case, an equity-like feature (e.g., a conversion option) would not be considered clearly and closely related to a debt host. Given the complexity involved in determining whether a host contract is debt-like or equity-like, registrants can expect the SEC staff to continue asking about the terms and features of convertible instruments to determine whether the registrant has (1) properly determined the nature of the host contract and (2) accounted for embedded features as stand-alone financial instruments when necessary.

Classification of Warrants

Example of an SEC Comment

Tell us why equity classification for the warrants [is] appropriate and reference the authoritative literature you rely upon to support your accounting.

If certain criteria are met, warrants issued in connection with debt and equity offerings are accounted for on a separate basis (i.e., as a freestanding financial instrument[2]). Under U.S. GAAP, an issuer of a stock purchase warrant is required to first determine whether the warrant should be classified as a liability under ASC 480. If the warrant is not classified as a liability under ASC 480, its classification as either debt or equity hinges on whether the instrument meets the definition of a derivative and qualifies for any scope exceptions under ASC 815-10-15. When a warrant is accounted for as a freestanding financial instrument,

[1] The ASC Master Glossary defines a hybrid instrument as a “contract that embodies both an embedded derivative and a host contract.”

[2] The ASC Master Glossary defines a freestanding financial instrument as a financial instrument that either (1) “is entered into separately and apart from any of the entity’s other financial instruments or equity transactions” or (2) “is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.”

the manner in which offering proceeds are allocated to the issued instrument and to the warrant depends on whether the warrant is classified as an equity instrument or as a liability instrument. Consequently, the SEC staff has asked registrants to explain the basis for their determination of how warrants should be classified, including the application of relevant accounting literature.

Calculation of BCFs

Examples of SEC Comments

- Please submit the analyses you performed in determining whether these classes of preferred shares contain [BCFs].
- Please tell us how you calculated the [BCF] you recorded in connection with the issuance of [convertible shares]. Further, please provide to us your accounting analysis which supports recognizing the BCF as a non-cash distribution that is recognized ratably from the issuance date through the conversion date in equity.

The SEC staff frequently comments on the recognition and calculation of BCFs. ASC 470-20 requires the issuer of a convertible security to measure the amount of any embedded BCF at the intrinsic value of the embedded conversion option, which is computed on the basis of the effective conversion price (i.e., the issuer computes the intrinsic value of the embedded conversion option by multiplying (1) the amount by which the fair value of the common stock or other securities into which the security is convertible exceeds the effective conversion price by (2) the number of shares into which the security is convertible). Accordingly, registrants can expect the SEC staff to ask how they calculated the value of a BCF that was recorded in connection with the issuance of a hybrid financial instrument. In addition, the SEC staff frequently asks registrants to provide the accounting analysis that supports the BCF calculation.

Financial Statement Classification, Including Other Comprehensive Income

The SEC staff frequently comments on registrants' classification of items in the financial statements, namely on whether their balance sheets, income statements, statements of cash flows, and statements of comprehensive income comply with the requirements of Regulation S-X and U.S. GAAP.

Balance Sheet Classification

Separate Presentation

> **Example of an SEC Comment**
>
> We note that over 10% of total current liabilities are aggregated into other accrued expenses for each period presented. Please revise future filings to separately state any current liabilities that exceed 5% of total current liabilities, as applicable. Refer to Rule 5-02.20 of Regulation S-X.

Under Regulation S-X, Rule 5-02, registrants should state separately on the face of the balance sheet or in a note to the financial statements (1) other current assets and other current liabilities in excess of 5 percent of total current assets and total current liabilities, respectively, and (2) other noncurrent assets and other noncurrent liabilities in excess of 5 percent of total assets and total liabilities, respectively. The SEC staff may ask a registrant to confirm whether the reported balances of other current assets and liabilities or other noncurrent assets and liabilities include any items in excess of 5 percent of total current assets and liabilities or total assets and liabilities, respectively. If the registrant confirms that any such items are included, the SEC staff will ask the registrant to state those items individually on the face of the balance sheet or in the notes.

Current Versus Noncurrent Classification

> **Example of an SEC Comment**
>
> [T]ell us how you considered the guidance in ASC 210-10-45-4 as it appears that this receivable balance has been outstanding longer than one year.

Many of the SEC staff's comments have addressed registrants' classification of current and noncurrent assets and liabilities, including debt. When presenting a classified balance sheet, registrants should consider the guidance in ASC 210-10-45 and other applicable accounting literature to determine whether an item should be classified as current or noncurrent. The SEC staff may ask a registrant to explain an item's classification and presentation or to reclassify an asset or liability appropriately.

Income Statement Classification

The SEC staff has commented on registrants' compliance with the technical requirements of Regulation S-X, Rule 5-03, which lists the captions and details that commercial and industrial registrants must present in their income statements. For example, the SEC staff has asked registrants to explain why they have excluded certain line items required by Rule 5-03 from the face of their income statements.

Because the guidance on classification of income and expense items lacks specificity, classification is often established through practice and the SEC comment process. The SEC staff has reminded registrants that when alternative classifications are permissible, they should disclose their policies and apply them consistently in accordance with ASC 235-10.

Separate Presentation

Example of an SEC Comment

We note from the disclosures that have been provided in Note 1 that the Company's revenues include revenues from both the provision of services and the sale of products. To the extent that your revenues from the sale of products [exceed] ten percent of your total revenues during the periods presented in your financial statements, please revise your consolidated statements of operations to provide separate disclosure of the revenues and related costs associated with revenues derived from sales of products and services. Refer to the guidance outlined in [Rule 5-03(b)(1)] of Regulation S-X.

The SEC staff frequently comments when registrants omit certain captions required by Rule 5-03 from the face of their income statements. It has asked registrants to explain their consideration of Rule 5-03 and to revise their income statement presentation accordingly. For example, the SEC staff has commented on the distinction between product and service revenue. If product or service revenue is greater than 10 percent of total revenue, the registrant must disclose such component as a separate line item on the face of the income statement. Costs and expenses related to these revenues should be presented in the same manner.

Cost of Sales

Example of an SEC Comment

In future filings, please revise your footnote disclosures to clarify, if true, that you allocate a portion of your depreciation and amortization to cost of goods sold. If you do not allocate a portion to cost of goods sold, please tell us how you considered the guidance in SAB Topic 11.B, including depreciation and amortization not being positioned in your statement of operations in a manner which results in reporting a figure for income before depreciation like gross margin. Please provide us your proposed disclosures.

The SEC staff often asks registrants to disclose the types of expenses that are included in or excluded from the cost-of-sales line item, in particular whether distribution costs are included in cost of sales. It may ask registrants to disclose the line item in which such costs are recorded as well as whether their gross margins are comparable to those of other registrants. The SEC staff has also commented on registrants' allocation of depreciation and amortization to cost of sales. SAB Topic 11.B states, in part:

> If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." . . . [D]epreciation, depletion and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation.

Most of the SEC staff's comments on this matter have stemmed from registrants' lack of awareness or incorrect application of the guidance in SAB Topic 11.B, particularly their inappropriate reporting of an amount for gross profit before depreciation and amortization.

Operating Versus Nonoperating Income

Example of an SEC Comment

We note you recorded $[X] as a gain on the sale of certain [assets] that were included in the previous . . . business segment, and have reflected the gain as non-operating income. Please explain why the gain is not included in operating income.

The SEC staff has commented about items that registrants have included in, or excluded from, operating income. Under Rule 5-03, a subtotal line item for operating income is not required on the face of the income statement. However, if a registrant presents a subtotal for operating income, it should generally present the following items (which are sometimes incorrectly excluded) in operating income:

- Gains or losses on asset sales.
- Litigation settlements.
- Insurance proceeds.
- Restructuring charges.

The following items should generally be excluded from operating income (but are sometimes incorrectly included):

- Dividends.
- Interest on securities.
- Profits on securities (net gains or losses).
- Interest and amortization of debt discount and expense.
- Earnings from equity method investments (or unconsolidated affiliates).
- Noncontrolling interest in income of consolidated subsidiaries.

Cash Flow Statement Classification

Category Classification

Example of an SEC Comment

You classify dividends received by the parent company as cash inflows from investing activities. Please tell us why you classified these cash inflows to the parent company as investing cash flows as opposed to operating cash flows. Please refer to ASC 230-10-45-16 (b) for specific guidance on how to classify dividends received on a statement of cash flows.

Many of the SEC staff's comments are related to misclassification among the three cash flow categories: operating, investing, and financing. ASC 230 distinguishes between returns **of** investment, which should be classified as inflows from investing activities (see ASC 230-10-45-12(b)), and returns **on** investment, which should be classified as inflows from operating activities (see ASC 230-10-45-16(b)). In the absence of specific facts and circumstances to the contrary, dividends should be presumed to be returns **on** investment and classified as cash inflows from operating activities. Under ASC 230-10-45-16(b), cash inflows from operating activities include "[c]ash receipts from returns on loans, other debt instruments of other entities, and equity securities — interest and dividends."

At the September 2014 AICPA Banking Conference, the SEC staff noted that it has observed an increased number of classification errors in registrants' statements of cash flows. Further, such errors are generally not attributable to complex fact patterns. The SEC staff speculated that the errors may be occurring because registrants (1) are relying on manually used spreadsheets instead of automated processes to prepare their statements of cash flows and (2) are preparing their statements of cash flows late in the financial reporting process. Accordingly, the staff cautioned registrants to revisit their processes and internal controls associated with the preparation of their statements of cash flows. For information about SEC staff comments on how registrants' errors could affect their conclusions about DCP and ICFR, see the Disclosure Controls and Procedures and Internal Control Over Financial Reporting sections.

Net Versus Gross Presentation

> **Example of an SEC Comment**
>
> Please note that intercompany investing activities and intercompany long-term financing activities are required to be presented gross, not net. . . . See ASC 230-10-45.

The SEC staff may challenge whether it is appropriate to report the net amount of certain cash receipts and cash payments on the face of the statement of cash flows. ASC 230-10-45-7 through 45-9 state that although reporting gross cash receipts and cash payments provides more relevant information, in certain instances financial statement users may not need gross reporting to understand certain activities. The SEC staff may ask a registrant to revise the presentation or to explain (in accordance with ASC 230) why it is more appropriate to report certain cash flows on a net basis rather than on a gross basis.

Comprehensive Income

Entities are required to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements.

Presentation of Tax Effects

> **Example of an SEC Comment**
>
> Please tell us your consideration of disclosing in the notes to the financial statements the gross changes, along with the related tax expense or benefit, of each classification of other comprehensive income. Refer to ASC 220-10-45-12 and 220-10-45-17.

The SEC staff has also commented on ASC 220-10-45-12, which requires entities to "present the amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments." Entities must present such information each reporting period either on the face of the statement where the OCI is presented or in the footnotes.

Foreign Currency

Quantification of Foreign Currency Adjustments

> **Example of an SEC Comment**
>
> You indicate . . . that increases in the value of the U.S. dollar relative to other currencies may adversely affect your business, results of operations and financial condition. Please address the need to expand your segment discussions to address the impact that changes in the value of the U.S. dollar relative to other currencies had on segment sales and adjusted operating profit for each period presented.

The SEC staff's comments on quantitative disclosures related to foreign currency adjustments reflect its guidance[1] on the topic, under which registrants should:

- "[R]eview management's discussion and analysis and the notes to financial statements to ensure that disclosures are sufficient to inform investors of the nature and extent of the currency risks to which the registrant is exposed and to explain the effects of changes in exchange rates on its financial statements."
- Describe in their MD&A "any material effects of changes in currency exchange rates on reported revenues, costs, and business practices and plans."
- Identify "the currencies of the environments in which material business operations are conducted [when] exposures are material."
- "[Q]uantify the extent to which material trends in amounts are attributable to changes in the value of the reporting currency relative to the functional currency of the underlying operations [and analyze] any materially different trends in operations or liquidity that would be apparent if reported in the functional currency."

The foreign operations of many registrants may be subject to material risks and uncertainties that should be disclosed, including those related to the foreign jurisdiction's political environment, its business climate, currency, and taxation. The effects on a registrant's consolidated operations of an adverse event related to these risks may be disproportionate relative to the size of the registrant's foreign operations. Therefore, the registrant's segment information or MD&A may need to describe the trends, risks, and uncertainties related to its operations in individual countries or geographic areas and possibly supplement such disclosures with disaggregated financial information about those operations.

A registrant's assessment of whether it needs to provide disaggregated financial information about its foreign operations in its MD&A would need to take into account more than just the percentage of consolidated revenues, net income, or assets contributed by foreign operations. The registrant also should consider how the foreign operations might affect the consolidated entity's liquidity. For example, a foreign operation that holds significant liquid assets may have an exposure to exchange-rate fluctuations or restrictions that could affect the registrant's overall liquidity.

Disclosures About Venezuelan Operations

The SEC staff continues to focus on accounting and disclosure considerations related to the foreign currency exchange environment in Venezuela. Entities currently may be able to convert Venezuelan bolivar fuertes (BsF) to U.S. dollars at one of three legal exchange rates obtained via four exchange-rate mechanisms. Business operations in Venezuela may give rise to accounting questions about (1) which exchange rate is appropriate for remeasurement, (2) whether certain BsF-denominated monetary assets should be classified as noncurrent in a classified balance sheet, and (3) whether such operations should be deconsolidated or considered impaired. At the June 27, 2014, FASAC meeting, the SEC staff acknowledged that there is little guidance on which exchange rate an entity should use in a multiple-rate environment. The SEC staff advised registrants to disclose the exchange rates used and their thought processes in selecting the rate.

[1] Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, Section II.J.

Accordingly, registrants should consider providing disclosure in the notes to the financial statements as well as in the Description of Business, Risk Factors, and MD&A sections of their SEC filings. The SEC staff has informally indicated that additional disclosures related to a registrant's Venezuelan operations may be warranted if such operations are material. It has also provided certain disclosure recommendations, which can be found in Deloitte's Financial Reporting Alert 14-1.[2]

[2] Financial Reporting Alert 14-1, "Foreign Currency Exchange Accounting Implications of Recent Government Actions in Venezuela."

Impairments of Goodwill and Other Long-Lived Assets

Goodwill

Disclosures

Example of an SEC Comment

We note that during the second quarter of fiscal 2014, you forecasted a significant decline in revenue and operating revenue related to certain reporting units within your [X] reporting segment, which resulted in an interim evaluation of your goodwill for potential impairment. Tell us the percentage by which the fair value exceeded the carrying value for your [X] reporting segment at the time of your evaluation. Also, to the extent that you have determined the estimated fair value substantially exceeds the carrying value for your reporting units, please disclose this determination in future filings. Alternatively, if the estimated fair value for any of your reporting units is not substantially in excess of the carrying value and is potentially at risk of failing step one of your goodwill impairment analysis, please tell us and disclose the following in future filings:

- [T]he percentage by which the fair value of the reporting unit exceeded the carrying value as of the date of the most recent test;
- [D]iscuss the degree of uncertainty associated with the key assumptions; and
- [D]escribe the potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions used in determining fair value.

Section 9510 of the FRM discusses the SEC staff's views on when goodwill impairment disclosures in the critical accounting estimates section of MD&A are appropriate and the extent of such disclosures. The SEC staff has commented on a registrant's compliance with the disclosure requirements in Regulation S-K, Rule 303(a)(3)(ii), to discuss a known uncertainty — specifically, to disclose the potential for a material impairment charge — in light of potential impairment triggers. The staff has noted that it may use these disclosures to assess whether a registrant's goodwill impairment analysis is reasonable or whether the registrant should have performed an interim goodwill impairment analysis.

While registrants often provide the appropriate disclosures before incurring an impairment charge, the SEC staff has noted instances in which registrants did not disclose the specific events and circumstances that led to the charge in the period of impairment. After performing an interim impairment test, a registrant should consider disclosing (1) that it performed the test, (2) the event that triggered the test, and (3) the test result, even if it passed the test. Further, registrants should avoid attributing the impairment charge to general factors such as "soft market conditions" or expected reductions in sales price or sales volume. Instead, the disclosures should discuss (1) why the changes occurred, (2) why the change in forecasts or results occurred in the particular period of the impairment charge, and (3) what known developments or other doubts could affect the reporting unit's fair value estimate.

Reporting Units

Example of an SEC Comment

We have reviewed your analysis of whether the components have similar economic characteristics to aggregate each of your reporting units. Please provide the following for [each of your] reporting units:

- [T]he level of variation between the products and services offered by each of the component businesses within each [of the] reporting units[;]
- [A]dditional information as to the manner in which you operate each component business and the nature of the resources and services shared amongst the component businesses related to operational management, equipment and intellectual resources[;]
- [C]ontrast the shared activities discussed in response to the bullet above with the types of activities that are not shared among the components of each reporting unit;
- [E]xplain which of the qualitative factors you weighted most heavily in your analysis to conclude that the components should be aggregated; and
- [T]he financial information regularly reviewed by segment management to assess performance.

The SEC staff continues to comment on asset grouping for goodwill impairment testing (e.g., the identification and composition of reporting units), especially when a registrant does not clearly disclose that it tests goodwill at the reporting-unit level or when changes appear to have been made to a registrant's reportable segments (e.g., as the result of a reorganization or acquisition). Given the interaction between the guidance on reporting units in ASC 350-20 and the guidance on operating segments in ASC 280, the staff may also ask questions to better understand (1) how the reporting units were identified; (2) how many reporting units were identified; (3) how the reporting units align with the registrant's segment reporting; (4) whether and, if so, how the registrant aggregated reporting units to perform goodwill impairment testing; and (5) how the fair value of the reporting units was determined.

Interim Impairment Tests

Example of an SEC Comment

You disclose that during the fourth quarter ended January 31, 2013, you concluded there were indicators of potential goodwill impairment. As a result, you updated your goodwill impairment as of January 31, 2013 and recorded a goodwill impairment charge of $[X]. Please tell us how circumstances changed in the fourth quarter from the second quarter when you performed you annual impairment testing and the third quarter, and the factors that existed in the fourth quarter to trigger the impairment charge in the fourth quarter that did not exist or were not reasonably foreseen in the second and third quarters. Also, tell us your assessment of the circumstances that existed in the third quarter and your conclusion at that time with respect to the prospect that impairment charges may be forthcoming. Additionally, tell us the three reporting units for which the carrying values including goodwill exceeded their fair values and how much the carrying value exceeded the fair value for each.

ASC 350-20 requires entities to test goodwill for impairment annually and also between annual tests if facts and circumstances indicate that goodwill may be impaired. The SEC staff has asked registrants about negative trends that could trigger the requirement to test for impairment between annual tests and often asks them to describe the events leading up to the recording of an impairment charge, including how circumstances changed from prior quarters and from when the registrant had performed its previous annual goodwill impairment test. The SEC staff may also request an explanation of how the impairment had not been reasonably foreseen during management's prior-period assessments. Specifically, the staff may question why management did not identify an impairment during a previous quarter.

Other Long-Lived Assets

In its comments on impairments of long-lived assets, the SEC staff may ask a registrant that is recording, or is at risk of recording, impairment charges to either disclose or inform the SEC staff about the following:

- The adequacy and frequency of the registrant's asset impairment tests, including the date of its most recent test.
- The factors or indicators (or both) used by management to evaluate whether the carrying value of other long-lived assets may not be recoverable.
- The methods and assumptions used in impairment tests, including how assumptions compare to recent operating performance, the amount of uncertainty associated with the assumptions, and the sensitivity of the estimate of fair value of the assets to changes in the assumptions.
- The timing of the impairment, especially if events that could result in an impairment had occurred in periods before the registrant recorded the impairment. In these circumstances, the SEC staff may ask registrants to justify why the impairment was not recorded in the previous period.
- The types of events that could result in impairments.
- In the critical accounting policies section of MD&A, the registrant's process for assessing impairments.
- The facts and circumstances that led to the impairments, along with a reminder that a registrant may be required to disclose in MD&A risks and uncertainties associated with the recoverability of assets in the periods before an impairment charge is recorded. For example, even if an impairment charge is not required, a reassessment of the useful life over which depreciation or amortization is being recognized may be appropriate.

Other Deloitte Resources

- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Income Taxes

The SEC staff's comments about income taxes continue to focus on (1) disclosure of potential tax and liquidity ramifications related to the repatriation of foreign earnings, (2) valuation allowances, (3) rate reconciliation disclosures, and (4) unrecognized tax benefits. More recently, the staff has asked registrants to support situations in which their valuation allowances were reduced or reversed.

The staff continues to ask registrants to provide early-warning disclosures to help users understand these items and how they potentially affect the financial statements. For additional information about early-warning disclosures, see the Management's Discussion and Analysis section.

Repatriation of Foreign Earnings and Liquidity Ramifications

Example of an SEC Comment

We note . . . you hold . . . undistributed earnings in non-U.S. subsidiaries that you plan to reinvest outside the U.S. indefinitely. [P]lease tell us the amount of cash and equivalents and liquid investments held by your foreign subsidiaries . . . and quantify the amount that would not be available for use in the U.S. without incurring U.S. taxes. . . . Further, as we note . . . that the majority of your net long-lived assets are in the U.S., please discuss for us the impact on your liquidity and capital positions if cash and cash equivalents as well as liquid investments held by your foreign subsidiaries were not available for use in the U.S. Similarly, discuss the impact of income tax liabilities you would incur if you were to repatriate the cash and cash equivalents as well as liquid investments held by your foreign subsidiaries to the U.S.

In accordance with ASC 740, when the earnings of a foreign subsidiary are indefinitely reinvested, registrants should disclose the nature and amount of the temporary difference for which no deferred tax liability (DTL) has been recognized as well as the changes in circumstances that could render the temporary difference taxable. In addition, registrants should disclose either (1) the amount of the unrecorded DTL related to that temporary difference or (2) a statement that determining that liability is not practicable.

Registrants may need to repatriate cash from foreign subsidiaries. ASC 740-30-25-19 states that "[i]f circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance."

The SEC staff continues to (1) ask for additional information when registrants claim that it is not practicable to determine the amount of unrecognized DTL and (2) request that registrants expand disclosures in MD&A about their indefinitely reinvested foreign earnings. In addition, the staff has indicated that it evaluates such an assertion by taking into account registrants' potential liquidity needs and the availability of funds in U.S. and foreign jurisdictions.

Disclosures in an MD&A liquidity analysis should include the following:

- The amount of cash and short-term investments held by foreign subsidiaries that would not be available to fund domestic operations unless the funds were repatriated.
- A statement that the company would need to accrue and pay taxes if repatriated.
- If true, a statement that the company does not intend to repatriate those funds.

Valuation Allowances

Examples of SEC Comments

- Your disclosure indicates that it is generally difficult for positive evidence regarding projected future taxable income, exclusive of reversing taxable temporary differences, to outweigh objective negative evidence of recent financial reporting losses. Given your two years of recent losses, please tell us and revise future filings, including your next quarterly filing, to address the following:
  - [P]rovide a more robust discussion of the specific factors you considered in determining that no additional valuation allowance for deferred tax assets is necessary, including the reasons why you expect to return to profitability in FY 2014;
  - [D]isclose the amount of taxable income you are required to generate and the time period over which you are required to generate it to fully realize your deferred tax assets; and
  - [D]isclose the potential impact on your financial statements if you determine you will not return to profitability in FY 2014.
- We note your disclosure stating that after considering all available positive and negative evidence, you reversed $[X] of the remaining valuation allowance on your [Country A] and [Country B] deferred tax assets . . . , as you determined that it was more likely than not that these benefits would be realized.

  Given the impact of the reversal of the valuation allowance on your [net income], please provide draft disclosure to be included in future filings that expands discussion on the material positive and negative evidence you considered, along with how it was weighted, in determining that it is more likely than not that your deferred tax assets will be realized. Your response should provide a detailed analysis regarding how you determined [the] realization of the [Country B] deferred tax asset. Specifically address the positive and negative evidence considered for your [Country B] subsidiary . . . . Refer to the guidance in ASC 740-10-30-16 through 30-25.

ASC 740-10-30-5(e) requires entities to reduce deferred tax assets (DTAs) by "a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the [DTAs] will not be realized. The valuation allowance shall be sufficient to reduce the [DTA] to the amount that is more likely than not to be realized." ASC 740-10-30-16 through 30-23 provide additional guidance. In light of this guidance, the SEC staff has commented when registrants' filings indicate that no valuation allowance has been recorded, or when it seems that the valuation allowance recorded is insufficient. More recently, the staff has asked registrants about reversals of, or other changes in, their valuation allowances.

The staff has reminded registrants that in assessing the realizability of DTAs, they should consider cumulative losses in recent years to be significant negative evidence and that to avoid recognizing a valuation allowance, they would need to overcome such evidence with significant objective and verifiable positive evidence.

The SEC staff has indicated that factors for registrants to consider in making a determination about whether they should reverse a previously recognized valuation allowance would include:

- The magnitude and duration of past losses.
- The magnitude and duration of current profitability.
- Changes in the above two factors that drove losses in the past and those currently driving profitability.

Further, the staff has noted that registrants should bear in mind that the goal of the assessment is to determine whether sufficient positive evidence outweighs existing negative evidence. The staff has emphasized the importance of evidence that is objectively verifiable and has noted that such evidence carries more weight than evidence that is not. In addition, registrants should (1) assess the sustainability of profits in the current economic environment and (2) consider their track record of accurately forecasting future financial results. Doubts about the sustainability of profitability in a period of economic uncertainty may give rise to evidence that is less objectively verifiable. Likewise, a registrant's poor track record of accurately forecasting future results would also result in future profit projections that are less objectively verifiable. Thus, such evidence would carry less weight in a valuation allowance assessment.

The SEC staff has also pointed out that registrants' disclosures should include a discussion of the specific factors or reasons that led to a reversal of a valuation allowance to effectively answer the question "why now." Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the registrant weighed each piece of evidence in its assessment. In addition, the SEC staff has reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

For example, at the 2013 AICPA Conference, the SEC staff discouraged registrants from providing "boilerplate disclosures" and instead recommended that they discuss registrant-specific factors (e.g., limitations on their ability to use net operating losses and foreign tax credits). The SEC staff also stated that it has asked registrants to disclose the effect of each source of taxable income on their ability to realize a DTA, including the relative magnitude of each source of taxable income. In addition, the staff recommended that registrants consider disclosing the material negative evidence they evaluated since such disclosure could provide investors with information about uncertainties related to a registrant's ability to recover a DTA.

Rate Reconciliation

Example of an SEC Comment

We note your effective tax rate . . . compared to the prior year effective tax rate decreased [X]% due to changes in the geographical mix of income, among other reasons. If changes in the geographical mix of income were a significant driver of the decrease in your effective tax rate, please explain to us and disclose the facts and circumstances leading to the changes in the geographical mix of income and whether you expect these changes to continue. In this regard, an overview of how your effective tax rate may be impacted by a mix of earnings among your domestic and foreign operations would appear useful to an investor. We refer you to Item 303(a)(3)(i) of Regulation S-K and Section III.B of SEC Release No. 33-8350.

In accordance with ASC 740 and Regulation S-X, Rule 4-08(h)(2), registrants must disclose a reconciliation that uses percentages or dollar amounts of income tax expense or benefit attributable to continuing operations with the amount that would have resulted from applying domestic federal statutory tax rates (the regular rate, not the alternative minimum tax rate) to pretax income from continuing operations. Further, registrants should disclose the estimated amount and the nature of each significant reconciling item. ASC 740-10-50 does not define "significant." However, Rule 4-08(h) states that public entities should disclose (on an individual basis) all reconciling items that constitute 5 percent or more of the computed amount (i.e., income before tax multiplied by the applicable domestic federal statutory tax rate). Reconciling items may be aggregated in the disclosure if they are individually less than 5 percent of the computed amount.

At the 2013 AICPA Conference, the SEC staff noted the following issues related to registrants' tax rate reconciliation disclosures:

- Labels related to reconciling items were unclear, and disclosures about material reconciling items did not adequately describe the underlying nature of these items.
- For material reconciling items related to foreign tax jurisdictions, registrants did not disclose in MD&A (1) each material foreign jurisdiction and its tax rate and (2) how each jurisdiction affects the amount in the tax rate reconciliation.
- Registrants have inappropriately aggregated material reconciling items that are greater than 5 percent of the amount calculated by multiplying the pretax income by the statutory tax rate.
- Amounts reflected in the tax rate reconciliation were inconsistent with related amounts disclosed elsewhere in a registrant's filing.
- Corrections of errors were inappropriately reflected as changes in estimates.

Unrecognized Tax Benefits

Examples of SEC Comments

- You disclose . . . that the addition of unrecognized tax benefits . . . was primarily attributable to U.S. tax positions taken in the current year. Please explain in detail what these tax positions relate to by category and amount, including the facts and timing of the circumstances specific to these positions in the current year as compared to prior years. See FASB ASC 740-10-50.
- Reference is made to the discussion . . . regarding the [State A] audits of your tax returns and the related assessments. Please tell us your consideration of disclosing an estimate of the range of reasonably possible change in your unrecognized tax benefits or a statement that an estimate of the range cannot be made. Refer to ASC 740-10-50-15d.3. In addition, please tell us your consideration of expanding your critical accounting policy disclosure related to uncertain tax positions . . . to quantify the extent to which your estimate is sensitive to change.

Under ASC 740-10-25-6, entities cannot recognize a tax benefit related to a tax position unless it is "more likely than not" that tax authorities will sustain the tax position solely on technical merits. The tax benefit recognized is measured as the largest amount of the tax benefit that is more than 50 percent likely to be realized. The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured under ASC 740-10 is referred to as an "unrecognized tax benefit." Generally, if the unrecognized tax benefit would be settled by offsetting it with an available loss or tax credit carryforward, it should be netted against the related DTA for the carryforward. Otherwise, a liability is recognized for the amount of the unrecognized tax benefit. The SEC staff has commented when registrants omit disclosures required under ASC 740-10-50-15 and 50-15A about unrecognized tax benefits, which include a tabular reconciliation of such benefits.

In addition, the SEC staff may ask registrants about their conclusions regarding disclosures about reasonably possible changes in unrecognized tax benefits. Because the guidance on the acceptable level of aggregation of information for these disclosures is not prescriptive and permits judgment, the SEC staff evaluates a registrant's level of disclosure on a case-by-case basis.

Examples of what registrants should disclose under ASC 740-10-50-15(d) include the following:

- Information related to scheduled expiration of the tax position's statute of limitations. A registrant should disclose this information if (1) the statute of limitations is scheduled to expire within 12 months of the financial statement's date and (2) management believes it is reasonably possible that the statute's expiration will cause the total amounts of unrecognized tax benefits to significantly increase or decrease.
- Significant unrecognized tax benefits for tax positions that the registrant believes will be effectively settled within 12 months in accordance with ASC 740-10-25-9.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Leases

Nonperformance Provisions

Example of an SEC Comment

Please address the following regarding the classification of your leases:

- Please tell us whether your leases contain default covenants related to nonperformance. If so, please confirm all the conditions set forth in ASC 840-10-25-14 exist. Otherwise, confirm that you included the maximum amount that the lessee could be required to pay under the default covenant in your minimum lease payments for purposes of applying ASC 840-10-25-1(d);
- Please tell us whether your leases contain material adverse change clauses. If so, please tell us how this is determined and what potential remedies are available to you as the lessor;
- Please tell us if your leases contain cross-default provisions. If so, please tell us what consideration you gave to the potential impact of these provisions on your lease classification; and
- Please tell us if your leases include subjective default provisions. If so, please tell us whether there is any cap on potential remedies that would impact your lease classification.

Refer to ASC 840-10-25-41 through 25-69.

In recent years, the SEC staff has heightened its focus on registrants' accounting for nonperformance covenants contained in lease agreements. Examples of such covenants include material adverse change clauses, cross-default provisions, subjective default clauses, and change-in-control provisions. Nonperformance covenants do not affect lease classification if they meet all the conditions in ASC 840-10-25-14. However, if any one of those conditions is not met (e.g., if default is subjectively determined), the maximum amount the lessee is required to pay under the nonperformance covenant must be included as a minimum lease payment regardless of the probability of the occurrence of a default. The SEC staff has asked registrants whether any of their lease contracts contain such provisions and, if so, to explain how they considered the provisions in determining whether the lease was a capital or operating lease.

While registrants have used different methods to establish the amount to include from default provisions in the measurement of the lease liability, the SEC staff has indicated that there are only two acceptable ways for registrants to consider potential payments that may result from default when measuring the lease liability: (1) by using the probability of default as part of the measurement of the lease liability (with an ongoing reassessment of probability each reporting period) or (2) by recognizing the maximum amount payable under the default provision regardless of the probability of default.

Sale and Leaseback Transactions Involving Fixed-Price Renewal Options

The accounting for sale and leaseback transactions that involve fixed-price renewal options can be problematic. In the past, the SEC staff has commented on how registrants considered fixed-price renewal options in evaluating whether a real estate transaction qualifies for sale and leaseback accounting. A fixed-price renewal option may cause real estate to be precluded from sale accounting (i.e., the real estate would remain on the seller's books and be treated as a financing arrangement). Renewal options that cover substantially all of the useful life of the real estate and enable the seller-lessee to participate in the appreciation of the underlying property (i.e., through favorable rent rates) are a prohibited form of continuing involvement.

Although comments have focused on fixed-price renewal options, the SEC staff may ask about any renewal terms that allow the seller-lessee to participate in increases in the value of the underlying real estate, including fixed base rents during the renewal period that a registrant calculates by adjusting the current base rents with an inflationary index. While these are not technically fixed-price renewals, they do have the potential to give the seller-lessee upside participation to the extent that market rates for rents exceed the rate of inflation.

Materiality

Example of an SEC Comment

Please tell us in greater detail the facts and circumstances regarding the corrections to prior year's income taxes and depreciation of properties. In your response, tell us how you complied with ASC 250-10-45-22 and SAB Topics 1M and 1N, and provide us with your materiality assessment. Please be detailed in your response.

Registrants perform materiality analyses to determine the impact of identified misstatements on their financial statements. SAB Topics 1.M (SAB 99) and 1.N (SAB 108) contain the SEC staff's guidance on assessing the materiality of misstatements identified as part of the audit process or during the preparation of financial statements.

SAB Topic 1.M indicates that a "matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." The definition of materiality is based on FASB Concepts Statement 2[1] and on legal precedent in interpretations of the federal securities laws. The SEC staff has noted that in Supreme Court cases, the Court has followed precedent regarding materiality; namely, that the materiality requirement is met when there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

SAB Topic 1.M also indicates that registrants should consider (1) each misstatement individually and (2) the aggregate effect of all misstatements. SAB Topic 1.N provides guidance on how a registrant should consider the effects of prior-year misstatements when quantifying misstatements in current-year financial statements.

To understand registrants' materiality assessments and conclusions, the SEC staff frequently asks registrants about the nature of an error, the quantitative and qualitative factors that registrants considered, and an error's' impact on their conclusions about (1) the effectiveness of their ICFR and (2) other reporting requirements, such as the need to file a Form 8-K. Similarly, the staff challenges registrants' conclusions that errors are immaterial (e.g., whether the method of correcting the error is appropriate; whether restatement language is presented; and whether an Item 4.02 Form 8-K, indicating nonreliance on previously issued financial statements, was required).

Accordingly, registrants should first decide whether an individual error is material by considering the affected financial statement line item and the financial statements as a whole. Then, if the registrant concludes that an individual error has not caused the financial statements as a whole to be materially misstated, it should consider other errors, including offsetting errors, in determining whether the errors taken as a whole are materially misleading. In reaching this conclusion, the registrant should consider individual line items, subtotals, and totals in the financial statements. The SEC staff has cautioned registrants to avoid bright-line rules or litmus tests and "not to succumb" to rules of thumb or percentage thresholds when determining materiality, because no one factor can be viewed as determinative.[2]

SAB Topic 1.M specifies quantitative and qualitative factors a registrant should consider when assessing the materiality of known errors to its financial statements. The SEC staff has observed that registrants' materiality assessments are often presented in a "checklist" fashion in which only the factors in SAB Topic 1.M are considered. Instead, the staff believes that a registrant should describe how the factors were considered — that is, a registrant should provide a detailed, thoughtful analysis that takes into account the registrant's specific circumstances and is relevant to its investors and financial statement users.[3] In addition, the SEC staff has stressed that quantitative considerations in registrants' materiality assessments continue to be overemphasized while qualitative factors are often insufficiently evaluated.[4]

[1] FASB Concepts Statement 2, which has been superseded by FASB Concepts Statement 8, defined materiality as the "magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

[2] The SEC commented on this topic at the 2011 AICPA Conference. See Deloitte's December 14, 2011, *Heads Up* for additional information.

[3] In an October 2010 joint webcast with the CAQ, the SEC staff provided its views about registrants' materiality assessments.

[4] The SEC staff discussed qualitative and quantitative factors at the 2012 AICPA Conference.

The SEC staff has also indicated that registrants should consider company-specific trends, performance metrics that may influence investment decisions, and the effects of unrelated circumstances on factors that are important to reasonable investors (such as the magnification of an error in the income statement simply because it occurs in a period in which net income is "abnormally small" relative to historical and expected trends).

In considering company-specific trends and performance metrics, a registrant should address in its materiality assessments what metrics it deemed important enough to include in press releases and earnings calls as well as what analysts cover in their reports. The SEC staff often considers analysts' reports and investor calls as it assesses the registrant's assertion of what is important to investors.

When considering whether net income is abnormally small, management should determine whether a decline in operating performance is an abnormal event or whether it represents a new normal. Management should also determine whether "unusual" or infrequent events or transactions, such as an asset sale or impairment that would affect trends, are reflected in the results. Documentation of such considerations should be included in management's analysis.

The SEC staff has also observed that certain registrants have argued that a quantitatively large error in the GAAP financial statements is immaterial when it has a quantitatively small impact on non-GAAP metrics. While the staff has indicated that it may be appropriate for a registrant to look at metrics other than those that are GAAP-based in determining whether the financial statements taken as a whole are materially misstated, the SEC staff will most likely focus on the GAAP metrics until a registrant can demonstrate why other metrics are more important to its investors. In addition, the SEC staff has acknowledged that while it is possible for quantitatively small errors to be material and for quantitatively large errors to be immaterial,[5] a quantitatively material GAAP error does not become immaterial simply because of the presentation of non-GAAP measures.[6] Further, there may be circumstances in which an error that is otherwise immaterial to the GAAP financial statements — when taken as a whole and depending on the focus that management, investors, and financial statement users have historically placed on non-GAAP information — is material in the context of non-GAAP information.[7]

In addition to inquiring about a registrant's materiality analysis under SAB Topics 1.M and 1.N, the SEC staff often asks questions about the errors themselves. Registrants should consider the impact that misstatements (including immaterial restatements) may have on their previous conclusions about ICFR and DCP. As a result of such misstatement, the SEC staff may question whether a material weakness existed at the time of the initial assessment. For additional considerations, see the Disclosure Controls and Procedures and Internal Control Over Financial Reporting sections.

After reaching a materiality conclusion, registrants should also consider whether they are required to file Form 8-K. Under Item 4.02(a) of Form 8-K, a registrant must file Form 8-K when it has concluded that previously issued financial statements, covering either an annual or interim period, should no longer be relied upon because of an error.

Other Deloitte Resources

December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."

5 At the 2007 and 2008 AICPA conferences, the SEC staff addressed these topics. For more information, see Deloitte's December 20, 2007, and December 18, 2008, *Heads Up* newsletters.

6 At the 2010 AICPA Conference, the staff expressed its views on this topic. See Deloitte's December 16, 2010, *Heads Up* on the conference.

7 In its October 2010 joint webcast with the CAQ, the SEC staff also discussed non-GAAP financial measures in the context of materiality.

Noncontrolling Interests

Examples of SEC Comments

- Please . . . explain the process by which you determine the allocation of net income (loss) to each of the predecessor, previous owners, and noncontrolling interest, and why the remainder of that allocation represents net income attributable to partners.
- We note that as part of your statement of changes in stockholders' equity, you have a column titled "Noncontrolling Interest." In light of the fact that you have both redeemable and non-redeemable noncontrolling interest, please revise this column to clearly identify this amount as non-redeemable noncontrolling interest. Also, please revise to present a column for redeemable noncontrolling interest which includes a roll-forward of this temporary equity amount but does not combine the total with permanent equity. See guidance in ASC 810-10-50-1A(c).

SEC staff comments related to noncontrolling interests (NCIs) continue to focus on the allocation of net income (loss) to the NCI and the parent. Consequently, the staff frequently asks registrants to provide it with detailed information about how the registrant determined the allocation, particularly when the allocation is disproportionate to the NCI holder's initial investment.

The SEC staff also continues to comment on registrants' accounting for redeemable NCIs since SEC rules still prohibit registrants from including redeemable equity in any caption titled "total equity." ASC 480-10-S99-3A(2) requires equity instruments to be classified outside of permanent equity if they are redeemable:

(1) at a fixed or determinable price on a fixed or determinable date,

(2) at the option of the holder, or

(3) upon the occurrence of an event that is not solely within the control of the issuer.

Thus, the SEC staff has indicated that "registrants with redeemable noncontrolling interests, redeemable preferred stock or other redeemable equity classified outside permanent equity should not include these items in any total or subtotal caption titled 'total equity.'" Further, changing "the caption in the statement of changes in shareholders' equity [from] 'total equity' to 'total' does not make the inclusion of redeemable equity acceptable."

For additional information about classification of redeemable securities, see the Debt and Financial Instruments sections.

Other-Than-Temporary Impairment of Investments in Securities

Registrants are required to evaluate investments in debt and equity securities for impairment in each reporting period. An investment in debt or equity securities is impaired when its fair value is less than its carrying value, but an impairment loss is not recognized in net income (or loss) unless the impairment is determined to be other-than-temporary.

A registrant must use significant judgment in determining whether an investment is other-than-temporarily impaired because no "bright lines" or "safe harbors" for this determination are established by either the SEC or U.S. GAAP. A registrant should therefore be prepared to support its conclusion that unrealized losses are temporary.

The improved performance of the equity markets over much of the past year has resulted in fewer SEC staff comments on OTTI of securities. However, market factors, such as increases in interest rates (which would cause debt securities to decrease in value), may lead the SEC staff to ask registrants how they determined whether their investments were other-than-temporarily impaired.

Investments in Debt and Equity Securities — Recoverability

Example of an SEC Comment

Considering the significant judgment required to determine if a security is other than temporarily impaired and the focus users of financial statements have placed on this area, we believe comprehensive and detailed disclosure is required . . . . [W]e note [from] your disclosure that: (1) the market for collateralized mortgage obligations was not active, (2) all of the securities are in mezzanine tranches and are currently rated less than investment grade . . . , and (3) you have determined that not all contractual cash flows will be received on collateralized debt obligations back[ed] by trust preferred securities. Yet we note that you have determined there was no other-than-temporary impairment in the periods presented. Please provide us your other-than-temporary-impairment analysis which clearly identifies the key factors you considered in your conclusion. Refer to ASC 320-10-35-33.

For debt securities, ASC 320-10-35 provides guidance on determining whether a credit loss has occurred. For example, ASC 320-10-35-33C specifies that a credit loss exists if the present value of cash flows that an entity expects to collect from the security is less than the security's amortized cost basis. Further, ASC 320-10-35-33F requires entities to consider a number of factors in estimating whether a credit loss exists, including (1) the "length of time and the extent to which the fair value has been less than the amortized cost basis" and (2) "[a]ny changes to the rating of the security by a rating agency." ASC 320-10-35 also includes guidance on assessing whether equity securities are impaired (see below for additional information). Consequently, the SEC staff frequently focuses on the duration and severity of losses when asking registrants about their conclusions related to whether securities with significant unrealized losses are other-than-temporarily impaired. As a result, the SEC staff has asked registrants to explain their basis for concluding that they have the intent and ability to hold debt and equity securities until recovery.

In addition, when credit losses on debt securities have not been recognized, the SEC staff may ask:

- Why unrealized losses of a longer duration are not indicative of credit losses.
- Whether the registrant continues to receive interest payments in a timely manner.
- How the registrant considered significant inputs, such as:
    - The performance indicators of the security's underlying collateral (if any), including default rates, delinquency rates, and percentage of nonperforming assets.
    - Loan-to-collateral-value ratios.
    - Current levels of subordination.

- Geographic concentration.
- Credit ratings.

- Whether the registrant’s cash flow projections include expectations about a lack of receipt of future interest payments, principal payments, or both and, if so, the basis for this assumption.
- Whether a class of securities is considered investment-grade, including the amounts attributable to the securities that are considered below investment-grade.
- Whether there have been any changes to the rating of the security by a rating agency and, if so, when the changes occurred.
- Whether securities with unrealized losses are other-than-temporarily impaired when their credit spreads are significantly greater than credit spreads in the broader market.
- To what extent credit enhancement supports the registrant’s judgment about unrealized losses.

For equity securities, registrants should consider the guidance in ASC 320-10-35 and SAB Topic 5.M to determine whether an impairment is other-than-temporary. Under SAB Topic 5.M, a registrant should consider the following factors, either individually or in combination with other factors, when evaluating an equity security for OTTI:

- Length of time and extent of impairment.
- Financial condition and near-term prospects of the issuer.
- Ability and intent to hold the security until recovery.

Registrants should avoid overreliance on bright lines. For example, depending on the facts and circumstances, a 75 percent decline in an equity security’s fair value may be considered severe enough for an entity to recognize an OTTI even when the decline in fair value has been present for only three months.

OTTI Disclosures for Debt Securities

Because entities must use significant judgment to determine whether investments in securities are other-than-temporarily impaired, the SEC staff may ask registrants to provide qualitative and quantitative disclosures about the inputs and assumptions they used in discounted cash flow models to measure impairment losses and about the procedures they performed to determine whether a credit impairment exists. When bonds subsequently become other-than-temporarily impaired, the staff may ask the registrant to explain the facts and circumstances that led to the impairment and to disclose information about the potential for future impairment charges.

Timing of Recognition

The SEC staff may ask registrants to provide additional information about the facts and circumstances leading up to recognition of an OTTI, including their analysis supporting the recognition of the impairment in a given period rather than in an earlier period. In particular, the staff may ask what factors have changed since the last reporting period that triggered the recognition in the current period.

Pensions and Other Postretirement Benefits

The SEC staff continues to emphasize the disclosures related to how registrants account for pension and other postretirement benefit plans and how key assumptions and investment strategies affect their financial statements. Further, registrants may be asked how they concluded that assumptions used for their pension and other postretirement benefit accounting are reasonable relative to (1) current market trends and (2) assumptions used by other registrants with similar characteristics.

Critical Accounting Estimates

Examples of SEC Comments

- We see the significance and variability of your pension expense, in part related to your policy to fully [recognize] actuarial gains and losses in the fourth quarter of each year. However, we note that the disclosure in MD&A appears to mostly address the basic accounting policy. Please help us better understand your disclosure by responding to the following:
  - Tell us where you provide basic accounting policy disclosure in [your footnote] or elsewhere in your audited financial statements.
  - While we note that you make a general statement that reasonably likely changes in assumptions may have a material impact on future earnings, please tell us how your critical accounting policy disclosure considers the guidance from Section V of Release 33-8350. The cited guidance, in part, provides that: "Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors."
- Please tell us how you determined the discount rates used in the measurement of plan obligations at the most recent balance sheet date and why you believe the discount rates are reasonable based on the expected dates and amounts of cash outflows associated with retiree pension benefits.

Because of factors such as the low-interest-rate environment, optionality in U.S. GAAP accounting methods, and significant assumptions used in benefit obligation valuation, the SEC staff has continued to ask registrants about assumptions related to their pension and other postretirement benefit plans. Often the staff asks a registrant how its disclosures in the critical accounting estimates section of MD&A align with its accounting policy disclosures in the notes to the financial statements. The staff also requests more quantitative and qualitative information about the nature of the registrant's assumptions. In particular, the staff has focused on the discount rate and the expected return on plan assets.

In addition, the SEC staff has indicated that it may be appropriate for a registrant to disclose the following:

- Whether a corridor[1] is used to amortize the actuarial gains and losses; and, if so, how the corridor is determined and the period for amortization of the actuarial gains and losses in excess of the corridor.
- A sensitivity analysis estimating the impact of a change in expected returns on income. This estimate should be based on a reasonable range of likely outcomes.
- Regarding the extent to which historical performance was used to develop the expected rate of return assumption, if use of the arithmetic mean to calculate the historical returns yields results that are materially different from the results yielded when the geometric mean is used to perform this calculation, it may be appropriate for the registrant to disclose both calculations.

[1] ASC 715-30-35-24 provides guidance on net periodic pension benefit cost and defines the corridor as "10 percent of the greater of the projected benefit obligation or the market-related value of plan assets." Similarly, ASC 715-60-35-29 provides guidance on net periodic postretirement benefit cost and defines the corridor as "10 percent of the greater of the accumulated postretirement benefit obligation or the market-related value of plan assets."

- The reasons why the expected return has changed or is expected to change in the future.
- The effect of plan asset contributions during the period on profit or loss, when this effect is significant. The SEC staff has indicated that additional plan asset contributions reduce net pension costs even if actual asset returns are negative because the amount included in profit or loss is determined through the use of expected and not actual returns. Consequently, such information can provide an understanding of unusual or nonrecurring items or other significant fluctuations so that investors can ascertain the likelihood that past performance is indicative of future performance.

Liquidity and Capital Resources

Example of an SEC Comment

We note that you significantly increased your pension contributions for fiscal year 2013 above the minimum funding requirement and that you anticipate doing the same for fiscal year 2014. In future filings, please explain the factors that contributed to this cash management decision along with the impact to your consolidated financial statements.

Registrants should sufficiently disclose how changes to their plan assets and obligations may affect their liquidity and capital resources. The SEC staff has encouraged registrants to explain the trends and uncertainties related to pension or other postretirement benefit obligations (e.g., a registrant's funding requirements may be affected by changes in the measurement of its plan obligations and assets). A registrant also may want to disclose in both qualitative and quantitative terms what its plan contributions have been in the past and the expected changes to those contributions.

Registrants may take steps to "de-risk" their pension plans by acquiring bonds for their plan asset portfolios whose expected maturities match the expected timing of the plan's obligations. The SEC staff has reminded registrants that they are required to disclose their plan investment strategy. MD&A should inform investors about any changes to that investment strategy, the reasons for those changes, and how a change in strategy affects the underlying plan assumptions and the registrant's ability to fund the plans. For example, a decision to invest more in fixed-income securities could be expected to lower the overall rate of return on plan assets.

When a pension plan is funded with a noncash transaction (e.g., an entity's own stock), it may be appropriate to disclose how management funded the pension plan, with a reference to the associated cash flow statement line items.

When commenting on other postretirement benefit plans, which are usually funded as the related benefit payments become due, the SEC staff has noted that the footnote disclosures should include the plan's expected future benefit payments for each of the next five years and in the aggregate for the five years thereafter. This information may indicate a registrant's expected liquidity requirements, which could then warrant discussion in the liquidity section of MD&A or in the contractual obligations table.

Fair Value of Plan Assets

The disclosures required by ASC 715 for fair value measurements for retirement plan assets are similar to the disclosures about fair value measurements required by ASC 820. These disclosures include employers' investment strategies, major categories of plan assets, concentrations of risk within plan assets, and valuation techniques used to measure the fair value of plan assets. The SEC staff may ask registrants about their compliance with such disclosure requirements. For more information, see the Fair Value section. A registrant also should disclose whether the fair value or calculated value[2] of plan assets is used to determine the expected return on plan assets and, if the calculated value is used, how this value is determined.

Immediate Recognition of Gains and Losses

The SEC staff has noted instances in which registrants have changed their method of accounting for the amortization of actuarial gains and losses in net periodic pension or other postretirement benefit cost. For example, some registrants have decided to move to an approach in which they immediately recognize all actuarial gains and losses or, alternatively, all actuarial gains and losses outside the "corridor," as a component of net periodic pension cost. In accordance with ASC 250, such registrants have retrospectively applied this change in accounting principles to their financial statements.

Once an entity adopts a policy of immediately recognizing gains and losses, changing to a less preferable method (i.e., a subsequent change to a method that results in slower amortization) would be difficult to support. When entities adopt a policy of immediately recognizing actuarial gains and losses as a component of net periodic pension cost, they often present non-GAAP financial measures that "remove the actual gain or loss from the performance measure and include an expected long-term rate of return."[3] The SEC staff will generally comment when (1) the disclosures are not clear and the pension-related adjustment (e.g., actuarial gains or losses) is not labeled; (2) an adjustment is labeled as a "noncash" pension expense, because the pension liability will ultimately be settled in cash; and (3) context about adjustments related to actuarial gains and losses is not provided.

Disclosures for Non-U.S. Plans

ASC 715-20-50-4 states that a "U.S. reporting entity may combine disclosures about pension plans or other postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions." The SEC staff may ask registrants to explain the basis for combining pension and other postretirement benefit plan disclosures related to U.S. and non-U.S. plans. When there are significant differences in trends and assumptions between the U.S. and non-U.S. plans and the benefit obligation of the foreign plan is significant, the SEC staff has required registrants to provide disaggregated footnote disclosure for the U.S. and non-U.S. plans.

Other Deloitte Resources

- Financial Reporting Alert 13-3, "Financial Reporting Considerations Related to Pension and Other Postretirement Benefits."
- Financial Reporting Alert 11-2, "Pension Accounting Considerations Related to Changes in Amortization Policy for Gains and Losses and in Market-Related Value of Plan Assets."

[2] ASC 715-30-20 defines the market-related value of plan assets as follows: "A balance used to calculate the expected return on plan assets. The market-related value of plan assets is either fair value **or a calculated value** that recognizes changes in fair value in a systematic and rational manner over not more than five years. Different ways of calculating market-related value may be used for different classes of assets" (emphasis added).

[3] For more information, see the highlights of the June 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Revenue Recognition

Revenue Recognition Disclosures

Examples of SEC Comments

- We note your current revenue recognition disclosures. Confirm to us, if true, that you only recognize revenue if a sales transaction meets each of the criteria outlined at SAB Topic 13(A)(1). In that regard, in future filings please disclose whether there is persuasive evidence of an arrangement, the sales price is fixed or determinable, and management believes collectability is reasonably assured.
- We note that your business overview . . . separately discusses the nature of your regulated terminal operations, electricity transmission, regulated distribution, rail operations, port operations, toll road operations and energy transmission and distribution operations. Based on your consistent use of these categories to describe your business throughout your filing, it is unclear to us why disclosing revenues from each of those categories . . . would not be useful to investors. We note, for example, that your transport and energy platform consists of four separable lines of business in four different geographic regions: rail operations in Australia, port terminals in Europe, toll road operations in Chile, and natural gas transmission primarily in the U.S.

In addition to requesting general policy information, the SEC staff often asks registrants to clearly state whether a revenue recognition policy complies with SAB Topic 13, particularly the four criteria that generally must be met for revenue to be recognized. The staff may also ask how a criterion has been applied in the context of a particular transaction or group of transactions. For example, the SEC staff may inquire about whether collectibility is "reasonably assured" and whether the sales price the registrant is charging resellers for products is "fixed or determinable."

When reviewing the disclosures in a registrant's revenue policy footnote, the SEC staff often checks for completeness and consistency by comparing the disclosures with the revenue streams described in the business section, in MD&A, and on the registrant's Web site. At the 2013 AICPA Conference, the SEC staff indicated that registrants should consider expanding or clarifying their revenue recognition disclosures to include:

- The type, nature, and terms of significant revenue-generating transactions.
- The specific revenue recognition policy (including the manner in which revenue is recognized) for each type of revenue-generating transaction, including policies related to discounts, promotions, sales returns, post-shipment obligations, customer acceptance, warranties, credits, rebates, and price protection.
- The specific events or actions that trigger revenue recognition (i.e., avoid "boilerplate language").
- Relevant information about significant uncertainties related to revenue recognition (e.g., rights of return or variable consideration).
- A detailed breakdown of revenue by product/service line or business segment when the disclosure of revenue in the filing is less granular than the discussion of the registrant's results of operations in other publicly available information in or outside the filing.

The SEC staff may request more specific disclosures on the basis of the complexity or subjectivity of registrants' revenue recognition policies.

Sales Returns

Example of an SEC Comment

We note your statement that the sales return reserve represents the gross profit effect of sales returns. Please explain to us in more detail how you determine and record your sales return reserve. It is unclear to us if you are reducing sales for the gross profit of expected returns or if you are reducing sales and cost of sales to reflect estimated returns. Please refer to ASC 605-15-45-1.

The SEC staff continues to comment on registrants' failure to separately present or disclose information about their sales returns, particularly when other information in a registrant's filing or in other public communications suggests that sales returns may be material. In addition, the SEC staff will comment if it appears that a registrant has accounted for sales returns as a reduction in revenue on the basis of the gross profit of the related transactions instead of as a reduction in both sales and cost of sales as required by ASC 605-15.

Multiple-Element Arrangements

Examples of SEC Comments

- Tell us your consideration of disclosing whether the significant deliverables in your arrangements qualify as separate units of accounting, and the reasons that they do not qualify as separate units of accounting, if applicable. In addition, your disclosures should discuss the significant factors, inputs, assumptions and methods used to determine the selling price (whether vendor-specific objective evidence, third-party evidence, or estimated selling price) of the significant deliverables. We refer you to the guidance in ASC 605-25-50-2.
- Explain how you concluded that the set-up services have no stand-alone value upon completion. Your policy states that revenue recognition begins upon delivery. Indicate whether the delivery is the result of the set-up services. It appears from your response that the set-up services require a significant amount of time and effort to complete. Indicate how the fee for these services compares to the entire contract value and whether this fee varies by contract or customer.

The SEC staff often asks registrants about the nature of, and accounting for, their multiple-element arrangements and whether they evaluated these arrangements under ASC 605-25. The staff typically asks for supplemental information, and sometimes requests additional disclosures, about multiple-element arrangements, including the following:

- A description of the registrant's rights and obligations under the arrangement.
- The registrant's method for determining whether certain deliverables in an arrangement qualify as separate units of accounting and the factors the registrant considered in making this assessment.
- The registrant's accounting policy for allocating and recognizing revenue for each deliverable.
- The registrant's support for its conclusion that a delivered item has stand-alone value.
- An analysis of how the transaction price was allocated to each deliverable, including how the selling price used for each unit of accounting was determined (i.e., VSOE, TPE, or estimated selling price).
- The period over which each unit of accounting is recognized.

The SEC staff has recently focused on registrants' accounting for set-up or installation services for products sold to customers, particularly when consideration for these services is paid at the inception of the arrangement or as the services are provided. The staff has asked registrants to explain whether such services have stand-alone value and how they determined the period over which the consideration for these services is recognized.

Principal-Agent Considerations

Example of an SEC Comment

Your revenue recognition policy continues to reiterate the overall revenue recognition requirements under U.S. GAAP. However, your disclosures should specifically address your policy for recognizing revenue in accordance with U.S. GAAP. For example, you should discuss how your current revenue recognition methodology complies with the Principal-Agent Considerations discussed in ASC Topic 605-45. In particular, tell us how you considered this literature in determining whether to report revenue gross as a principal or net as an agent.

The SEC staff often inquires into principal-agent considerations. ASC 605-45 discusses factors that an entity should consider in determining whether it acts as a principal (and records revenue at the gross amount billed to a customer) or as an agent (and records revenue at the net amount retained). The staff has asked registrants to explain how they determined gross or net reporting to be appropriate for certain revenue transactions under ASC 605-45. In addition, the SEC staff may request detailed information about the rights and obligations of the parties involved in a registrant's revenue transactions. The staff may ask registrants to provide expanded disclosures that describe the nature of these transactions and the factors they considered when determining whether revenue from such transactions should be recorded on a gross or a net basis. The focus of these disclosures is providing information that would enable an investor to understand whether title is transferred and who is the primary obligor. The SEC staff has stated that the analysis it applies to identify the primary obligor focuses on (1) identifying the product or service that is desired by the customer and (2) determining whether the registrant is responsible for providing that product or service.

Revenue Recognition for Long-Term Construction-Type and Production-Type Contracts

Examples of SEC Comments

- Please tell us . . . the percentage of revenue recognized using the percentage-of-completion method, using the completed-contract method, for [services], and for direct sales not provided in conjunction with the performance of construction contracts. . . . With respect to customer contracts, please revise future filings to disclose:
    - [T]he amount of contract losses recorded during each period presented and the current status of material loss contracts, as well as the current status of any contracts for which material losses are reasonably possible;
    - [T]he impact of material changes in contract estimates during each period presented; and
    - [T]he impact of contract penalties, claims, change orders and/or settlements during each period presented, if material.
- It appears $[X] of operating income in 2013 resulted from a change in estimates underlying your percentage-of-completion accounting on long-term contracts. [P]lease provide a discussion of the underlying reasons for the significant changes in estimates, including quantified information where available and useful for an investor's understanding of contract performance, the impact on operations, and the potential impact on future operations.

ASC 605-35 provides guidance on how and when to recognize revenue and costs for certain long-term construction-type and production-type contracts. The SEC staff frequently asks registrants to clarify their treatment of these contracts under ASC 605-35. For instance, the staff may ask a registrant to provide the following information:

- How the registrant developed its estimate of total contract costs and how those costs are directly related to contract performance.
- How the registrant treats precontract and early-stage contract costs, which should normally be expensed.
- A description of the nature, status, amounts, and types of change orders and claims that occurred during the periods presented and how the registrant accounted for them.
- Policy disclosures, including which contract accounting method was used (i.e., percentage-of-completion or completed-contract) and which method was used to measure progress toward completion (e.g., cost-to-cost, units of work).
- An analysis of a registrant's historical accuracy of making estimates and the likelihood of changes in those estimates in the future.
- The amount of contract losses recorded during each period presented.
- If there were changes in estimates during the period (e.g., the estimate of percentage complete or amount of profit recognized on claims), disclosures (under ASC 250-10-50-4) about the effect of the change in estimate in the financial statements.
- For transactions that recognize revenue under the completed-contract method, the specific criteria used to determine when a contract is substantially completed.

In addition, registrants that use the percentage-of-completion method should be aware that the SEC staff has asked some registrants that use that method to enhance their disclosures about the effect of changes in contract estimates. For example, the SEC staff may ask registrants to add disclosures in MD&A about gross aggregate favorable and gross aggregate unfavorable changes in contract estimates for each period presented.

Industry-Specific Considerations

See the Industry-Specific Topics section for industry-specific revenue considerations.

Other Deloitte Resources

- May 28, 2014, *Heads Up*, "Boards Issue Guidance on Revenue From Contracts With Customers."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

SAB Topic 11.M (SAB 74) — Disclosures About the Impact of Recently Issued Accounting Pronouncements

Example of an SEC Comment

We note from the disclosures provided in MD&A and in [a footnote] to the financial statements that you have not provided any disclosure as to how any recently issued accounting pronouncements may impact [your] financial statements in future periods. In future filings, please revise MD&A and the notes to the financial statements to discuss how any recently issued accounting standards or pronouncements may impact your financial statements. Refer to the guidance outlined in SAB Topic [11.M].

SAB Topic 11.M (SAB 74) indicates that a registrant should disclose the effects of recently issued ASUs and SABs that are not yet effective "unless the impact on [the registrant's] financial position and results of operations is not expected to be material" (footnote omitted). These disclosures are meant to help financial statement users assess the effect that new standards will have once adopted. SAB 74 disclosure is not required when a registrant will adopt a new accounting standard that will not affect the reported results (i.e., when only enhanced disclosures would be required by the new accounting standard).

According to SAB 74, a registrant should consider including the following disclosures in MD&A and the footnotes to the financial statements:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices . . .).

The SEC staff does not expect the disclosures to include a "laundry list" of new standards that registrants state will have no material effect on their financial statements; only those ASUs that are expected to have a material impact should be described in the financial statements. However, the staff expects disclosures about the potential effects of a new standard to be increasingly clear and precise as the standard's effective date approaches.

Accordingly, the SEC staff has commented on the following items related to SAB 74 disclosures:

- Failure to provide the required disclosures.
- Inadequate discussion of the accounting changes and how they will be adopted (i.e., whether retrospectively or prospectively and what periods will be affected).
- Disclosures about prospective accounting standards that are exactly the same in both the notes to the financial statements and MD&A. For example, registrants may consider the effect of adoption on their operations, financial condition, or liquidity in future periods and provide related disclosures in their MD&A. Disclosures in the financial statements should focus on whether the historical financial information will change (e.g., as a result of the retrospective application of the standard).

Segment Reporting

Segment reporting remains a perennial topic of SEC staff comments. Like those issued in previous years, recent SEC staff comments have specifically addressed (1) the identification and aggregation of operating segments, (2) changes in reportable segments, (3) product and service revenue by segment, (4) the interaction of operating segments and goodwill impairment testing, and (5) disclosure of information about geographic areas.

Identification and Aggregation of Operating Segments

In asking registrants about the identification and aggregation of their operating segments, the SEC staff's comments have centered on (1) the identification of the chief operating decision maker (CODM), (2) how the company identifies operating segments and supports its process for identifying them, (3) the quantitative and qualitative factors used to support the aggregation of operating segments, and (4) how the registrant has considered whether previous decisions about the identification and aggregation of operating segments remain appropriate (i.e., how it has continued to assess such conclusions in light of changes in its management or operations).

Examples of SEC Comments

- We understand that you have identified your CEO as your CODM, although you acknowledge that he " . . . leads the Company with a supporting senior leadership team [(SLT)] that assists in providing input and driving the performance of the Company." You further clarify by stating that "the CEO utilizes inputs from the SLT to evaluate performance." Please describe the nature and form of this input. Additionally, explain the extent to which the input pertains to your [brands], and includes any combination of operating metrics, budgets or targets, related to sales, costs or market share.
- We note the discussion of your major markets . . . and the breakout of net sales by market application in Management's Discussion and Analysis . . . . Please tell us how you determined that you only have two [reportable] segments, [A] and [B], under FASB ASC 280-10-50. Your response should address the following:
    - Describe the contents of the information you provide to your chief operating decision maker.
    - Explain your disclosure that the segmentation reflects the go-to-market strategies for various products and markets.
- It appears to us that you aggregate four operating segments into your [X] reportable segment. Please demonstrate to us how you determined aggregation is appropriate and complies with ASC 280-10-50-11. We note we previously commented on this issue . . . . We also note since that time the number of your operating segments has increased . . . . Please ensure your assessment provides a specific and comprehensive discussion of the similar economic characteristics of each operating segment during each period presented.

Although ASC 280 has been effective for many years, segment reporting is still a frequent SEC comment letter topic. The staff often challenges registrants' conclusions about identification of operating segments, identification of the entity's CODM, and aggregation of operating segments into reportable segments. ASC 280 prescribes the "management approach" for the presentation of segments in a public entity's financial statements. The objective of the management approach is to allow users to (1) see through the eyes of management the entity's performance, (2) assess the entity's prospects for future cash flows, and (3) make more informed judgments about the entity as a whole. It is presumed that investors would prefer disaggregated information. Consequently, operating segments should not be aggregated unless providing more detailed information would not enhance an investor's understanding of the entity.

Determining an entity's operating segments is the first step in the assessment of what segment information needs to be reported in the entity's financial statements. An operating segment is a component of the business (1) that engages in business activities from which it may earn revenues and incur expenses, (2) whose operating results are regularly reviewed by the public entity's CODM, and (3) that has discrete financial information available. When challenging a registrant's conclusion about its operating segments, the SEC staff has historically placed a great deal of weight on the information regularly provided to, and reviewed by, the CODM (i.e., the CODM package). The SEC staff would frequently request copies of the CODM package to determine whether the information in the CODM package supports how operating segments are identified and aggregated.

However, technology advancements in registrants' financial reporting systems allow the CODM to easily access additional information that may not be reflected in the CODM package. These advancements have led the SEC staff to revisit its views on the importance of the CODM package in supporting a registrant's segment reporting. At the September 2014 AICPA Banking Conference, the SEC staff noted that while its views on how it should assess information in a registrant's CODM package are evolving, it may have overemphasized the importance of the CODM package. The staff indicated that rather than viewing the CODM package as the determinative factor in identifying operating segments, it would treat the CODM package as only one of many factors to be considered. Similarly, the staff noted that it would not view the CODM package as a safe harbor for registrants. In other words, the staff would not be supportive of an assertion that information in the CODM package would automatically nullify other information (i.e., information that might suggest different operating segments). Registrants should expect that the staff will review other publicly available information for consistency with the registrant's segment disclosures, such as the information in the forepart of Form 10-K (i.e., the business section and MD&A), the registrant's Web site, analysts' reports, and press releases.

As used in ASC 280, the term "chief operating decision maker" identifies a function, not an individual in the company who has the specific title. The CODM determines the allocation of resources and assesses the performance of the operating segments. While the CODM is usually an individual, sometimes the function is performed by a group.

At the AICPA Banking Conference, the SEC staff noted that it would place a renewed emphasis on the determination of a registrant's CODM. The staff remarked that although most registrants identify their CEO as the CODM, questions from the staff sometimes engender a change in the registrant's conclusion about its CODM's identity, which in turn affects the registrant's determination of operating segments. Accordingly, the staff indicated that it would also focus on understanding management's structure (e.g., through organization charts or other information) in supporting the person (or group) identified as the CODM.

In addition, ASC 280-10-50-11 allows entities to aggregate operating segments into reportable segments if the operating segments exhibit (1) similar economic characteristics (e.g., similar historical and expected future performance such as through similar long-term average gross margins) and (2) other similar characteristics, including:

a. The nature of the products and services

b. The nature of the production processes

c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

ASC 280-10 does not define the term "similar" or provide much guidance on the aggregation criteria, and the determination of whether two or more operating segments are similar depends on the individual facts and circumstances and is subject to a high degree of judgment. Further, many registrants have complex business models and organizational and reporting structures. Such complexities often make it difficult for registrants to determine the basis for economic similarity when aggregating operating segments. As a result, the SEC staff may ask a registrant to provide an analysis of how it determined that its aggregation of operating segments complies with ASC 280-10.

Consequently, registrants should continually monitor any changes in facts and circumstances that may affect the identification or aggregation of operating segments. Examples of changes that may prompt the SEC staff to seek additional information about registrants' reportable segments include changes in internal reporting after an acquisition and changes in the CODM. In addition, the staff may comment when the economic measures of a registrant's aggregated operating segments have not converged over time despite the registrant's previous assertion that it expected such measures to become more similar in the future.

For additional information, see Deloitte's Financial Reporting Alert 14-3, "Segment Reporting."

Changes in Reportable Segments

Example of an SEC Comment

We note your disclosure . . . that you began including your . . . services within your [A] segment on July 1, 2013. Please tell us whether you have restated prior segment financial information pursuant to ASC 280-10-50-34. Please quantify for us total assets of the transferred operations and the related impact they had on your statements of income, including revenues and net economic earnings, for all periods presented in your filing.

ASC 280-10-50-34 and 50-35 require public entities to recast information from prior periods for consistency with current reportable segments. If a registrant changes the structure of its business after year-end or quarter-end, the new segment structure should not be presented in financial statements until operating results managed on the basis of that structure are reported (typically in a periodic filing such as a Form 10-K or 10-Q). Paragraph 13310.1 of the FRM indicates that "[i]f annual financial statements are required in a registration or proxy statement that includes subsequent periods managed on the basis of the new organization structure, the annual audited financial statements should include a revised segment footnote that reflects the new reportable segments." A registrant can either include the revised financial statements in the registration or proxy statement or recast them in a Form 8-K, which can be incorporated by reference. See the SEC Reporting section for more information.

Product and Service Revenue by Segment

Example of an SEC Comment

Please explain to us how you considered ASC 280-10-50-40 in your determination that product line disclosures are not required. For example, we note from your business disclosures and your website that you appear to sell products across multiple product categories.

Registrants should remember to identify the "[t]ypes of products and services from which each reportable segment derives its revenues" and to report the total "revenues from external customers for each product and service or each group of similar products and services" in accordance with ASC 280-10-50-21 and ASC 280-10-50-40, respectively. The SEC staff has objected to overly broad views of what constitutes "similar" products and services.

Operating Segments and Goodwill Impairment

As discussed in the Impairments of Goodwill and Other Long-Lived Assets section, registrants should be aware that incorrect identification of operating segments can affect goodwill impairment testing. Goodwill is tested at the reporting-unit level in accordance with ASC 350-20, and reporting units are identified as either operating segments or one level below. If a registrant has not correctly identified its operating segments, it could be incorrectly testing goodwill for impairment (i.e., at the wrong level).

Information About Geographic Areas

The SEC staff has frequently asked registrants to include disclosures about geographic information in future filings in accordance with ASC 280-10-50-41 unless it is impracticable to do so.

Other Deloitte Resources

- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."

Share-Based Payments

Disclosures

Example of an SEC Comment

Please review the disclosure requirements for stock-based compensation found at ASC 718-10-50 and provide the following disclosures in future annual filings:

- [Please] revise future filings to include the total intrinsic value of options exercised during the year pursuant to ASC 718-10-50-2d2;
- Please disclose the weighted-average remaining contractual term of options currently exercisable pursuant to ASC 718-10-50-2e; and
- Please revise future filings to include the method used to estimate the fair value of all of your options, as well as, the significant assumptions used to determine fair value pursuant to ASC 718-10-50-2b & f.

Registrants should ensure that their disclosures address the following objectives outlined in ASC 718-10-50-1:

- The "nature and terms" of share-based payment arrangements.
- The "effect of [the related] compensation cost . . . on the income statement."
- The "method [for determining] the fair value of the equity instruments granted."
- The "cash flow effects [of] share-based payment arrangements."

Accordingly, the SEC staff's comments on share-based payment disclosures have focused on items such as:

- The nature of, and reason for, a modification in the share-based payment award's terms and how the registrant accounted for that modification.
- The terms and conditions of awards, including whether award holders are entitled to dividends or dividend equivalents.
- The number of options that are expected to vest and the assumptions used in developing those expectations.
- The registrant's valuation method, including significant assumptions used (e.g., volatility).

In its comments about disclosures, the SEC staff frequently refers to ASC 718-10-50-2, which describes the "minimum information needed to achieve the objectives in [ASC 718-10-50-1]."

In addition to commenting on the types of share-based payment transactions discussed above, the SEC staff often asks registrants about share-based payment information they are required to include in a proxy statement (e.g., those disclosures required by Regulation S-K, Item 402). See the Executive Compensation and Other Proxy Disclosures section for more information about staff comments on registrants' proxy statements.

Share-Based Payment Awards Issued by Privately Held Companies

Example of an SEC Comment

Please tell us about each significant factor contributing to the difference between the estimated IPO Price and the fair value of your shares since the September 2013 grant and any subsequent grants through the date of your response. In your response, please tell us about significant intervening events and reasons for changes in assumptions, as well as the weighting of expected outcomes and selection of valuation techniques employed.

Calculating share-based compensation for privately held companies can be complex and may require registrants to use significant judgment in determining the fair value of the equity instrument because there is typically no active market for the common stock of such companies. The SEC staff continues to comment on registrants' accounting and valuation assumptions for equity securities issued as compensation in periods before an IPO (commonly referred to as "cheap stock" considerations). The AICPA's accounting and valuation guide (known as the "Cheap Stock Guide") contains guidance on these accounting considerations.

A registrant preparing for an IPO should also refer to paragraph 7520.1 of the FRM, which outlines considerations for registrants when the "estimated fair value of the stock is substantially below the IPO price." In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

While the SEC staff has historically asked registrants to expand the disclosures in their critical accounting estimates to provide additional information about the valuation methods and assumptions used for share-based compensation in an IPO, it recently updated its FRM to indicate that registrants should significantly reduce such disclosures. Specifically, the staff revised Section 9520 of the FRM to clarify what disclosures are expected in an IPO registration statement and thereby encourage registrants to provide less information about cheap stock. However, paragraph 9520.2 of the FRM notes that the staff may continue to "issue comments asking companies to explain the reasons for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO)." Such requests are meant to ensure that a registrant's analysis and assessment support its accounting for share-based compensation and do not necessarily indicate that the registrant's disclosures need to be enhanced.

At the Practising Law Institute's "SEC Speaks in 2014" Conference, the SEC staff provided insights into how registrants would be expected to apply the guidance in paragraph 9520.1 of the FRM (and thereby reduce their share-based compensation disclosures):

- The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares. A registrant need **only** state that it used the income approach, the market approach, or a combination of both.

  Further, while registrants are expected to discuss the nature of the material assumptions they used, they would **not** be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a **statement** indicating that "a discounted cash flow method is used and [such method] involves cash flow projections that are discounted at an appropriate rate"; no additional details would be needed.

- Registrants would have to include a **statement** indicating that the estimates in their share-based compensation valuations are "highly complex and subjective." They would not need to provide additional details about the estimates.

- Registrants would also need to include a **statement** disclosing that such "valuations and estimates will no longer be necessary once the company goes public [because] once it goes public, it will rely on the market price to determine the market value of [its] common stock."

For a discussion of SEC staff comments related to IPOs, see the Initial Public Offerings section.

Financial Statement Presentation

Under SAB Topic 14.F, share-based compensation expenses should be classified in the same manner as other cash compensation costs, and the presentation should not be driven by the form of consideration paid. Share-based compensation expense should be allocated to items such as cost of sales, R&D, and SG&A (as applicable) and should not be separately presented in a single share-based compensation line item. Further, SAB Topic 14.F states, "Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A."

Other Deloitte Resources

- April 28, 2014, *Heads Up*, "MD&A Disclosures About 'Cheap Stock' in IPO Transactions."
- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."

SEC Disclosure Topics

Management's Discussion and Analysis

Regulation S-K, Item 303, provides guidance on the information a registrant should consider providing in its discussion of financial condition and results of operations in MD&A. The SEC staff continues to indicate that MD&A is the leading source of SEC staff comments and that well over half of all MD&A-related comments are about the results of operations section. Consequently, the SEC staff's comments have addressed most topics of MD&A1[1] but have continued to focus on greater transparency in registrants' disclosures about (1) material trends and uncertainties that affect results of operations, (2) liquidity and capital resources, (3) estimates in critical accounting policies, and (4) obligations subject to uncertainties.

The staff continues to stress that registrants should focus on providing disclosures that are material and relevant to their operations. In addition, the SEC staff continues to recommend [2] that registrants consider including an executive overview section in MD&A that contains a balanced discussion of the key drivers, challenges, and risks that affect results of operations and liquidity.

Results of Operations

The SEC staff frequently comments on how a registrant can improve its discussion and analysis of known trends, demands, commitments, events, and uncertainties and their impact on the results of operations. Such discussion and analysis is crucial to a financial statement user's understanding of the quality of, and potential variability in, a company's earnings and cash flows as well as the extent to which reported results indicate future performance. A determination of the appropriate disclosure generally should include (1) consideration of financial, operational, and other information; (2) identification of known trends and uncertainties; and (3) an assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's financial condition and operating performance.

Example of an SEC Comment

We note that you do not quantify the impact of the various factors that affected your revenues from period to period. For example, . . . you state that the sales . . . were negatively impacted by the exit of [certain product lines] and lower sales in your . . . product lines prior to being sold, but you do not quantify the impact. Similarly, you state . . . that gross profit . . . increased in 2013 primarily due to favorable raw material costs, but do not indicate either the change in raw material costs or the impact of this change. These are just examples. In future filings please quantify the effects of such factors and also discuss whether you believe these factors are the result of a trend, and, if so, whether you expect it to continue and how it may impact your financial condition and results of operations. See Item 303 of Regulation S-K and SEC Release No. 33-8350.

Under Item 303(a)(3), registrants are required to disclose in MD&A material known trends or uncertainties that may affect future performance (whether favorable or unfavorable). Registrants are commonly asked to (1) quantify components of overall changes in financial statement line items and (2) enhance their analysis of the underlying factors that cause such changes or the reasons for the components affecting the overall change — including an analysis of changes at the segment level because such an analysis is often meaningful in MD&A. The SEC staff has also suggested that in addition to discussing how volume and product mix affect a registrant's results of operations, the registrant should consider explaining other potential influences, such as pricing changes, acquisitions, new contracts, inflation, and foreign exchange rates.

The SEC staff also encourages registrants to:

- Use appropriate metrics to help them "tell their story" — including those that may be common to their industry (e.g., same-store sales, average subscribers). However, the SEC staff distinguishes such metrics from non-GAAP measures that are adjusted GAAP measures. See the Non-GAAP Financial Measures, Retail and Distribution, and Technology sections for additional information.

[1] See paragraphs 9110.1 and 9110.2 of the FRM for the SEC staff's interpretive views about the objectives of a registrant's MD&A.

[2] See the SEC's interpretive release for additional information.

- Present changes in a tabular format (e.g., a table that summarizes disaggregated cost of sales components by reportable segment).

The SEC staff has also asked registrants to separately discuss the impact of online sales on their results of operations. See the Retail and Distribution section for additional information.

Liquidity and Capital Resources

Example of an SEC Comment

In future filings, please provide a more informative analysis and discussion of changes in operating cash flows, including changes in working capital components, for each period presented. In doing so, please explain the underlying reasons for and implications of material changes between periods to provide investors with an understanding of trends and variability in cash flows. Please ensure your discussion and analysis is not merely a recitation of changes evident from the financial statements. Refer to Item 303(a) of Regulation S-K.

The SEC staff frequently requests more meaningful analysis in a registrant's MD&A of material cash requirements, historical sources and uses of cash, and material trends and uncertainties so that investors can understand the registrant's ability to generate cash and meet cash requirements. In addition, rather than repeating items that are reported in the statement of cash flows, registrants should (1) concentrate on disclosing the primary drivers of cash flows and the reasons for material changes in specific items underlying the major captions reported in their financial statements and (2) disclose significant developments in liquidity or capital resources that occur after the balance sheet date.

The SEC staff has noted that it is important for registrants to "accurately and comprehensively explain [their] liquidity story" and has advised registrants to consider including discussions of key liquidity indicators, such as leverage ratios and other metrics that management uses to track liquidity.[3] In addition, the SEC staff has indicated that MD&A disclosures should take into account how the following factors, among others, affect a registrant's liquidity:

- Any changes in leverage strategies.
- Any strains on liquidity caused by changes in availability of previously reliable funding.
- Sources and uses of funds.
- Intraperiod debt levels.
- Restrictions on cash flows between the registrant (i.e., the parent) and its subsidiaries.
- The impact of liquidity on debt covenants and ratios.

Registrants should also consider whether they need to provide enhanced disclosures about:

- Significant debt instruments, guarantees, and covenants. See the Debt section for more information about financial covenant disclosures in MD&A.
- Effects on liquidity of material cash balances that are held. For additional information, see the Income Taxes section.

[3] At the 2011 AICPA Conference, the SEC staff highlighted the need for registrants to include appropriate narratives regarding liquidity and capital resources.

Critical Accounting Policies

> **Example of an SEC Comment**
>
> Your discussion of goodwill . . . substantially duplicates the footnote disclosure. Please revise this section to provide an analysis of your goodwill accounting policies and the significant underlying estimates that supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and provides greater insight into the quality and variability of information regarding your impairment test of goodwill.

The critical accounting policies section of MD&A is intended to highlight only those financial statement items that require significant management estimates and judgment. Registrants should not simply copy their accounting policy disclosures from the footnotes to the financial statements. Instead, the SEC staff expects discussion and analysis of material uncertainties associated with the methods and assumptions underlying each critical accounting estimate.

To provide comprehensive and meaningful disclosures, management should consider disclosing the following items in the critical accounting policies section of MD&A:

- The method(s) used to determine critical accounting estimates.
- The accuracy of past estimates or assumptions.
- The extent to which the estimates or assumptions have changed.
- The drivers that affect variability.
- Which estimates or assumptions are reasonably likely to change in the future.

In addition, registrants should include an analysis of the sensitivity of estimates to change on the basis of outcomes that are reasonably likely to occur and that would have a material effect. The sensitivity analysis should be quantitative if it is reasonable for registrants to obtain such information.

The economy and volatility in the financial markets may also affect a registrant's defined benefit plans and related disclosures. For example, the SEC staff has indicated that registrants may need to expand disclosures in MD&A about key assumptions, pension asset investment strategies, changes to pension plan assets, and consideration of statutory minimum funding requirements. For additional information, see the Pensions and Other Postretirement Benefits section.

In addition to pension accounting, SEC staff comments to registrants have frequently focused on the management estimates used in the valuation of long-lived assets, income taxes (including DTAs and uncertain tax positions), and fair value estimates. See the Impairments of Goodwill and Other Long-Lived Assets, Income Taxes, and Fair Value sections for more information.

Tabular Disclosure of Contractual Obligations

Examples of SEC Comments

- Please expand footnote 1 [in your contractual obligations table] to disclose the components of "Other Liabilities" that were excluded from the Contractual Obligations table and the reasons why as stated in your response.
- We note . . . that you have long-term raw material and power supply contracts. Please tell us why you do not report these long-term contracts in your contractual obligations table under Item 303(a)(5) of Regulations S-K. In addition, tell us why amounts due under your revolving credit agreement are also excluded from the table. Please provide revised tabular disclosure of your contractual obligations to be included in future filings which includes these obligations or tell us how your current presentation complies with Item 303(a)(5) of Regulation S-K.

The SEC staff continues to comment on the contractual obligations table and the associated notes and disclosures. Such comments typically focus on (1) a registrant's omission of material obligations, such as interest payments on debt, pension obligations, and uncertain tax position liabilities, and (2) omission of disclosures about the terms of obligations, such as purchase obligations. See the Income Taxes section for more information about ASC 740-10 liabilities.

Some registrants have questioned how obligations subject to uncertainties about timing or amount should be presented in the table of contractual obligations. The SEC staff has noted that registrants should consider their circumstances and use judgment in determining whether to include such information in the table or the footnotes to the table.[4] The staff has also indicated that the footnotes should be used to clarify amounts in the table and to (1) explain the nature of the obligations, including whether they were included in, or excluded from, the table (and the reasons for inclusion or exclusion); (2) describe whether the obligations are subject to uncertainty; and (3) describe the uncertainty.[5]

Off-Balance-Sheet Arrangements

Example of an SEC Comment

Please revise to include a separately-captioned section within MD&A discussing your off-balance sheet arrangements as required by Item 303(a)(4) of Regulation S-K.

The SEC staff continues to focus on the requirement that registrants include a discussion of off-balance-sheet arrangements in a separately captioned section in MD&A[6] and has encouraged registrants to focus on the following themes in their disclosures about such arrangements:

- Any material difficulties that off-balance-sheet entities are experiencing (including asset write-downs or credit downgrades) and the effect on the registrant.
- Detailed disclosure of support the registrant has provided, or is obligated to provide, to off-balance-sheet entities (including obligations to provide liquidity).
- The potential effect on debt covenants, capital ratios, credit ratings, or dividends, should the registrant consolidate or incur losses associated with the entities.

[4] See the highlights of the September 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff for discussion of a registrant's use of judgment related to disclosures in the table of contractual obligations.

[5] To the extent that the obligations cannot be quantified, the SEC staff expects registrants to disclose information that investors and users need to understand the nature and extent of the registrant's obligations. As indicated in paragraph 9240.7 of the FRM, registrants may include footnotes "to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant's specified contractual obligations."

[6] A reason for the staff's focus on off-balance-sheet arrangements is noted in paragraph 9230.2 of the FRM, which states that the disclosure requirements related to such arrangements "are intended to elicit disclosure about why the registrant engages in the off-balance sheet arrangement, the magnitude and importance of the arrangement and the circumstances that would cause the registrant to recognize material liabilities or losses related to the arrangement."

Early-Warning Disclosures

Item 303 requires disclosure of "any known trends or uncertainties that . . . the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Early-warning disclosures give investors insight into when charges may be incurred in the future; whether a charge is related to contingencies, restructuring activities, goodwill or other long-lived asset impairments, or the settlement of uncertain tax positions; when revenue growth or profit margins may not be sustainable because of underlying economic conditions; or when the registrant will be unable to comply with debt covenants. Such disclosures give investors insight into the underlying conditions and risks that the company faces before a material charge or decline in performance is reported.

Other Deloitte Resources

- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."
- December 14, 2011, *Heads Up*, "Highlights of the 2011 AICPA National Conference on Current SEC and PCAOB Developments."

SEC Reporting

SEC authoritative literature includes a number of requirements that govern the form and content of a registrant's financial statements and other information that must be included in filings with the SEC. The SEC staff often comments on these requirements, and they have been the subject of discussion at a variety of forums, including the annual AICPA Conference, various industry conferences, and joint meetings of the SEC staff and the CAQ SEC Regulations Committee.

At the 2013 AICPA Conference, the SEC staff noted that there may be situations in which registrants seek relief from complying with certain SEC reporting rules and regulations (see below for a discussion of many of those provisions). For example, a registrant may seek relief from complying with Regulation S-X, Rule 3-05, under which the registrant must provide financial statements of an acquired business if the required significance test yielded a result that the registrant believes is unusual or anomalous. With this in mind, the staff acknowledged that relief may be warranted in some cases and that registrants may seek to obtain a waiver from CF-OCA. The SEC staff provided best practices for registrants to consider when seeking reporting relief.

Private-Company Accounting Alternatives

As noted above and discussed further below, there are instances in which a registrant must provide the financial statements of other entities in its registration statements or periodic filings. Under ASU 2013-12, the definition of a public business entity (PBE) includes entities that are "required by the [SEC] to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing)." PBEs are not permitted to adopt private-company accounting alternatives. Accordingly, the effects of any previously elected private-company accounting alternatives would have to be eliminated from the historical financial statements of an entity whose financial statements are included in the SEC filing of a registrant.

Significant Business Acquisitions (Rule 3-05)

Examples of SEC Comments

- Please provide to us your significance calculations for [the acquisition of Company A] under the asset, investment and income tests as prescribed by Rule 3-05 of Regulation S-X and tell us your basis for not providing financial statements under Rule 3-05 for this acquisition.
- [C]onfirm that for each business acquired, or to be acquired, you have acquired substantially all of the target's key operating assets. Provide your analysis of why presenting full financial statements under Rule 3-05 of Regulation S-X is appropriate as you are not acquiring certain assets and assuming certain liabilities.

When a registrant consummates, or it is probable that it will consummate, a significant business acquisition, the SEC staff may require the registrant to file certain financial statements for the acquired or to be acquired business (acquiree) under Rule 3-05 in a Form 8-K, registration, or proxy statement. The following factors govern whether, and for what period, financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business for SEC reporting purposes.
- The significance of the acquired or to be acquired business. The significance is calculated on the basis of three tests: the investment (purchase price) test, the asset test, and the income test.
- Whether consummation of the business acquisition is probable or has occurred.

The SEC staff comments on the application of Rule 3-05 in connection with significant business acquisitions when registrants:

- Incorrectly determine that the acquired or to be acquired assets and liabilities do not meet the definition of a business for SEC reporting purposes. The definition of a business for SEC reporting purposes under Regulation S-X, Article 11, is not the same as the definition under ASC 805 for U.S. GAAP purposes.
- Did not perform the significance calculations correctly. Some of the most common mistakes are misapplications of the income test, such as excluding unusual gains or losses from the test.
- Did not realize that Rule 3-05 also applies, in a registration statement or certain proxy statements, to probable acquisitions whose significance is greater than 50 percent.
- Did not consider, in a registration statement or proxy statement, the cumulative significance of previously consummated individually insignificant acquisitions.

The staff may also question the financial statements provided by a registrant under Rule 3-05 when the registrant has acquired only selected parts of an entity. In such situations, it may be appropriate, on the basis of the facts and circumstances, for the registrant to include (1) full financial statements of the entity, (2) carve-out financial statements of the assets and operations acquired, or (3) abbreviated financial statements (i.e., Statement of Assets Acquired and Liabilities Assumed and Statement of Revenue and Direct Expenses). For additional information about how to determine what financial statements are appropriate when the registrant has acquired selected parts of an entity, see Section 2065 of the FRM.

Investments in Equity Method Investees (Rules 4-08(g) and 3-09)

Example of an SEC Comment

Please demonstrate to us that audited financial statements pursuant to Rule 3-09 of Regulation S-X were not required for any of your unconsolidated investees . . . . Provide all calculations and assumptions as applicable.

When a registrant has a significant equity method investment, Regulation S-X, Rules 4-08(g) and 3-09, may require the registrant to provide summarized financial information of the investee in the footnotes to the financial statements, separate financial statements of the investee, or both. To determine whether summarized information is required under Rule 4-08(g), a registrant must perform all three significance tests: the investment test, the asset test, and the income test.

Under Rule 3-09, significance is calculated for equity method investees on the basis of only two tests performed annually: the investment test and the income test. If an investee is significant, its separate financial statements must be filed in the registrant’s Form 10-K. Thus, a registrant’s compliance with Rule 3-09 is particularly important because its failure to file the financial statements of a significant investee may cause it to become a delinquent filer and lose Form S-3 eligibility.

Common errors that registrants make when performing the significance tests under Rules 4-08(g) and 3-09 include:

- Failure to document the tests each year. This is most common when an equity investee has been clearly insignificant in the past. In certain situations, such as a near-break-even year for the registrant or a large income or loss at the investee level, the current year’s significance may change, making the equity investee significant for the first time.

- Failure to update the tests each year. Registrants should update and reassess the significance tests for all years presented in a Form 10-K after they report a retrospective change, such as a change in accounting principle or classification of a component as a discontinued operation. See paragraph 2410.8 of the FRM.

For additional SEC staff interpretations of Rules 4-08(g) and 3-09, see Section 2400 of the FRM.

Restrictions on Dividends (Rules 4-08(e), 5-04, and 12-04)

Registrants must consider the requirements of Regulation S-X, Rules 4-08(e), 5-04, and 12-04, when the transfer of assets (cash or other funds) to the parent company/registrant from its subsidiary (or subsidiaries) or equity method investee is materially restricted, limited, or in need of a third party's approval.

For additional discussion, see the Debt section.

Guarantors of Registered Securities (Rule 3-10)

Regulation S-X, Rule 3-10, requires a registrant to provide separate financial statements for each subsidiary issuer or guarantor of debt securities registered or being registered unless certain criteria are met. The information required under Rule 3-10 must be presented in registration and proxy statements and Forms 10-K and 10-Q. Therefore, a registrant should consider the requirements under Rule 3-10 if (1) the registrant registers debt and the debt is guaranteed by one or more of its subsidiaries or (2) one of the registrant's subsidiaries registers debt and the debt is guaranteed by the parent company or one or more of its other subsidiaries.

As noted above, Rule 3-10, contains certain exceptions under which a registrant may provide more limited financial information in lieu of full financial statements. If the registrant meets the exception criteria, it may be eligible to provide, in a footnote to the parent company's financial statements, either of the following types of modified financial information in lieu of separate financial statements:

- Condensed consolidating financial information.
- Narrative disclosures about each subsidiary issuer or guarantor.

All of the exceptions under Rule 3-10 require (1) the subsidiary issuer and guarantors to be "100 percent owned" by the registrant and (2) the guarantee to be "full and unconditional." The SEC staff sometimes comments on whether the registrant specifically meets these and other criteria necessary for the presentation of modified financial information.

For additional SEC staff interpretations of Rule 3-10, see Section 2500 of the FRM.

Definition of 100 Percent Owned

Example of an SEC Comment

Please revise your disclosure in future filings to clarify that all of the guarantor subsidiaries and the issuer are 100% owned by the parent as defined in [Rule] 3-10(h)(1) of Regulation S-X, if correct. In this regard, we note your reference to the guarantor subsidiaries as "wholly-owned", which has a different meaning than 100% owned. Please also refer to [Rule] 1-02(aa) of Regulation S-X for guidance.

Registrants must disclose that a subsidiary is 100 percent owned to meet one of the conditions for relief under Rule 3-10. The SEC staff has reminded registrants that under Regulation S-X, "100 percent owned" does not mean the same thing as "wholly owned" and that the terms are therefore not interchangeable. In addition, the staff has indicated that wholly owned under Regulation S-X, Rule 1-02, means that the parent owns substantially all of the outstanding voting stock of the subsidiary whereas 100 percent owned is defined as ownership of all outstanding shares of the subsidiary. For further clarification of the definition of 100 percent owned, see Rule 3-10(h)(1).

Full and Unconditional Guarantees and Release Provisions

> **Example of an SEC Comment**
>
> You disclosed that . . . all guarantees are full and unconditional, subject to certain customary release provisions set forth in the applicable Indenture. Please provide us with a specific and comprehensive discussion regarding how you considered these release provisions in determining that the guarantees are "full and unconditional" and in your reliance on Rule 3-10 of Regulation S-X.

A guarantee must be full and unconditional to allow the registrant to provide limited financial information in lieu of full financial statements under Rule 3-10. Paragraph 2510.4 of the FRM clarifies that an "arrangement that permits a guarantor to opt out of its obligation prior to or during the term of the debt is not a full and unconditional guarantee." However, a subsidiary whose guarantee is released automatically by one of the customary release provisions referred to in paragraph 2510.5 of the FRM may rely on the relief provided by Rule 3-10. Accordingly, registrants should disclose any qualifications of subsidiary guarantees and should not characterize a subsidiary guarantee as full and unconditional without disclosing the circumstances under which it can be released.

The FRM's guidance on customary release provisions applies only to subsidiary guarantees, not to parent guarantees. The SEC staff has clarified that to qualify for Rule 3-10 relief, a registrant must meet certain conditions specified in the rule, one of which is the filing of the parent company's financial statements for the periods indicated. Therefore, if the parent could be released from its guarantee, there would be no basis for relief under Rule 3-10. However, the staff has allowed limited exceptions to parent release provisions, such as situations in which the parent's guarantee is released when the debt is repaid. Registrants are encouraged to contact the staff regarding any parent release provisions in their debt indentures.

Condensed Consolidating Financial Information

> **Example of an SEC Comment**
>
> We note positive operating cash flows recorded for either the Parent or Guarantor in each period presented. It is unclear how the Parent was able to generate substantial positive operating cash flows . . . given the absence of any revenue transactions in the fiscal years presented and the lack of dividends from subsidiaries during [those fiscal years]. . . . Please advise and provide us a reconciliation of operating cash flows from net income using the indirect method for the Parent, Guarantor subsidiary and the Non-Guarantor subsidiaries for each period presented.

If a registrant presents condensed consolidating financial information, it should use a columnar format and include certain or all of the following as applicable: (1) the parent, (2) subsidiary issuer(s) of the security, (3) subsidiary guarantor(s), (4) nonguarantor subsidiaries, and (5) consolidating adjustments. Registrants should also provide sufficient detail about the assets, liabilities, operations, and cash flows for each of the parent, issuer, subsidiary guarantors, and nonguarantor subsidiaries, as appropriate.

The SEC staff often discusses form and content considerations related to the preparation of condensed consolidating financial information under Rule 3-10 and has highlighted that under this rule:

- The information should be presented in the same level of detail (i.e., the major financial statement captions) as interim financial statements prepared in accordance with Regulation S-X, Article 10.
- The information should be presented in accordance with U.S. GAAP[1] (e.g., intercompany receivables should be shown as an asset and not as a negative liability).

[1] One exception is that investments in subsidiaries should be presented under the equity method of accounting. See Rule 3-10(i)(5).

- The classifications in the condensed consolidated statement of cash flows should also comply with U.S. GAAP.
- A total for comprehensive income should be presented in either a single continuous statement or two separate but consecutive statements.[2]

The SEC staff may also comment when a registrant:

- Incorrectly assumes that certain exceptions in Rule 3-10 are met and therefore concludes that it does not have to provide separate financial statements, condensed consolidating financial information, or narrative disclosures.
- Incorrectly prepares the required condensed consolidating financial information by not presenting subsidiaries under the equity method of accounting, or not presenting information in sufficient detail to allow investors to determine the assets, results of operations, and cash flows of each of the consolidating groups.

The SEC staff has also commented when the parent (or guarantor) has recorded positive operating cash flows in a particular period in the absence of any revenue-generating activities during that time frame. Positive cash flow from operations often results when the parent (or guarantor) classifies dividends received from its subsidiaries as a "return on its investment." ASC 230 distinguishes between returns **on** investment, which should be classified as inflows from operating activities (see ASC 230-10-45-16(b)), and returns **of** investment, which should be classified as inflows from investing activities (see ASC 230-10-45-12(b)). The parent (or guarantor) should consider its particular facts and circumstances when determining whether the cash flows resulting from a dividend distribution represent a "return on" or a "return of" the related investment in the underlying subsidiary. The SEC staff may ask registrants to disclose (1) how they have accounted for such dividends and (2) the amount of dividends received from subsidiaries included in cash flows from operations.

Recently Acquired Subsidiary Issuers or Subsidiary Guarantors (Rule 3-10(g))

Under Rule 3-10(g), which applies to recently acquired subsidiary issuers or subsidiary guarantors, a registrant must provide separate financial statements of a significant subsidiary issuer or guarantor if the subsidiary's historical results have not been included in the parent's audited financial statements for at least nine months of the most recent fiscal year. The SEC staff noted that the significance test under Rule 3-10(g) is different from the tests under Rule 3-05 for businesses acquired or to be acquired (see Significant Business Acquisitions (Rule 3-05) above). To determine significance under Rule 3-10(g), a registrant should compare the net book value or purchase price (whichever is greater) of the subsidiary with the principal amount of the securities being registered. If the test result equals or exceeds 20 percent, the registrant must file separate financial statements of the acquired subsidiary that are audited in accordance with the standards of the PCAOB for the most recent fiscal year and unaudited interim financial statements for the appropriate interim period preceding the acquisition.

In computing significance under Rule 3-10(g), a registrant must aggregate the acquisitions of a group of related subsidiary issuers or guarantors before their acquisition. A registrant is also required to include financial statements in registration statements but not in periodic reports filed under the Exchange Act (e.g., Forms 10-K and 10-Q).

[2] Separately, the SEC staff has clarified that a registrant should present total comprehensive income in a manner consistent with the interim requirements for the registrant's primary financial statements. See paragraphs 2515.2 and 2810.1 of the FRM for additional information.

Issuers of Securities That Collateralize Registered Securities (Rule 3-16)

Example of an SEC Comment

Please advise whether the collateral includes the securities of any of the guarantors and, if so, whether such securities constitute a "substantial portion" of the collateral for the [notes] as defined in Rule 3-16 of Regulation S-X. In addition, . . . please advise how you intend to monitor any future obligation to provide financial statements pursuant to Rule 3-16.

Regulation S-X, Rule 3-16, requires a registrant to file full audited financial statements for each of the registrant's affiliates whose securities constitute a "substantial portion of the collateral" for any class of securities registered or being registered. This requirement may apply when the capital stock of some or all of the registrant's subsidiaries are pledged as collateral for a debt instrument. The registrant must provide these financial statements in its Forms 10-K and certain registration statements.

Registrants often look at the tests under Rules 3-10 and 3-16 as one test or related tests. However, they should be aware that these tests are performed separately and that the results must be assessed individually.

Rule 3-16 includes its own specific test (the "substantial portion of the collateral" test) and "bright-line" requirements. Unlike Rule 3-10, Rule 3-16 does not permit condensed consolidating financial information in lieu of full financial statements. Therefore, Rule 3-16 requires full audited financial statements of each affiliate whose securities constitute a substantial portion of the collateral of a security.

For additional SEC staff interpretations of Rule 3-16, see Section 2600 of the FRM.

Pro Forma Financial Information (Article 11)

Example of an SEC Comment

[T]ell us how you determined that these . . . expenses are (i) directly attributable to the transaction, (ii) not expected to have a continuing impact, and (iii) factually supportable. Refer to Rule 11-02(b)(6) of Regulation S-X.

Pro forma information is required under Regulation S-X, Article 11, when (1) it is material to an understanding of a significant consummated or probable transaction, such as a business combination; (2) a transaction is subject to a shareholder vote; or (3) other conditions outlined in Article 11 are met. Pro forma financial information under Article 11 may be required in a registration or proxy statement or a Form 8-K but is not required in a Form 10-K or 10-Q. Although Article 11 pro forma financial statements are not required in a registrant's Form 10-K or 10-Q, a registrant must separately evaluate the need for pro forma disclosures under ASC 805 (related to business combinations) in its financial statements included in a Form 10-K or 10-Q. See the Business Combinations section for more information about pro forma disclosures that are required under U.S. GAAP.

Registrants should generally present Article 11 pro forma financial statements in columnar form with separate columns for historical financial information, pro forma adjustments, and pro forma results. In limited circumstances, registrants may present narrative disclosures in lieu of pro forma financial statements. Further, Article 11 requires pro forma balance sheet adjustments to reflect events that are (1) factually supportable and (2) directly attributable to the transaction. In addition, pro forma income statement adjustments must have a "continuing impact" on the registrant's operations (i.e., they are not "onetime").[3] The SEC staff continues to comment on certain form and content matters, such as when a registrant fails to clearly explain each financial statement adjustment or does not clearly demonstrate how the above requirements are met.

[3] The SEC staff has expanded on its view of what would constitute continuing impact. See the highlights of the June 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff for additional information.

When calculating pro forma adjustments, registrants should assume that the transaction occurred (1) as of the date of the most recent balance sheet for the pro forma balance sheet and (2) at the beginning of the fiscal year presented for the pro forma income statement. In the past, the SEC staff has clarified that this guidance applies only to calculating the amount of the pro forma adjustment and should not be used to determine whether an adjustment is appropriate. For example, in the preparation of a pro forma income statement, it would be inappropriate for a registrant to make a pro forma adjustment for a charge in the historical financial statements on the basis of an assertion that if the transaction had been consummated at the beginning of the year, the charge would not have been incurred.

For companies doing an IPO, the SEC staff has clarified that it would be rare for costs "that a company expects to incur as a public company" to be pro forma adjustments "since such costs are not directly attributable to the transactions for which pro forma information is presented." However, the staff has noted that depending on the facts and circumstances, a registrant may disclose the types and ranges of such costs in the notes to the pro forma financial information. See the Initial Public Offerings section for more information.

Section 3300 of the FRM summarizes special problems and issues that are often associated with pro forma financial information.

SEC Reporting Considerations for Material Changes That Require Retrospective Application

After the registrant has issued its annual financial statements, an event may occur that requires it to make a material retrospective change (e.g., the initial adoption of certain accounting pronouncements, a segment change, or the classification of a component as a discontinued operation). If the registrant files a new registration statement after it has filed interim financial statements that report the material retrospective change, it generally must file updated financial statements and other financial information (e.g., MD&A, selected financial data) to reflect the retrospective adjustments for periods before adoption of the change. These filings are typically made on Form 8-K. The SEC staff has allowed limited exceptions to this requirement for certain retrospective changes (see Section 13500 of the FRM for information regarding retrospective presentation of stock splits). In addition, there are different considerations for (1) currently effective registration statements (see Regulation S-K, Item 512(a)), (2) registration statements on Form S-8 (see the note to Section 13100 of the FRM), and (3) retrospective changes to provisional amounts recorded for business combinations (see Section 13600 of the FRM).

Topic 13 of the FRM provides additional information about the effects of retrospective changes on financial statements required in registration statements.

Audit Report Requirements

Examples of SEC Comments

- Please provide a dated audit report reflecting the city and state where issued as required by Rule 2-02(a) of Regulation S-X.
- We note that your auditor's report refers to "the auditing standards" of the PCAOB rather than to "the standards" of the PCAOB as is required by the PCAOB's Auditing Standard No. 1. Please explain why the report includes the qualifier "auditing"; and if the reason is a typographical error, please amend the filing to include a corrected audit report.

The SEC staff continues to comment when a registrant does not comply with Regulation S-X, Rule 2-02(a), and Regulation S-T, Rule 302. For example, the staff has commented when:

- A signature did not conform to Regulation S-X and S-T requirements.[4]
- A public accounting firm's city and state were omitted from the audit report.
- A registrant included a report from its auditor that does not appropriately identify all financial statements covered by the audit report.

The SEC staff will generally ask the registrant to amend its filing or provide a revised audit report if its Report of the Independent Registered Public Accounting Firm is not in compliance with the technical requirements of Regulation S-X, Rule 2-02(a), or Regulation S-T, Rule 302.

In addition, the CAQ issued Alert 2012-16 to remind auditors that "it **would not** be appropriate for the auditor's report for issuers or other entities that require compliance with PCAOB requirements to reference only the ***auditing* standards** of the PCAOB" since this qualifying language may imply that the auditor did not adhere to other standards of the PCAOB (e.g., its independence standards). The alert also encouraged registrants and auditors to review paragraph 4110.5 of the FRM for additional information regarding certain PCAOB requirements in various SEC filings.

Other Deloitte Resources

- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."

4 In February 2011, the CAQ issued Alert 2011-04 to remind auditors about (1) the requirement under Regulation S-X, Rule 2-02(a), for registrants to include signed audit reports in EDGAR filings and (2) the additional requirements related to typed "signatures" in electronic submissions.

Disclosures About Risk

The SEC staff continues to expect registrants to provide investors with tailored, comprehensive, and transparent risk disclosures.

Risk Factors

> **Example of an SEC Comment**
>
> Please ensure that your risk factors fully describe the material risks faced by you and explain specifically how such risks are related to your business.

In recent years, the SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language. In an April 11, 2014, speech[1] highlighting the SEC staff's "disclosure effectiveness" initiative, a staff member indicated that "risk factors could be written better — less generic and more tailored — and they should explain how the risks would affect the company if they came to pass."

Accordingly, the SEC staff routinely asks registrants to replace boilerplate risk disclosures with a discussion of the risks that specifically affect the registrant and their possible impact on the registrant's business. This discussion may be supplemented with quantitative information to provide additional context about the risks. In addition, the staff often asks registrants whether they have (1) discussed all relevant risk factors and (2) provided sufficient MD&A discussion when a risk constitutes a material trend or uncertainty. The staff also reminds registrants that the title of each risk factor should adequately describe the related risk.

Cybersecurity

> **Example of an SEC Comment**
>
> We note your disclosure that an unauthorized party was able to gain access to your computer network "in a prior fiscal year." So that an investor is better able to understand the materiality of this cybersecurity incident, please revise your disclosure to identify when the cyber incident occurred and describe any material costs or consequences to you as a result of the incident. Please also further describe your cyber security insurance policy, including any material limits on coverage.

The SEC staff has noted the increasingly frequent occurrence of cyber incidents, which may cause registrants to incur significant remediation and other costs for (1) direct damages (both real and reputational), (2) the impact on their customers, and (3) increased protection from future cybersecurity attacks. It is important for registrants to consider the nature of any cyber incidents that occur and to provide the appropriate level of disclosure about such incidents in their filings.

At the "SEC Speaks in 2014" Conference, the SEC staff acknowledged that no SEC rules explicitly require registrants to disclose cybersecurity-related matters in their filings. However, registrants were reminded that the SEC's Division of Corporation Finance has issued CFDG Topic 2, which provides interpretive guidance on potential disclosures related to material cybersecurity matters. CFDG Topic 2 indicates that under existing SEC requirements, registrants may need to provide disclosures in various sections of an SEC filing, including risk factors, legal proceedings, MD&A, and the financial statements. For example, cybersecurity risks and cyber incidents may constitute material known trends and uncertainties that a registrant should consider disclosing in MD&A in accordance with Regulation S-K, Item 303(a)(3)(ii).

[1] Keith Higgins, director, Division of Corporation Finance, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," April 11, 2014.

In other remarks at the conference, the SEC staff clarified its expectations regarding the nature and extent of a registrant's cybersecurity disclosures. It noted that a registrant should avoid boilerplate cybersecurity disclosures and instead should include such information as (1) the aspects of the business that are subject to risks, (2) updates for new information, and (3) cost estimates, if possible and material. The staff reminded registrants that they should not state that there is a risk of a cybersecurity breach after the occurrence of an actual cyber-attack; rather, such registrants should disclose that they have experienced security breaches or cyber-attacks. However, the staff indicated that it would not expect disclosures to be so detailed that they constitute a "roadmap" that would further expose a registrant to cyber-attack. In addition, the staff acknowledged that limited disclosures may be justified in certain situations (e.g., when the registrant is working with law enforcement officials after a cybersecurity breach).

Accordingly, the SEC staff may monitor information outside a registrant's filings and ask why certain cyber incidents are not disclosed. Further, a registrant may be asked to confirm that it has disclosed the occurrence of material cyber incidents in its filings.

Issuers Based in China

At the 2013 AICPA Conference, the SEC staff discussed risk factor disclosures that issuers with substantial operations based in China should consider making (although the same considerations could apply to issuers with operations in other jurisdictions). See the Consolidation section for addition information.

Other Deloitte Resources

- October 16, 2014, *Heads Up*, "SEC Staff Suggests Ingredients for Effective Disclosures."
- August 26, 2014, *Heads Up*, "The Road to Effective Disclosures."
- April 8, 2014, *Heads Up*, "Highlights of the SEC's Cybersecurity Roundtable."
- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Non-GAAP Financial Measures

Example of an SEC Comment

Given your disclosure stating that you utilize your non-GAAP measure [to determine the amount of cash available for distribution to your limited partners,] please explain why you have not reconciled this non-GAAP liquidity measure to operating cash flow as the most directly comparable GAAP measure, rather than net income, to comply with Item 10(e)(1)(i)(B) of Regulation S-K.

SEC Rule 33-8176 defines a non-GAAP financial measure as a "numerical measure of a registrant's historical or future financial performance, financial position or cash flows" that includes amounts that are not part of the most directly comparable GAAP measure or excludes amounts that are part of the most directly comparable GAAP measure. Common non-GAAP financial measures include EBITDA or adjusted EBITDA, adjusted revenues, free cash flows, core earnings, funds from operations, and measures presented on a constant-currency basis.

The SEC staff has continued to comment on non-GAAP financial measures, primarily focusing on the extent of a registrant's disclosures and whether the disclosures demonstrate the purpose of the measures (i.e., how management uses them and their usefulness to investors). Regulation S-K, Item 10(e)(1)(i), states that for financial measures used in documents that are filed with the SEC, the following information should accompany a registrant's disclosure of non-GAAP financial measures:

(A) A presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP);

(B) A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP [financial] measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . ;

(C) A statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and

(D) To the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not [otherwise] disclosed.

The SEC staff has commented when a non-GAAP financial measure is not reconciled to the appropriate GAAP measure as determined on the basis of whether the purpose of the non-GAAP measure is to assess the registrant's performance or its liquidity. For example, the staff has indicated that the most directly comparable GAAP measure for reconciling EBITDA is typically net income (loss) for a performance measure and cash flows from operating activities for a liquidity measure.

The SEC staff focuses on consistency in communications with investors. It may ask a registrant about inconsistencies between (1) the measures identified as key metrics in information disclosed outside the registrant's SEC filings, such as on its Web site and in its press releases, earnings calls, and analyst presentations, and (2) the metrics in the registrant's SEC filings. The SEC staff has noted that it does not require registrants to use non-GAAP measures in their filings. However, the staff may comment if a registrant discusses non-GAAP financial measures in other communications to investors but such discussion is omitted from, or contradicts, the information in the registrant's filings. In addition, if a non-GAAP measure is the focal point in all of a registrant's outside communications but is not included in filed documents, the SEC staff may ask why.[1]

[1] The SEC staff discussed this topic at the 2010 AICPA Conference. See Deloitte's December 16, 2010, *Heads Up* for additional information.

At the 2013 AICPA Conference, the SEC staff noted that it continues to focus on disclosures of non-GAAP measures and particularly on whether registrants have (1) clearly labeled and described non-GAAP measures and adjustments (e.g., titles should not be confusingly similar to those of GAAP financial measures), (2) used appropriate conventional accounting terminology, and (3) provided context for their presentation.

The SEC staff has indicated that a registrant should not present non-GAAP measures if they are misleading — regardless of whether the registrant intends to use them in or outside a filing. Further, the staff has indicated that the following items should not be excluded from non-GAAP financial measures:

- Expenses that are necessary to run the business, such as traditional recurring cash operating expenses.
- The largest expenses that are necessary to generate the registrant's revenues.

The staff has also indicated that registrants should not eliminate recurring cash charges from a profit measure in a misleading way. When the staff believes that a registrant's presentation of a non-GAAP measure is misleading, it may take action in addition to issuing a comment, which could include bringing an enforcement action against the registrant.

See the Materiality and Real Estate sections for additional information about non-GAAP financial measures.

Nonrecurring, Infrequent, and Unusual Items

Example of an SEC Comment

We note your reconciliation of adjusted net earnings from continuing operations contains an adjustment for acquisition amortization . . . . Further, we note that you are providing this non-GAAP measure because it helps your investors understand the effect of nonrecurring items on your reported results. Explain to us why the acquisition adjustment item should not be considered a recurring item. In this regard, we note this adjustment was made for the past three fiscal years in your reconciliation. . . . Please revise your disclosure so that you do not indicate that these items are nonrecurring, infrequent or unusual. We refer you to Item 10(e)(1)(ii)(B) of Regulation S-K.

The SEC staff often comments when adjustments to non-GAAP measures are labeled as nonrecurring, infrequent, or unusual. Question 102.03 of the C&DIs related to non-GAAP financial measures clarifies the guidance in Regulation S-K, Item 10(e), which prohibits registrants from adjusting a non-GAAP financial performance measure "to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years." Specifically, Question 102.03 indicates that a charge or gain may be included as an adjustment as long as it is not inappropriately labeled or described as nonrecurring, infrequent, or unusual.

Undue Prominence of a Non-GAAP Financial Measure

Example of an SEC Comment

Your disclosures include a full non-GAAP income statement, which appears to be provided for the purposes of reconciling non-GAAP measures to the most directly comparable GAAP measures. We believe this may cause undue prominence to the non-GAAP information. Please confirm for us that you will revise your disclosures in future filings such that a full non-GAAP income statement is not included and your reconciliations are disclosed in a different format. We refer you to question 102.10 in the Division of Corporation Finance's Compliance and Disclosure Interpretations at http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

The SEC staff will comment when a registrant presents its non-GAAP financial measures more prominently than its GAAP measures in terms of the order of presentation or the degree of emphasis. A registrant may receive a comment if its discussion of non-GAAP financial measures is significantly longer than its discussion of the corresponding GAAP financial measures, or if it uses a full non-GAAP income statement format instead of applying the guidance in Question 102.10 of the C&DIs related to non-GAAP financial measures. In recent comments, the SEC staff has indicated that as a substitute for presenting a full non-GAAP income statement, registrants may consider presenting only individual non-GAAP measures (e.g., line items) as long as each measure is used in a manner consistent with Item 10(e)(1)(i).

C&DIs Related to Non-GAAP Financial Measures

The SEC's C&DIs related to non-GAAP financial measures give registrants greater flexibility to disclose such metrics in filings with the Commission. The topics covered in the C&DIs include disclosure of non-GAAP financial measures in business combination transactions; interpretive issues related to the non-GAAP liquidity and performance measure prohibitions in Item 10(e) (including issues related to EBIT, EBITDA, and segment performance measures); and compliance issues related to the release of quarterly and annual financial information under Item 2.02 of Form 8-K.

In addition to the C&DIs, SEC resources on non-GAAP measures include Regulation S-K, Item 10(e); Regulation G; and Topic 8 of the FRM.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Disclosure Controls and Procedures

In their quarterly discussions of disclosure controls and procedures (DCP),[1] registrants must use language that conforms to the requirements in Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act.[2] The SEC staff often comments when registrants do not use the proper definition of DCP or omit certain language in reaching conclusions about the effectiveness of their DCP. In these situations, the staff frequently requires registrants to confirm that their DCP are effective in the current year and to revise their disclosures in future filings.

Inappropriate Conclusion About DCP

> **Example of an SEC Comment**
>
> We note your statement that your disclosure controls and procedures are not effective for a company your size. Please revise to remove the qualifier "for a company our size." Refer to Item 307 of Regulation S-K, which requires a clear and unqualified statement as to whether your disclosure controls and procedures are effective or ineffective.

The SEC staff has noted that management must clearly state, without using any qualifying or alternative language, its conclusion about whether DCP are "effective" or "ineffective" as of the end of the respective quarter. Examples of unacceptable language include phrases such as "adequate," "effective except for," "effective except as disclosed below," or "reasonably effective."

In addition, the SEC staff has also commented when registrants refer to the level of assurance of the design of their DCP. Although registrants are not required to discuss such assurance, the staff has asked registrants that choose to do so to also state clearly whether the DCP are, in fact, effective at the "reasonable assurance" level.

In addition, when registrants have concluded that their DCP are ineffective, the staff has asked them to discuss how they intend to remedy the deficiencies identified.

Incomplete Definition of DCP

> **Example of an SEC Comment**
>
> We note that you disclose a partial definition of disclosure controls and procedures. When you include a definition of disclosure controls and procedures, the entire definition in Exchange Act Rules 13a-15(e) or 15d-15(e) is required. Alternatively, you can simply reference the Rule 13a-15(e) without including the definition. Please revise your disclosure in future annual and quarterly reports accordingly.

Registrants are not required to define DCP in their conclusion. However, if they choose to define the term, they must use the entire definition in Rule 13a-15(e) or Rule 15d-15(e).

Conclusion That DCP Were Effective If a Restatement Is Required, a Material Weakness Exists, or Reports Were Not Filed in a Timely Manner

> **Example of an SEC Comment**
>
> We note your disclosure of a material weakness related to the failure to maintain qualified accounting personnel. Your disclosure describes certain remediation efforts and states that you expect remediation to continue. Given Internal Controls over Financial Reporting ("ICFR") are an integral part of Disclosure Controls and Procedures ("DC&P"), please tell us how you came to the conclusion that your material weakness related to ICFR did not impact your conclusion on the effectiveness of your DC&P or amend to revise your conclusion on the effectiveness of your DC&P.

1 Under Part I, Item 4 of Form 10-Q and Part II, Item 9A of Form 10-K.

2 As required by Regulation S-K, Item 307.

Paragraph 4310.9 of the FRM states, "Because of the substantial overlap between ICFR and DCP, if management concludes that ICFR is ineffective, it must also consider the impact of the material weakness on its conclusions related to DCP." If a registrant concludes that its DCP are effective when a material weakness exists, the SEC staff often asks for information on the factors the registrant considered in reaching such a conclusion. In addition, when a registrant is required to file amended periodic reports containing restated financial statements, the SEC staff generally asks the registrant to reconsider its conclusions about the effectiveness of its DCP.

The SEC staff has also asked about management's conclusion that DCP were effective when a registrant did not file periodic reports in a timely manner. A registrant should design DCP to ensure that information it must disclose in its reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the periods specified in the SEC's rules. If the registrant does not report such information within these periods, the staff may request the registrant to supply additional information to support management's conclusion.

A Change in the Conclusion That DCP Were Effective If No Changes to ICFR Were Disclosed

Example of an SEC Comment

In light of the fact that your Form 10-K discloses that management determined that both disclosure controls and procedures and internal controls over financial reporting were not effective due to certain disclosed material weaknesses, please explain to us why you believe that it is appropriate to conclude that disclosure controls and procedures are effective for the quarterly periods subsequent to your most recent year-end. In this regard, we also note from your disclosure in your Form 10-Qs that there have been no changes in internal controls in the applicable quarterly periods. Please advise or revise to change your disclosure in your Form 10-Qs accordingly.

If a registrant concludes that its DCP were effective after a period in which the DCP had been deemed ineffective, the SEC staff may ask the registrant to explain the basis for its conclusion. The SEC staff is especially likely to do so if the registrant has disclosed in the same period that there have been no changes to its ICFR.

Internal Control Over Financial Reporting

In addition to disclosing material changes in ICFR on a quarterly basis,[1] a registrant must annually provide management's report on ICFR and, if applicable, the attestation report of the registrant's registered public accounting firm.[2] These reports are not required in registration statements or Form 11-K.[3] Newly public companies generally do not need to provide management's report on ICFR in the first Form 10-K that they file after their initial public registration statement is declared effective.[4] Further, the JOBS Act amended Section 404(b) of the Sarbanes-Oxley Act by exempting emerging growth companies (EGCs) from the requirement to obtain an attestation report on ICFR for as long as such entities retain their EGC status. See the Emerging Growth Companies section for considerations related to EGCs.

Entities should be mindful of the SEC's interpretive release regarding management's assessment of ICFR, particularly the guidance on the evaluation of control deficiencies. The OCA has stated that internal control reporting is a focus in its reviews and enforcement actions this year, and this focus is evidenced by two recent charges. In the first case, the SEC's Division of Enforcement brought an enforcement action against the CEO and CFO of a computer equipment company alleging internal control violations, including (1) the failure to disclose to their company's auditors significant deficiencies in internal control and (2) falsely representing in their signed certifications under Section 302 of the Sarbanes-Oxley Act that they disclosed all such deficiencies to the auditors. In the second case, an enforcement action was brought against a corporation for FCPA violations, including internal control violations of the Exchange Act, with the chief of the Division of Enforcement's FCPA Unit noting that "[w]hen a company makes the strategic decision to sell its products overseas, it must ensure that the right internal controls are in place and operating."

Evaluation of Severity of Control Deficiencies

Example of an SEC Comment

We note that you have concluded that no significant deficiencies or material weaknesses (arising from either your consolidation policies or revenue recognition policies or a combination of both) existed as of December 31, 2012 and December 31, 2013. Tell us whether you identified the existence of any control deficiencies as of either of those dates in relation to consolidation or revenue recognition that did not rise to the level of a significant deficiency or material weakness. If so, explain what they are and discuss how you assessed their severity. [Emphasis omitted]

When registrants identify numerous control deficiencies but do not report a material weakness, the SEC staff issues comments to understand how they evaluated the severity of the deficiencies in aggregate. The SEC staff has reiterated that the existence of a material weakness does not depend on the actual magnitude of the error in a restatement but instead depends on whether there is a reasonable possibility that a material misstatement could occur and not be detected or prevented by the registrant's ICFR.[5] In the interpretive release discussed above, the SEC stated that management needs to consider "whether each deficiency, individually or in combination, is a material weakness as of the end of the fiscal year . . . even though such deficiencies may be individually less severe than a material weakness"; in addition, the SEC noted an increased likelihood of misstatement when there are "[m]ultiple control deficiencies that affect the same financial statement amount or disclosure." At the 2013 AICPA Conference, Brian Croteau, deputy chief accountant in the OCA, stated that he remains convinced that "at least some of the PCAOB's inspection findings related to the audits of internal control over financial reporting are likely indicators of similar problems with management's evaluations of ICFR, and thus potentially [are] also indicative of risk for unidentified material weaknesses." He also questioned whether all material weaknesses are being properly identified and noted that only in rare instances does management identify a material weakness in the absence of a material misstatement. He attributed this to the following possibilities: (1) "the deficiencies are not being identified in the first instance" or (2) "the severity of deficiencies is not being evaluated appropriately."

1 Under Part I, Item 4, of Form 10-Q and Part II, Item 9A, of Form 10-K.

2 The requirement for an attestation report applies only to large accelerated and accelerated filers because nonaccelerated filers are exempt from this requirement under Section 404(b) of the Sarbanes-Oxley Act.

3 Form 11-K is used to file the annual reports for employee stock purchase, savings, and similar plans.

4 However, paragraph 4310.6 of the FRM states, "A company that historically reported under the Exchange Act as a voluntary filer or because of registered debt, and therefore filed annual reports up to and through the date of its [equity] IPO, in which it was required to comply with . . . Item 308(a) of Regulation S-K, is therefore required to provide management's report on ICFR in its first annual report following the IPO."

5 The SEC staff discussed this issue at the 2010 AICPA Conference. See Deloitte's December 16, 2010, *Heads Up* for more information.

Evaluation of Control Deficiencies Related to Immaterial Misstatements

Example of an SEC Comment

We note that during the second quarter of 2013, you identified an immaterial cumulative error . . . . We also note that you have corrected three separate financial statement item errors during the year ending December 31, 2013 which you have determined as immaterial to your previously reported amounts contained in your interim and annual reports. Please provide to us the following:

a) The amount(s) and a full description of the nature of the error . . . ;

b) [A]n explanation of factors considered by management in determining that the effect of the $[X] or [Y]% reduction to depreciation and depletion expense and [Z]% benefit to pre-tax loss in the second quarter was not material to results of operations for the second quarter of 2013 or to any of the prior periods affected by this error;

c) [Y]our criteria or policy for assessing an error as material. Please provide an explanation of the quantitative and qualitative factors considered by management in its conclusion that all three errors were not material to your financial statements for the year ended December 31, 2013 or any of the prior periods affected by these errors; and

d) [A]n explanation of how you considered the identification and correction of these errors in your evaluation of disclosure controls and procedures and internal controls over financial reporting as of the end of each related period, i.e., December 31, 2011, 2012, and 2013. In addition, tell us if the identification and correction of errors resulted in any changes to your internal controls that have materially affected, or [are] reasonably likely to affect materially, your internal control over financial reporting as of December 31, 2013.

At the 2014 AICPA Banking Conference, the SEC staff indicated that it will question how registrants have considered and evaluated the severity of deficiencies in ICFR related to immaterial misstatements that were corrected by immaterial restatements.[6] The staff reminded registrants that the severity of a deficiency does not depend on whether a misstatement actually has occurred; rather, it depends on whether there is a reasonable possibility that the deficiency could result in a misstatement, and the evaluation of the severity warrants consideration of risk factors including, but not limited to, the potential future consequences of the deficiency. Accordingly, it is possible that an immaterial restatement represents a material weakness in ICFR even though the actual magnitude of the error was not material. The SEC's interpretive release states:

> Management evaluates the severity of a deficiency in ICFR by considering whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis.

Evaluation of Deficiencies Identified in the Other COSO Components

Example of an SEC Comment

In light of the multiple significant deficiencies involving multiple accounts and processes, please explain the extent to which you considered whether deficiencies existed in other components of the Committee of Sponsoring Organizations of the Treadway Commission Internal Control Framework (COSO), such as the control environment, information and communication, risk assessment, and monitoring. To the extent any deficiencies existed in these components, please tell us how you evaluated the severity of these deficiencies along with the existing significant deficiencies and other control deficiencies.

[6] An immaterial restatement is a restatement of previously issued financial statements for the correction of a misstatement that is either of the following:

- Not material to the prior period being changed but would be material to the current period if corrected in the current period.
- Not material to any periods being presented.

The SEC staff has questioned whether deficiencies in control activities may also be indicative of related deficiencies in the control environment, information and communication, risk assessment, and/or monitoring components of ICFR. Specifically, the SEC staff may ask a registrant to provide a detailed analysis on how it concluded that the controls related to each of the other four COSO components were effective.

Disclosure of Material Changes in ICFR

Example of an SEC Comment

Please disclose whether there has been any change in your internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, your internal control over financial reporting. Refer to paragraph (c) of Item 308 of Regulation S-K.

The SEC staff has commented when a registrant has not explicitly and clearly asserted whether there has been a change in ICFR in the last fiscal quarter that had or could have a material effect on its ICFR, as required by Regulation S-K, Item 308(c). Registrants should state clearly whether there were changes in ICFR for the quarter and, if so, should disclose the nature of the changes. The staff has stressed that registrants should avoid "boilerplate" disclosure that there have been no material changes affecting ICFR in a period, particularly when identifiable events such as layoffs, changes in outsourcing arrangements, or changes in accounting policies exist.[7]

Consequently, the staff expects to see increased disclosures regarding changes in ICFR, specifically those related to remediation of material weaknesses. For example, the SEC staff has reminded registrants that it is important for management to monitor and consider disclosing a change in ICFR in the quarter in which management remediates a material weakness.[8]

At the 2013 AICPA Conference, the SEC staff stated that in reviewing registrant filings, it looks for indicators of potential ICFR deficiencies. Common indicators include disclosures about changes in ICFR and corrections of errors (discussed below). If indicators are observed, the staff routinely asks registrants about management's consideration of such indicators in relation to its conclusions about the effectiveness of ICFR (i.e., whether a deficiency in internal control represents a material weakness that should have been identified and disclosed). For the quarter in which any material changes in ICFR occur, registrants should provide disclosures about such material changes, including (1) the identification of any material weaknesses and (2) changes made to remediate material weaknesses.

Disclosures About the Impact and Remediation of Material Weaknesses

Example of an SEC Comment

Please address the following in relation to [the error you identified]:

- Provide further information to help us understand how you considered the identification and correction of the error in your evaluation of internal controls over financial reporting (ICFR) as of December 31, 2013 and whether control deficiencies existed due to the error. To the extent that you determined there were control deficiencies due to the error, describe the deficiencies and how you evaluated the severity of each identified.
- In addition, describe the evaluation performed on whether there was a reasonable possibility that your controls would have failed to prevent or detect a material misstatement associated with other related aspects of the consolidation process.
- Last, tell us if the identification and correction resulted in changes to your internal controls and if so, describe those changes and the timing.

[7] This issue was discussed by the staff of the SEC's Division of Corporation Finance in a speech at the Forums on Auditing in the Small Business Environment hosted by the PCAOB in December 2012.

[8] The SEC staff discussed remediation of material weaknesses and related disclosure considerations at the 2010 AICPA Conference. See footnote 5.

The SEC staff has indicated that management's disclosures about material weaknesses are expected to go beyond merely identifying the existence of one or more material weaknesses or providing a limited description. Rather, such disclosures should contain enough information to allow investors to understand the cause of a material weakness and determine the pervasiveness of its effect on ICFR.[9]

Similarly, the staff has called for more transparent disclosures about the pervasiveness of a material weakness's impact on the registrant's financial reporting and its ICFR. The staff has stressed that registrants need to avoid narrowly focusing their disclosures on a particular financial statement line item affected by a material weakness and that they should consider other financial statement line items that may also be affected.[10]

Registrants that have identified a material weakness have been asked to discuss (1) management's plans to remediate the weakness, (2) the estimated timing of management's remediation efforts, and (3) the related material costs.

In addition, in certain instances, the SEC staff has observed that questions about the validity and completeness of management's disclosures regarding material weaknesses have arisen as a result of management's discussion of its remediation plans. Sometimes the remediation plans are broader than the material weakness identified, potentially indicating that the actual material weakness is more pervasive than the material weakness disclosed or that there may be another material weakness that was not identified and disclosed. In providing disclosures about remediation plans, registrants should therefore consider the root cause of a material weakness and whether it highlights a more pervasive material weakness in their ICFR, or deficiencies in other controls.[11]

Further, the SEC staff has recently commented when registrants identified one or more material weaknesses in ICFR but either refrained from concluding on the effectiveness of ICFR or concluded that their ICFR is effective. In such instances, the staff has reminded registrants that Regulation S-K, Item 308(a)(3), prohibits a conclusion that ICFR is effective when one or more material weaknesses exist and has asked registrants to amend their filings to state that their ICFR is not effective as a result of the material weaknesses that were identified.

Conclusion That ICFR Remains Effective After a Restatement

Example of an SEC Comment

We note . . . that you continue to believe your internal controls over financial reporting and disclosure controls and procedures are effective despite this error in your financial statements. Given the significance of the error, we believe you should revise the conclusion in your fiscal 2013 10-K to state that your internal controls over financial reporting and disclosure controls and procedures were not effective. If you have since remediated the weaknesses in controls, you may disclose the remediations in your fiscal 2014 10-K.

Because a restatement is typically indicative of a material weakness in ICFR, the SEC staff may challenge registrants when they conclude that their ICFR (and DCP) are effective after restating their financial statements. As a result, registrants can expect questions from the staff about the effectiveness of their ICFR after a restatement has occurred. In addition, since most elements of ICFR are subsumed within the definition of DCP and it is therefore typically difficult for a registrant to conclude that its DCP are effective when its ICFR is ineffective, the SEC staff may ask registrants after a restatement has occurred to explain why they concluded that their DCP are effective. At the 2013 AICPA Conference, Mr. Croteau discussed a registrant's responsibility to maintain effective DCP and directed registrants' management to (1) review an SEC enforcement order that addresses a registrant's failure to maintain effective controls and (2) consider whether its own DCP and ICFR processes and procedures could be improved in light of the issues raised in that order. He also indicated that the adequacy of such controls and management's evaluations and conclusions about them are likely to be a focus of future Enforcement Division investigations.

9 For additional information, see Deloitte's December 18, 2008, *Heads Up* on the 2008 AICPA Conference. Also, see Deloitte's December 16, 2010, *Heads Up* on the 2010 AICPA Conference.

10 This issue was discussed at the December 2012 Forums on Auditing in the Small Business Environment. See footnote 7.

11 This issue was discussed at the 2008 AICPA Conference. See footnote 9.

Registrants should consider paragraphs 4310.16 and 4310.17 of the FRM regarding the restatement of financial statements:

> There is no requirement for a company to reevaluate the effectiveness of its internal controls and/or reissue a revised management's report on ICFR when a company restates its financial statements to correct errors . . . . However, a company may need to consider whether or not its original disclosures in management's report continue to be appropriate in light of these errors, and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. . . . If a company's management concludes that its original assessment of ICFR was incorrect, it should consider whether or not to revise its original report on ICFR.

Domestic Companies With a Majority of Operations Outside the United States

Example of an SEC Comment

We note that you conduct substantially all of your operations outside of the United States. In order to enhance our understanding of how you prepare your financial statements and assess your internal control over financial reporting, we ask that you provide us with information that will help us understand more about the background of the people who are primarily responsible for preparing and supervising the preparation of your financial statements and evaluating the effectiveness of your internal control over financial reporting and their knowledge of U.S. GAAP and SEC rules and regulations. Do not identify people by name, but for each person, please tell us:

- What role he or she takes in preparing your financial statements and evaluating the effectiveness of your internal control;
- What relevant education and ongoing training he or she has had relating to U.S. GAAP;
- The nature of his or her contractual or other relationship to you;
- Whether he or she holds and maintains any professional designations such as Certified Public Accountant (U.S.) or Certified Management Accountant; and
- About his or her professional experience, including experience in preparing and/or auditing financial statements prepared in accordance with U.S. GAAP and evaluating effectiveness of internal control over financial reporting.

The SEC staff is interested in understanding the credentials of the individuals preparing U.S. GAAP financial statements for domestic registrants with a substantial amount of their operations in foreign countries and has continued to focus on registrants' assertions that the internal controls of a foreign operation are effective. In evaluating assertions of U.S. GAAP expertise, the SEC staff attempts to ensure that management of the foreign operation has the appropriate knowledge and capability to prepare financial statements in accordance with U.S. GAAP, which may be demonstrated through:

- Education and ongoing training in U.S. GAAP.
- Professional qualifications such as a U.S. CPA license.
- Professional experience either as an auditor or a preparer of U.S. GAAP financial statements.

The SEC staff has mentioned that viewing the Internet and attending one-off conferences would not qualify as persuasive evidence of appropriate U.S. GAAP expertise. The staff has noted that its ultimate goal is to reduce material weaknesses by ensuring that registrants possess sufficient expertise and capabilities.[12] In addition, the staff has observed that it may ask registrants about their relationship with an outside consultant and about the consultant's qualifications if there is any doubt about the consultant's U.S. GAAP expertise.[13]

[12] This issue was discussed at the 2011 AICPA Conference. For additional information, see Deloitte's December 14, 2011, *Heads Up*.

[13] This issue was discussed at the December 2012 Forums on Auditing in the Small Business Environment. See footnote 7.

In addition, the SEC staff has reminded registrants that when a majority of their subsidiaries' operations are outside the United States, management should assess the U.S. GAAP competence and knowledge of those preparing U.S. financial information overseas for ICFR implications.[14]

Disclosure of the Framework Used to Evaluate ICFR

> **Example of an SEC Comment**
>
> Please revise future filings to clarify which version, 1992 or 2013, of the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control — Integrated Framework* you utilized when performing your assessment of internal control over financial reporting.

The COSO framework is one of the most widely applied frameworks used by registrants in evaluating the effectiveness of their ICFR. On May 14, 2013, COSO released an updated version of its *Internal Control — Integrated Framework* to reflect the significant changes in business and operational environments that have occurred since the original framework was introduced in 1992. Although the components of internal control under the framework remain unchanged, the update introduces 17 new principles that explicitly articulate and describe the components of internal control. At the 2013 AICPA Conference, the SEC staff stated that registrants must disclose the internal control framework they applied in assessing the effectiveness of their ICFR. Because the COSO framework was updated in 2013 and provides for a transition period before the original framework is superseded, registrants should disclose whether they applied the 2013 framework or the original framework.

The SEC staff often comments when registrants do not disclose the framework used to evaluate the effectiveness of ICFR. The staff has cited specific examples in which management did not identify the framework used, as well as instances in which management inappropriately referred to SEC guidance or COSO's small-company guidance as the framework used for the evaluation.[15] As a result, a registrant may be asked to advise the SEC staff of the framework used in the current year and to revise the disclosures in current and future filings. While COSO has indicated that it will consider the 1992 framework superseded by December 15, 2014, the SEC has not issued a formal statement concerning the transition and implementation of the revised framework for purposes of Section 404 of the Sarbanes-Oxley Act. However, the staff has stated that it will monitor the transition of issuers to the revised framework and evaluate the need for further actions by the SEC in the future. Registrants are encouraged to closely monitor this issue and any further statements by the SEC in planning any potential transition to the revised framework.[16]

The SEC staff has also noted that "the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework."[17]

[14] This issue was discussed at the 2010 AICPA Conference. See footnote 5.

[15] The SEC staff discussed this issue in a speech at the 2008 AICPA Conference. See footnote 9.

[16] For additional information, see Deloitte's June 10, 2013, *Heads Up* on the revised COSO framework.

[17] For additional information, see the highlights of the September 2013 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Disclosure of the Date of an ICFR Evaluation

Example of an SEC Comment

Please note that pursuant to Item 308(a)(3) of Regulation S-K, management's conclusion on its assessment of the effectiveness of internal control over financial reporting is required as of the end of the most recent fiscal year. [P]lease revise the disclosure to state, if true, that as of March 31, 2013, management concluded that your internal control over financing reporting was not effective. [Emphasis omitted]

Regulation S-K, Item 308(a)(3), requires registrants to assess and conclude on the effectiveness of their ICFR as of the end of their most recent fiscal year. In several instances, the SEC staff has issued comments to registrants when they have either failed to indicate a date for their ICFR evaluation or included a date other than the end of their most recent fiscal year in their filing. Registrants should ensure that the appropriate date of their ICFR evaluation is prominently displayed in any filing with the SEC.

Other Deloitte Resources

- September 5, 2014, *Heads Up*, "Challenges and Leading Practices Related to Implementing COSO's *Internal Control — Integrated Framework*."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Executive Compensation and Other Proxy Disclosures

Proxy disclosure, particularly executive compensation, continues to be a topic of SEC staff focus. Many of the staff's comments are related to disclosures about (1) how performance is assessed, including the use of performance targets and benchmarking; (2) CD&A, including compensation table disclosures; and (3) related-party transactions.

Determining Compensation — Assessment of Performance

Performance Targets

Examples of SEC Comments

- Please revise this section to provide a more detailed explanation and analysis of specific factors that are considered in setting compensation for each of the named executive officers. For example, disclose the specific financial, operational and strategic objectives, in addition to personal achievement targets and/or goals established for each of the named executive officers. In that regard, we note you state . . . that the compensation committee reviews and approves corporate goals and objectives. Similarly, for each named executive officer, discuss the aspects of his individual performance, prior experience and level of responsibility that factored into the total compensation he received during the last year. See Item 402(b)(2) of Regulation S-K.
- Based on your disclosure, it is unclear how the compensation committee used the pre-established performance goals and evaluated individual performance to determine the actual amount that was paid to the NEOs in 2013. Please supplementally explain how each of the annual incentive bonuses for fiscal 2013 [was] determined for each named executive officer and include similar disclosure in future filings. Please also clearly state if the compensation committee established any individual performance goals for the NEOs.

The SEC staff frequently asks registrants that use performance targets to disclose them and provide information about their use.[1] Under Regulation S-K, Item 402(b), a registrant is required to discuss any compensation awarded to NEOs in its CD&A. The discussion should include the objectives of the compensation program, what the compensation program is designed to reward, the elements of the compensation, the registrant's reasons for paying each element, how each element is calculated (including any formula used), and how the program fits into the registrant's objectives. The SEC staff frequently comments on how certain performance factors affect compensation arrangements for NEOs as well as how nonequity incentive compensation granted to NEOs is calculated. Item 402(b) also requires discussion of whether and, if so, how the results of shareholder advisory votes on executive compensation may affect the registrant's decisions and policies related to executive compensation.

To help financial statement users understand the registrant's compensation policies and decisions, the SEC staff has asked registrants to:

- Quantify and disclose the performance target and explain the purpose of performance factors.
- Disclose actual performance results and detail the specific elements of individual performance and contributions that affected the compensation received.
- Discuss the correlation between achievement of performance targets and the compensation ultimately awarded.
- Indicate whether the compensation committee or others had discretion or additional qualitative input when determining the final amount of compensation awarded, and the factors that affected the determination.

[1] Registrants may exclude performance targets (and other confidential information) if disclosing such material would result in competitive harm. However, registrants must satisfy "confidential-treatment" criteria and demonstrate to the SEC staff, upon request, that they have done so. Even when omission of targets or other factors or criteria is appropriate, a registrant should disclose how difficult it will be for the executive, or how likely it will be for the registrant, to achieve the undisclosed target levels or other criteria.

Benchmarking

> **Example of an SEC Comment**
>
> It appears that total compensation levels for named executive officers were benchmarked at the [X] percentile of the benchmark compensation levels. However, your disclosure stating that "industry compensation survey data" represented [X]%, [Y]% and [Z]% of benchmark total compensation for certain officers is unclear. Please revise to clarify this statement.

A registrant may use benchmarks for total compensation or a material element of compensation (e.g., the registrant compared its executive compensation to that of a peer group in the same industry or used compensation surveys to determine compensation levels). When it does, the registrant must identify (1) the benchmark for each NEO and (2) the components of compensation used and the entities that constitute the benchmark group.[2]

If benchmarks are used, the SEC staff may request that registrants disclose:

- All elements of compensation that are subject to benchmarking.
- The impact of the benchmarking on compensation decisions.
- Additional details about how they used the comparison information, including whether they had discretion regarding when and how to use it as well as the nature and extent of such discretion.
- Where payments fell with respect to the benchmark for each NEO.
- The degree to which their compensation committees consider entities in the benchmark group to be comparable to the registrants themselves.

The staff has also asked for explanations when actual compensation fell outside the targeted range.

Compensation Discussion and Analysis

The SEC staff continues to focus on CD&A, particularly the summary compensation table, because it gives investors important information about a registrant's compensation polices and decisions.

> **Examples of SEC Comments**
>
> - [W]e note that your "NEOs are compensated through a combination of equity grants, carried interest and incentive fees . . . " and that Messrs. [X] and [Y] received incentive fees in fiscal 2013. Please explain why these compensation awards are not included in the compensation table.
> - We note that you have disclosed in the "Bonus" column rather than the "Non-Equity Incentive Plan Compensation" column amounts earned pursuant to your annual bonus program . . . . Please advise regarding your basis for disclosing these amounts in the "Bonus" column. For guidance, refer to Question 119.02 of the Regulation S-K Compliance and Disclosure Interpretations.

The SEC staff often asks about inconsistencies between the amounts disclosed in the financial statements and the amounts disclosed in the summary compensation table. Regulation S-K, Item 402(c), requires that for each NEO, registrants include tabular disclosures specifying the NEO's name and principal position, the fiscal year covered, the base salary earned, the bonus earned, the stock/option awards, nonequity incentive plan compensation, the change in pension value and nonqualified deferred compensation earnings, all other compensation, and the total amount of compensation. Both the cash portion and the noncash portion of salary and bonus must be disclosed.

[2] See Regulation S-K, Item 402(b)(2)(xiv), for additional information.

Accordingly, the SEC staff often comments when registrants disclose amounts in incorrect columns of, or exclude types of compensation from, the table. For example, the SEC staff often asks why bonuses paid to NEOs (on the basis of achieved performance targets) are disclosed in the bonus column instead of in the nonequity incentive plan compensation column.

In addition, for stock awards included in CD&A, the SEC staff often asks for the aggregate grant-date fair value of the awards as computed in accordance with ASC 718 and for disclosure of all assumptions used in valuing share-based compensation, which the registrant can accomplish by including a reference to its footnotes to the financial statements or to the critical accounting policies section of its MD&A. Regulation S-K, Item 402(k)(2)(iii), also requires disclosure of the aggregate grant-date fair value and aggregate number of stock awards as of fiscal year-end for each director.

Related-Party Transactions

Regulation S-K, Item 404(a), requires disclosure of transactions that the registrant participated in, or will participate in, with related parties in which the "amount involved exceeds $120,000, and [the related party] had or will have a direct or indirect material interest." ASC 850 does not establish a quantitative threshold but requires disclosure in the financial statements when the information "would make a difference in decision making." In addition, Regulation S-X, Rule 4-08(k), requires registrants to disclose related-party transactions that affect the financial statements and, when material, to separately present amounts on the face of the balance sheet, income statement, or statement of cash flows. Types of related-party transactions that the SEC staff often comments about include sales and loans involving related parties.

As part of identifying related-party transactions, registrants should consider consulting with legal counsel and reviewing the instructions to Item 404(a) to better understand the definition of a "related person" and the types of transactions they need to disclose.

Policies and Procedures

Example of an SEC Comment

Please discuss your policies and procedures for the approval of related party transactions, as required by Item 404(b) of Regulation S-K, in future filings.

The SEC staff may request that the registrant provide a complete discussion of the policies and procedures related to the review, approval, or ratification of transactions with related persons, as required by Regulation S-K, Item 404(b). Registrants often disclose the existence, or a general summary, of such policies and procedures but exclude material features such as the types of transactions covered by the policies and procedures, the standards to be applied to the transactions, and the persons or group of persons responsible for applying the policies and procedures.

Transactions Involving Indebtedness

Example of an SEC Comment

For all transactions involving indebtedness, please revise to disclose the amount of principal paid during the periods for which disclosure is provided. Refer to Item 404(a)(5) of Regulation S-K.

The SEC staff also often asks registrants to improve their disclosures about related-party transactions involving indebtedness. Item 404(a) indicates that registrants should disclose the major terms of related-party indebtedness (e.g., the amounts involved, the largest principal amount outstanding during the period and as of the latest practicable date, the principal and interest payments during the period, the interest rate, and the interest-payable amount).

Other Deloitte Resources

- December 2013, Center for Corporate Governance, *Hot Topics: The 2014 Boardroom Agenda*.
- October 2013, Center for Corporate Governance, *Hot Topics: CEO Pay Ratio Disclosure: What Would It Take to Implement the SEC Proposal?*

Emerging Growth Companies

An emerging growth company (EGC) is a new type of issuer created by the JOBS Act to encourage public offerings by small and developing companies. The regulatory and reporting requirements for EGCs are less stringent than they are for other types of issuers and include the following:

- Only two years of audited financial statements are required in an IPO for common equity.
- The periods required for selected financial data in both registration statements and periodic filings do not extend to periods before the first year presented in the EGC's equity IPO.
- EGCs may elect to defer the adoption of new accounting standards until they become effective for private companies (i.e., nonissuers).
- EGCs are exempt from the requirement to obtain an attestation report on ICFR from their auditor.

In addition, an EGC may submit registration statements to the SEC for confidential reviews. Under the JOBS Act, an EGC would be required to make publicly available (at least 21 days before its "road show") any documents that were submitted to the SEC staff for confidential review. Accordingly, the SEC staff's comment letters to the EGC (and the EGC's responses) must be filed on EDGAR.

The staff in the SEC's Division of Corporation Finance has issued FAQs on numerous aspects of the JOBS Act, many of which are related to qualifying for EGC status and the filing requirements for EGCs. In addition, the SEC staff has incorporated EGC-related guidance in section 10000 of the FRM.

In its comment letters to EGCs, the SEC staff primarily has asked companies to disclose (1) that they qualify for EGC status, (2) how and when they may lose their EGC status, and (3) the elections they made under Title I of the JOBS Act.

EGC Status and Elections

Example of an SEC Comment

Since you appear to qualify as an "emerging growth company," as defined in the Jumpstart Our Business Startups Act, please:

- Disclose that you are an emerging growth company;
- Describe how and when a company may lose emerging growth company status;
- Briefly describe the various exemptions that are available to you, such as exemptions from Section 404(b) of the Sarbanes-Oxley Act of 2002 . . . ; and
- State your election under Section 107(b) of the JOBS Act:
    - If you have elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b), include a statement that the election is irrevocable; or
    - If you have elected to use the extended transition period for complying with new or revised accounting standards under Section 102(b)(1), provide a risk factor explaining that this election allows you to delay the adoption of [those standards until they] apply to private companies. Please state in your risk factor [and in your critical accounting policy disclosures] that, as a result of this election, your financial statements may not be comparable to companies that comply with public company effective dates.

Filing Status

A company can maintain EGC status for up to a maximum of five years after an equity IPO as long as certain conditions apply.[1] The SEC staff has asked EGC filers to disclose information about their filing status, including how and when the company may lose EGC status.

Extended Transition Period to Adopt New or Revised Accounting Standards

EGCs are allowed to adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) for ASUs issued after April 5, 2012 (i.e., the date of the enactment of the JOBS Act). Consequently, the SEC staff has asked EGC filers to indicate the basis on which they are adopting accounting standards. Further, the SEC has asked EGCs that elect to adopt accounting standards on the basis of adoption and transition dates that apply to private companies to disclose as a risk factor that their financial statements may not be comparable with those of registrants that elect (or are required) to adopt accounting standards on the basis of adoption and transition dates that apply to public companies. The SEC staff has also asked registrants to include similar disclosures in their critical accounting policy section of MD&A.

Section 404(b) Exemption

The JOBS Act amends Section 404(b) of the Sarbanes-Oxley Act by exempting EGCs from the requirement to obtain an attestation report on the company's ICFR from its registered public accounting firm. The staff has required registrants to disclose that they are exempt from obtaining an audit of their ICFR (for as long as they maintain EGC status).[2]

Other Considerations

Scope

Because a main objective of the JOBS Act is to promote smaller companies' access to capital markets, some of the JOBS Act's accommodations for EGCs resemble reporting requirements for smaller reporting companies (e.g., annual financial statement requirements in an IPO registration statement under Regulation S-X, Article 8). However, the rules are not the same, and the SEC staff has asked EGC filers to clarify descriptions of their filing status.

Reduced Financial and Proxy Reporting Requirements

Example of an SEC Comment

Briefly describe . . . exemptions [from the requirements related to obtaining shareholder approval of executive compensation under] Section 14A(a) and (b) of the Securities Exchange Act of 1934.

An EGC is required to present only two years of audited financial statements in its equity IPO registration statement. Further, the periods for which an EGC presents select financial data in its registration statements and periodic filings may be limited to the earliest year presented in its equity IPO registration statement. In addition, certain JOBS Act provisions for scaled disclosures may interact with other SEC rules (e.g., other entities' financial statements may be required under Regulation S-X, Rules 3-05 and 3-09). EGCs should therefore consider the SEC staff's FAQs on the JOBS Act to assess whether reduced reporting requirements apply in these situations. For additional information on Rules 3-05 and 3-09, see the SEC Reporting section.

1 For example, the EGC's total gross revenues do not exceed $1 billion during the five-year period; the EGC's market capitalization does not exceed $700 million (i.e., the EGC does not meet the definition of a large accelerated filer); and the EGC does not issue more than $1 billion in nonconvertible debt in a three-year period (which is not limited to calendar or fiscal years and is a rolling three-year period from the date of the EGC's last debt issuance).

2 EGCs are also exempt from any future PCAOB rules that may require (1) auditor rotation or (2) expansion of the auditor's report to include an auditor's discussion and analysis of the company under audit.

Under the JOBS Act, EGCs can comply with the SEC's proxy requirements regarding executive compensation by providing the same reduced disclosures that are required of smaller reporting companies. In addition, the JOBS Act exempts EGCs from certain proxy provisions of the Dodd-Frank Act.

Requests for Written Communications

Example of an SEC Comment

Please supplementally provide us with copies of all written communications, as defined in Rule 405 under the Securities Act, that you, or anyone authorized to do so on your behalf, present to potential investors in reliance on Section 5(d) of the Securities Act, whether or not they retain copies of the communications. Similarly, please supplementally provide us with any research reports about you that are published or distributed in reliance upon Section 2(a)(3) of the Securities Act added by Section 105(a) of the Jumpstart Our Business Startups Act by any broker or dealer that is participating or will participate in your offering.

The JOBS Act significantly changed the rules governing communication between EGCs and certain potential investors. Under the JOBS Act, an EGC, or any person authorized to act on behalf of an EGC, may engage in oral or written communications with potential investors that are qualified institutional buyers or institutional accredited investors to "test the waters" before the EGC files its registration statement. Consequently, the SEC staff has requested copies of such communications.

Other Deloitte Resources

April 15, 2014, *Heads Up*, "Two Years After the JOBS Act."

Other SEC Reporting Matters

Certifications

Example of an SEC Comment

We note that your officer certification is not in the exact form as set forth in Item 601(b)(31)(i) of Regulation S-K. Your certifications include inappropriate modifications, such as the following:

- [O]mitting reference to establishing and maintaining internal controls over financial reporting in paragraph 4 introductory language; and
- [O]mitting [subparagraph 4(b)] related to the design of internal controls over financial reporting;

Please file an amended Form 10-K [and similarly file an amended Form 10-Q] to provide officer certifications consistent with the language that is set forth exactly as provided for by Item 601(b)(31).

Registrants must provide quarterly and annual certifications in the form specified by Regulation S-K, Item 601(b)(31). When these certifications contain errors, registrants are often asked to file an amendment to an entire periodic filing in addition to submitting a corrected certification. Interpretation 246.14 of the C&DIs of Regulation S-K states:

> The following errors in a certification required by Item 601(b)(31) are examples of errors that will require the company to file a corrected certification that is accompanied by the entire periodic report: (1) the company identifies the wrong periodic report in paragraph 1 of the certification; (2) the certification omits a conformed signature above the signature line at the end of the certification; (3) the certification fails to include a date; and (4) the individuals who sign the certification are neither the company's principal executive officer nor the principal financial officer, or persons performing equivalent functions.

The SEC staff often comments when registrants' certifications, including punctuation marks and parenthetical phrases, do not appear exactly as specified in Regulation S-K, Item 601(b)(31). The staff routinely notes that inclusion of a registrant's certifying officer's title constitutes an inappropriate modification. In addition, the staff regularly comments on certifications that are dated incorrectly.

Registrants must include certifications when they are filing amendments to periodic reports. See Question 161.01 of the C&DIs of Exchange Act Rules for guidance on what paragraphs can be excluded in amendments to periodic reports.

Use of Experts and Consents

Examples of SEC Comments

- It appears that you attribute information to third parties in the registration statement. If any of these reports or publications were commissioned by you for use in connection with the registration statement, please file consents of such third parties pursuant to Rule 436 of the Securities Act as exhibits to your registration statement.
- Please file an updated consent from your independent registered public accounting firm.

In their registration statements under the Securities Act and periodic reports under the Exchange Act (e.g., Forms 10-K and 10-Q), registrants sometimes refer to an "independent valuation firm" or other third party. The SEC staff has asked such registrants whether management or the board relied on a third-party expert and will sometimes infer reliance on a third-party expert even when the registrants do not refer to one. Examples of third-party experts that registrants commonly consider or rely on include the following:

- Valuation firms, about:
  - The valuation of a registrant's common and preferred stock in an IPO.
  - The fair value determination of goodwill and assets acquired and liabilities assumed in a business combination.
  - The determination of goodwill impairment.
  - The determination of asbestos liability.
- An independent actuary, about the estimation of workers' compensation liability.
- Petroleum engineers, about the evaluation of oil and gas reserves. See the Oil and Gas section.
- Pricing services or brokers that provide information used to determine the fair values of financial assets or liabilities. See the Fair Value section for additional considerations.

The SEC staff has stated that in registration statements or periodic reports, registrants generally are not required to refer to an independent valuation firm or other expert. If a registrant does not refer to the expert in its filing, the registrant is not required to name the expert or obtain the expert's consent; however, certain SEC requirements may compel the registrant to include or summarize an expert's report or opinion in its filing and could trigger a consent requirement. Registrants that refer to experts in their filings should consider the implications related to periodic reports and registration statements.

Periodic Reports (Securities Exchange Act)

Consents are not required for Form 10-K or 10-Q. However, the guidance below on registration statements should be applied if the registrant (1) refers to an independent valuation firm or other expert in periodic reports and attributes statements in the report to the expert and (2) incorporates that periodic report by reference into a registration statement.

Registration Statements (Securities Act)

Historically, if a registrant has referred to third-party experts in a registration statement, the SEC staff has asked the registrant to provide the experts' consents, including those from their independent registered public accounting firm. However, on the basis of informal discussions with the SEC staff and C&DIs issued by the staff, it appears that the key to assessing whether consent will be required is determining the degree to which management takes responsibility for statements related to work performed by a third-party expert that are included in or incorporated into the registration statement.

That is, if the registrant essentially "outsourced" the services to the third-party expert and management takes no responsibility for the ultimate statements or conclusion noted in the registration statement, management must obtain the consent of the third-party provider to be named an expert under the Securities Act. The SEC staff indicated that it would evaluate the totality of the disclosure provided when determining whether management is taking responsibility for the conclusion.[1]

Scope

The SEC staff has also commented on the use of "limiting" language in consents provided by third-party experts or in their reports. The staff has emphasized that an expert's consent should not contain any language that limits the use of the consent to the registrant or suggests that there is a limit on potential investor reliance.

Material Contracts

Example of an SEC Comment

We note that although you have filed as an exhibit your [X] Agreement with [Company Y], you have not filed your distribution agreement with that company. Please provide your analysis as to why filing of the distribution agreement is not required or file the agreement as an exhibit. Refer to Item 601(b)(10)(ii)(A) of Regulation S-K.

Regulation S-K, Item 601, requires registrants to file certain material contracts as exhibits if, during the reporting period, such contracts (1) become effective or (2) are executed, amended, or modified.

Recent comment letters have instructed registrants to do either of the following:

- File the material agreements in their entirety, including schedules and related exhibits, as exhibits to Form 10-K or 10-Q or separately on Form 8-K in accordance with Regulation S-K, Item 601.
- Explain why they have not filed the agreements.

The SEC staff also comments when registrants omit certain material agreements. Item 601(b)(10) requires a registrant to file:

- Every material contract that is "not made in the ordinary course of business."
- Any material contract "made in the ordinary course of business":
    - With certain parties, such as directors, officers, promoters, voting trustees, certain security holders, or underwriters, other than contracts involving only the purchase or sale of current assets at a price that equals a determinable market price.
    - On which the registrant's business substantially depends.
    - For the acquisition or disposition of any property, plant, or equipment for consideration exceeding 15 percent of the registrant's total consolidated fixed assets.
    - For a lease under which part of the property is held by the registrant.
- Generally, any management contract or compensatory plan, contract, or arrangement in which a director or NEO of the registrant participates (such contracts are considered material) and any other material management contract or any other compensatory plan, contract, or arrangement in which any other executive officer of the registrant participates.[2]

[1] Registrants may look to Question 233.02 of the C&DIs of the Securities Act Rules that were issued by the SEC staff in November 2008 but should be aware that other consent-related C&DIs of the Securities Act Rules may apply to their specific circumstances and that they should therefore review such C&DIs periodically.

[2] For examples of management contracts or compensatory plans, contracts, or arrangements that are exempt from this filing requirement, see Item 601(b)(10)(iii)(C).

- Any other material compensatory plan, contract, or arrangement "adopted without the approval of security holders pursuant to which equity may be awarded" in which any employee of the registrant (i.e., regardless of whether the employee is an executive officer) participates.

The SEC staff has also issued a number of C&DIs related to Regulation S-K, Item 601, to address the various circumstances in which a registrant may be required to file agreements as exhibits. Registrants are encouraged to consult these and, in particular, the C&DIs in Sections 146 and 246.

Backlog Disclosures

Examples of SEC Comments

- Please revise future filings to provide the following additional disclosures regarding your backlog:
    - Discuss how backlog is calculated, including what it includes and excludes;
    - Discuss any changes in the methodology used to determine backlog during each period, if material and applicable;
    - To allow better insight into changes in backlog from period to period, provide a roll-forward of backlog. The roll-forward should include beginning and ending balances, new contracts, cancellations, amounts recognized in revenue, and any other major categories relevant to your business.
- We note your disclosure of unbilled deferred revenue backlog for existing subscription agreements. Please tell us how you considered disclosing the amount of backlog not reasonably expected to be filled within the current fiscal year consistent with the requirements in Item 101(C)(1)(viii) of Regulation S-K.

Regulation S-K, Item 101(c)(1)(viii), requires disclosure of the "dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog." Because backlog information is a non-GAAP financial measure, the SEC staff has requested expanded disclosures about it, including (1) the methods used (or changes in methods used) to determine backlog and (2) changes in backlog resulting from new contracts, canceled contracts, and contracts recognized in revenue. In addition, the SEC staff has reminded registrants to disclose in accordance with Item 101(c)(1)(viii) the backlog not reasonably expected to be filled within the current fiscal year.

Disclosures Regarding State Sponsors of Terrorism

Examples of SEC Comments

- Cuba, Sudan and Syria are designated by the Department of State as state sponsors of terrorism and are subject to U.S. economic sanctions and export controls. Please describe to us the nature and extent of your past, current, and anticipated contacts with Cuba, Sudan and Syria, whether through subsidiaries, affiliates, partners, customers, joint ventures or other direct or indirect arrangements. Your response should describe any services, products, information or technology you have provided to Cuba, Sudan or Syria, directly or indirectly, and any agreements, commercial arrangements, or other contacts you have had with the governments of those countries or entities controlled by their governments.
- Please discuss the materiality of any contacts with Cuba, Sudan and Syria described in response to the foregoing comment, and whether those contacts constitute a material investment risk for your security holders. You should address materiality in quantitative terms, including the approximate dollar amounts of any associated revenues, assets, and liabilities for the last three fiscal years and the subsequent interim period. Also, address materiality in terms of qualitative factors that a reasonable investor would deem important in making an investment decision, including the potential impact of corporate activities upon a company's reputation and share value. Various state and municipal governments, universities, and other investors have proposed or adopted divestment or similar initiatives regarding investment in companies that do business with U.S.-designated state sponsors of terrorism. Your materiality analysis should address the potential impact of the investor sentiment evidenced by such actions directed toward companies that have operations associated with Cuba, Sudan and Syria.

The U.S. Department of State has designated four countries as state sponsors of terrorism — Cuba, Iran, Sudan, and Syria. These countries are subject to U.S. economic sanctions and export controls. Registrants that do business in these countries are required to disclose material operations conducted in them and any agreements, commercial arrangements, or other contracts with the countries' respective governments or with entities controlled by such governments.[1] The SEC staff regularly comments on this subject and believes that such disclosures are important to investors in making investment decisions. The staff has asked registrants to disclose the nature and extent of these contracts (past, present, and probable) — as well as to provide a detailed analysis of the materiality of contacts with these countries — on the basis of both quantitative and qualitative factors. See the Materiality section for additional information about materiality considerations. In addition to providing quantitative disclosures of revenues, assets, and liabilities associated with these countries, registrants are encouraged to disclose any related qualitative factors that may have a significant impact on their activities.[2]

[1] In 2007, the SEC issued a concept release that requested input on certain matters related to sponsors of state terrorism. The concept release indicates that the "federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism." However, as with other requirements to disclose material information, the "federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company's statements, in the light of the circumstances under which they are made, not misleading." [Footnote omitted]

[2] Further, the Iran Threat Reduction and Syria Human Rights Act of 2012 requires registrants to include certain disclosures related to sanctionable activities in all quarterly and annual reports. For implementation guidance, see Questions 147.01 through 147.07 of the C&DIs of Exchange Act Sections.

Interactive Data — eXtensible Business Reporting Language (XBRL)

SEC Staff's Review and Observations

Examples of SEC Comments

- The staff notes that you have not submitted electronically and posted on your corporate Web site every Interactive Data File required to be submitted and posted during the preceding 12 months. Please file this information pursuant to Rule 405 of Regulation S-T.
- The XBRL Document and Entity Identification Information rendered as part of your filing appears to contain a number of data element errors, including but not limited to, your classification as a non-accelerated filer. Please revise to comply with the requirements of Section 405 of Regulation S-T and the EDGAR Filer Manual.

The SEC staff continues to monitor registrants' interactive data file (i.e., XBRL) submissions for completeness and compliance with the provisions of Regulation S-T, Rule 405. The staff often asks whether the registrant has (1) submitted its interactive data files as an exhibit to Form 10-K and Form 10-Q in accordance with Regulation S-K, Item 601(b)(101), (2) checked the appropriate box on the cover page of its Form 10-K or 10-Q to indicate that all required interactive data files have been submitted, and (3) posted its interactive data files on its Web site. When a registrant has omitted a required interactive data file exhibit, the staff may ask why and request an amended filing that includes the missing information.

The SEC staff also considers the quality of interactive data filings and has commented broadly on the problems encountered in that regard. For example, the staff has indicated that it continues to see basic errors in interactive data submissions and has directed registrants to its observations on the SEC's Web site for additional details. Specifically, the staff has reminded registrants to (1) use negative values properly, (2) ensure the completeness of tagging, and (3) use custom tags only when appropriate.

In its July 2014 report *Staff Observations of Custom Tag Rates*, the SEC staff noted that although it has seen a steady decline in custom tag use by larger filers, it has not observed a similar decline in usage by smaller filers.[1] Further analysis revealed that this trend may be partially attributable to smaller filers' use of certain third-party providers. The staff expressed its intention to continue monitoring registrants' use of custom tags and indicated that it may issue further guidance or take additional action in the future.

Requirement to Include Calculation Relationships

Sections 6.14 and 6.15 of the EDGAR Filer Manual provide guidance on complying with the requirement to include calculation relationships in an interactive data file. In addition, the SEC staff's "Dear CFO" letter,[2] which was posted to the SEC's Web site in July 2014 and has been sent to a number of public companies, reminds registrants that the XBRL rules require them to "include calculation relationships for certain contributing line item elements for [the] financial statements and related footnotes." The letter advises registrants to "take the necessary steps to ensure that [they] are including all required calculation relationships" in their XBRL files.

Interactive Data Requirements in Other Filings

Example of an SEC Comment

We note that you have not included XBRL tagged financials as exhibits to your registration statement. Rather, you make reference to the XBRL information in your annual report on Form 10-K for the fiscal year ended December 31, 2013. Please include electronically tagged Interactive Data Files with your next amendment.

[1] The staff used the term "smaller filers" to refer to U.S. GAAP filers that are not large accelerated filers.

[2] *Sample Letter Sent to Public Companies Regarding XBRL Requirement to Include Calculation Relationships.*

Under Regulation S-T and Regulation S-K, Item 601(b)(101)(i), registrants must submit an interactive data file as an exhibit to a registration statement if the statement contains (1) financial statements and (2) a price or price range. For purposes of Item 601(b)(101)(i), the disclosure of the "offering price" of a shelf offering, an at-the-market offering, an exchange offer, or a secondary offering in a filed registration statement is construed as a price or price range.

In addition, Item 601(b)(101)(i) highlights that an interactive data file would be required for a Form 8-K filing "when the Form 8-K contains audited annual financial statements that are a revised version of financial statements that previously were filed with the [SEC] that have been revised pursuant to applicable accounting standards to reflect the effects of certain subsequent events, including a discontinued operation, a change in reportable segments or a change in accounting principle."

Other Deloitte Resources

- July 8, 2014, *Deloitte Accounting Journal*, "SEC Issues Communications to XBRL Filers."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- September 19, 2013, *Heads Up*, "XBRL — Past, Present, and Future."

Disclosure Topics in Initial Public Offerings

Initial Public Offerings

An IPO is most commonly thought of as the initial sale of equity securities to the public by a private company that registers its securities on Form S-1. However, there are other situations in which a company can register debt or equity securities with the SEC for the first time, such as by exchanging debt securities previously issued in a private transaction for registered debt securities (typically on a Form S-4), registering currently outstanding equity securities, or distributing shares in a spin-off transaction by a public company (typically on a Form 10). All such transactions are referred to as IPOs in this discussion. As a result of the JOBS Act, which was signed into law on April 5, 2012, certain companies that meet the requirements for emerging growth company (EGC) status are eligible to raise capital and register as new issuers by complying with less stringent regulatory and reporting requirements than those required for a typical IPO. See the Emerging Growth Companies section for additional information on such requirements.

Because an IPO typically represents a company's first filing with the SEC, the SEC staff nearly always reviews the related registration statement. The staff's review is typically comprehensive, covering reporting, accounting, and legal issues. In addition, comments about reporting topics often include:

- Significant business acquisitions (Regulation S-X, Rule 3-05).
- Investments in equity method investees (Regulation S-X, Rule 3-09).
- Guarantors of registered securities (Regulation S-X, Rule 3-10).
- Issuers of securities that collateralize registered securities (Regulation S-X, Rule 3-16).
- Pro forma financial statements (Regulation S-X, Article 11).

For more information on these topics, see the SEC Reporting section. Other SEC staff comments on IPOs have addressed accounting and disclosure topics such as (1) complex equity instruments; (2) share-based compensation, including equity securities issued as compensation in periods before an IPO (commonly referred to as "cheap stock" considerations); and (3) revenue recognition. For more information, see the Debt, Financial Instruments, Revenue Recognition, and Share-Based Payments sections. The SEC staff also comments on certain issues that are more specific to IPO registration statements. Such issues are discussed in this section.

Registrant Financial Statements

A company undergoing an IPO is required to present its financial statements, footnotes, and schedules for certain annual and interim periods in its registration statement. Regulation S-X, Rules 3-01 through 3-04, describe the general financial statement requirements for the registrant and its predecessors. Registrants must determine which financial statements to include in their initial registration statement on the basis of their individual facts and circumstances and must continue to update the financial statements throughout the registration process. The SEC staff often comments when registrants do not include the required financial statements in the registration statement.

Recently Organized Registrant

Example of an SEC Comment

Tell us why you have not included an audited balance sheet for the registrant as of a point within 135 days of filing your registration statement as would ordinarily be required under Rule 3-01 of Regulation S-X.

Sometimes the legal entity registering securities in an IPO is a newly formed company that will succeed to the operations of an existing business before the effective date of the initial registration statement. In such cases, the entity may need to include the balance sheet of the recently organized registrant in addition to the financial statements of the existing business. See Section 1160 of the FRM for additional guidance on newly formed entities. In addition, Regulation S-X, Rule 3-01, provides guidance on a registrant's balance sheet requirements.

Age of Financial Statements

> **Example of an SEC Comment**
>
> Please consider the financial statement updating requirements set forth in Rule 3-12 of Regulation S-X.

A registrant's financial statements must meet the "age of financial statements" requirements as of every filing date as well as when the registration statement is declared effective. The age of financial statements generally refers to the specific annual and interim periods for which financial statements are required in a filing. Regulation S-X, Rule 3-12, provides guidance on such periods and on when the financial statements become stale (i.e., should be updated).

Predecessor Financial Statements

> **Examples of SEC Comments**
>
> - We note from your website [your relationship with Company A]. Please describe your relationship with [Company A] and provide us with your analysis addressing whether [Company A] represents a predecessor for which financial statement information should be provided.
> - Please tell us what factors you considered, and why you concluded, [Company A] represents your predecessor. In your response, please tell us how you are actually succeeding to substantially all of the business of [Company A], and what impact control of [Company A] has upon your ability to succeed to the business. We may have further comment.

Section 1170 of the FRM addresses the requirements for predecessor financial information. It states that the designation "predecessor" is required when "a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired." Because a predecessor's historical financial information is considered important to an investing decision, when a predecessor is identified, the registration statement must also present the predecessor's financial information and reflect such information as if it were the registrant's. That is, financial statements for both the registrant and its predecessor should be presented as of and for all periods that are required by Regulation S-X.

Carve-Out Financial Statements

Examples of SEC Comments

- Please note that the historical income statements of a registrant should reflect all of its costs of doing business. We note your disclosure [that the parent company] is responsible for the payment of your operating expenses, legal and accounting expenses related to the merger. Please tell us how you account for uncompensated services rendered by [the parent company]. Refer to SAB Topic 1.B.1.
- We note from your disclosures . . . that the predecessor financial statements represent the combination of carve out financial statements for the [assets] that [Company A] intends to transfer to [Company B] prior to the offering. Please explain to us in more detail how you determined these combined carve out financial statements were the most appropriate financial statements to present as the predecessor.

"Carve-out financial statements" is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. A carve-out occurs when a parent company segregates a portion of its operations and prepares a distinct set of financial statements in preparation for a sale, spin-off,[1] or IPO of the "carve-out entity." Examples of a carve-out entity may include (1) all or part of a subsidiary of a parent company or (2) a line of business that was previously part of a larger parent company.

In many cases, the parent may not have historically accounted for the carve-out entity separately, and the registrant (i.e., the carve-out entity) may have relied on the parent for certain functions. SAB Topic 1.B indicates that the registrant's historical income statements should present all of the costs of doing business, including expenses incurred by the parent on behalf of the registrant. Examples of such costs include salary, rent, depreciation, advertising, accounting and legal services, and other SG&A. Registrants must use a reasonable method to allocate the common expenses from the parent to the registrant if specific identification is not practicable. The method for such allocation must also be disclosed in the notes to the financial statements, with an explanation of why management believes such method is reasonable. To the extent that the registrant and the parent have shared functions (e.g., treasury or cash management), these shared functions need to be evaluated so that the appropriate amount of expense and related assets and liabilities to be allocated to the carve-out entity can be determined.

When financial statements of a carve-out entity are used in an IPO, it is critical that the carve-out financial statements identify the appropriate assets and operations of the registrant. A registrant's determination of the composition of the carve-out financial statements depends on the its specific facts and circumstances and may require significant judgment because the process of identifying appropriate assets and operations of the registrant in an IPO transaction is complicated. As stated in the highlights of the September 23, 2014, CAQ SEC Regulations Committee joint meeting with the SEC staff, the staff (1) acknowledged that "identifying the predecessor entity in many transactions requires careful analysis of all relevant facts and circumstances," (2) "noted that current guidance in the FRM, GAAP and various SABs did not contemplate the level of complexity encountered in recent transactions," and (3) "encourages companies to pre-clear these transactions."

[1] A spin-off is a type of divestiture in which an independent company is created through the sale or distribution of new shares of a portion of a parent's operations.

Spin-off transactions can be highly complex and involve numerous legal and accounting decisions that registrants must consider, including the accounting for the transaction (i.e., forward spin or reverse spin) in accordance with ASC 505-60. Registrants should also consider other aspects of carve-out financial statement reporting, including (1) the allocation of items such as pension and postretirement benefit plans, income taxes, impairment of goodwill and other intangible assets, and debt and contingencies and (2) the application of pushdown accounting and treatment of intercompany transactions. In addition, carve-out entities in an IPO will need to consider their ongoing compliance with Rules 3-05 and 3-09 for acquisitions and equity method investments, respectively, whose level of significance may differ from that of the parent's acquisitions and equity method investments. Further, the SEC staff may ask about segment reporting and EPS in these complex transactions.

For additional considerations related to carve-out transactions, see Deloitte's June 2013 publication *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*.

Public-Entity Disclosures and Transition Provisions

A nonpublic entity's previously issued financial statements may not be sufficient for an IPO. Nonpublic entities will need to revise their financial statements to include the public entity disclosures required under U.S. GAAP and Regulation S-X.[2] In addition, such entities will need to obtain an auditor's report on their financial statements that (1) is issued by a PCAOB-registered accounting firm and (2) refers to the PCAOB's Standards.[3]

U.S. GAAP

Certain provisions of U.S. GAAP differ for public and nonpublic entities. A registrant's financial statements in an IPO must adhere to accounting principles and disclosures required for public entities for all periods presented.[4] The term "public entity" generally refers to an entity that files its financial statements with the SEC. However, there are different definitions of public entity under U.S. GAAP. Examples of accounting principles and disclosures that apply to public entities include EPS (under ASC 260-10-15-2 and 15-3); segment reporting (under ASC 280-10-15-3 and ASC 280-10-20); and pensions and other postretirement benefits, such as defined benefit plans (under ASC 715-20-20). See the Earnings per Share, Pensions and Other Postretirement Benefits, and Segment Reporting sections for additional reporting considerations related to these topics.

In addition, the transition provisions related to the adoption of a new accounting pronouncement may differ depending on how a public entity is defined in ASC topics. Some guidance is effective for public entities before it is effective for nonpublic entities. Since registrants must follow public-entity guidance for all periods presented in the IPO financial statements, a nonpublic entity may be required to retrospectively change its adoption date to that required for a public entity.[5]

Further, a company that is preparing to go public — or that may consider going public in the future — should be cautious about electing the alternatives developed by the PCC. Because such a company would be considered a PBE, it would not be permitted to adopt PCC accounting alternatives. Accordingly, any previously elected PCC alternatives would need to be eliminated from the company's historical financial statements before such statements can be included in its IPO registration statement. See the SEC Reporting section for additional information about PBEs.

2 EGCs are allowed to adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) "if such standards apply to companies that are not issuers." See the Emerging Growth Companies section for additional information.

3 See paragraph 4110.5 of the FRM for additional information.

4 See footnote 2.

5 See footnote 2.

SEC Rules and Regulations

Examples of SEC Comments

- As required by Rule 4-08(k) of Regulation S-X, please identify and state the amounts of your related party transactions on the face of the consolidated balance sheets, income statements, and/or statements of cash flows.
- You disclose that you are in the process of redeeming $[X] of your redeemable [preference shares]. Please clarify whether you are redeeming these shares for common stock or for cash. Please also tell us whether you were required to redeem these shares or if you had the sole option to redeem the preferred shares. Tell us how you considered Rules [5-02.27 and 5-02.28] of Regulation S-X in determining the classification of your redeemable preferred stock as of [period end].
- We note that "under certain circumstances, including a change in control . . ." the company is obligated to purchase common stock from shareholders at fair market value. Please tell us why these shares should not be presented outside of permanent equity pursuant to the guidance in [ASC 480-10-S99-3A]. Your response should be detailed and specific and should consider circumstances and examples such as those described in [ASC 480-10-S99-3A.7–9].

In an IPO, the registrant's financial statements should comply with the applicable requirements of Regulation S-X, and SABs, for each period presented in the financial statements. Because such requirements and guidance are new to the registrant, the SEC staff frequently requests additional disclosures. Regulation S-X prescribes the types, form, and content of the financial information that registrants must file. Many of these requirements expand on the disclosures directly required by U.S. GAAP. SABs provide guidance on 14 broad topics, including business combinations, revenue recognition, and share-based payment arrangements. Requirements addressed by Regulation S-X and SABs that often affect nonpublic-entity financial statements during the IPO process include:

- Balance sheet and income statement presentation requirements (Regulation S-X, Rules 5-02 and 5-03) and age of financial statement requirements (Regulation S-X, Rule 3-12).
- Summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons (Regulation S-X, Rule 4-08(g)).
- Income tax expense (Regulation S-X, Rule 4-08(h)).
- Related-party disclosures (Regulation S-X, Rule 4-08(k)).
- Audited financial statement schedules (Regulation S-X, Articles 5 and 12).
- Preferred stock subject to mandatory redemption requirements or whose redemption is outside the issuer's control (Regulation S-X, Rule 5-02.27; ASR 268; ASC 480-10-S99-3A).
- Pushdown accounting to reflect a change in basis because of an acquisition (ASU 2014-17).[6]

For additional reporting considerations related to these topics, see Financial Statement Classification, Including Other Comprehensive Income; Income Taxes; and SEC Reporting.

6 In November 2014, the FASB issued ASU 2014-17, which gives an acquired entity the option of applying pushdown accounting in its stand-alone financial statements upon the occurrence of a change-in-control event. The guidance is effective immediately. Also, in connection with the FASB's issuance of ASU 2014-17, the SEC has rescinded SAB Topic 5.J, which historically has conveyed the SEC staff's views on the application of pushdown accounting for SEC registrants. See the November 18, 2014, *Deloitte Accounting Journal* entry for additional information.

Distributions to Owners

Examples of SEC Comments

- [W]e note that prior to the closing of this offering [the Company] intends to make additional cash distributions of approximately $[X] to the [owners of the Company] to enable them to meet their estimated income tax obligations for the period . . . . We also note that the board . . . has authorized an $[X] distribution to its members in the third quarter . . . . In this regard, we assume that you will reflect the distribution accrual (but not giving effect to the offering proceeds) in the pro forma balance sheet [alongside] the historical balance sheet in the filing.
- We . . . assume that the pro forma per share data will give effect to the number of shares whose proceeds would be necessary to pay the dividend (but only the amount that exceeds current year's earnings). The number of shares to be added to the denominator for purposes of pro forma per share data should not exceed the total number of shares to be issued in the offering. Also note that a dividend declared in the latest year would be deemed to be in contemplation of the offering with the intention of repayment out of offering proceeds to the extent that the dividend exceeded earnings during the previous twelve months.

It is common for registrants to plan dividends or distributions to owners as of, or immediately before, the closing of an IPO. The SEC staff often comments on the need for pro forma information related to such distributions.

SAB Topic 1.B.3 and paragraph 3420.1 of the FRM express the SEC staff's view that a significant planned distribution that is not reflected in the latest historical balance sheet should be presented in a pro forma balance sheet regardless of whether it has been declared or will be paid from the proceeds of the offering. The pro forma balance sheet should be presented alongside the most recent historical balance sheet in the filing and should reflect the accrued distribution (but not give effect to the offering proceeds).

In addition, SAB Topic 1.B.3 indicates that if a distribution will be paid to owners from the proceeds of the offering rather than from the earnings in the current year, the registrant should present pro forma EPS data for the latest year and interim period in addition to historical EPS. Paragraph 3420.2 of the FRM provides additional guidance on the calculation of such pro forma per share data.

Changes in Capitalization

Entities often have other capitalization changes that occur before, or concurrently with, the effective date or closing of an IPO. Some changes, such as a stock split, are reflected retrospectively in all periods presented in the financial statements. Other changes, which may include (but are not limited to) the redemption or automatic conversion of preferred stock into common stock or the conversion of debt to equity, are only recorded prospectively and may not be reflected in the financial statements presented in an IPO filing. Registrants should present such changes in capitalization as part of the pro forma information. The SEC staff often focuses on the presentation of such pro forma information.

Pro Forma Balance Sheet

Example of an SEC Comment

Please revise to present a pro forma balance sheet giving effect to the redemption of the [preferred stock], excluding effects of the offering proceeds, alongside of the most recent historical balance sheet. Please also include disclosure in the notes to financial statements that describes the pro forma presentation.

The SEC staff asks registrants to present pro forma information when changes in capitalization will occur after the date of the latest balance sheet. Paragraph 3430.2 of the FRM indicates that when such changes will result in a material reduction in permanent equity or are the result of a redemption of a material amount of securities in conjunction with the offering, a filing should include a pro forma balance sheet (presented alongside the historical balance sheet) that takes into account the change in capitalization but not the effects of the offering proceeds.

Pro Forma EPS

Example of an SEC Comment

We note that your convertible preferred stock will convert to [X] shares of common stock upon the closing of this offering. Revise to present unaudited pro forma basic and diluted EPS for the latest year giving effect to the conversion.

Paragraph 3430.3 of the FRM indicates that when a conversion of outstanding securities occurs after the latest balance sheet date and will result in a material reduction in EPS exclusive of the effects of the offering, registrants should present pro forma EPS (but should exclude the effects of the offering). Such pro forma EPS should be presented for the latest fiscal year and interim period.

Draft Audit Reports

Example of an SEC Comment

We note that your reverse stock split will be effective immediately prior to completion of the offering. This reverse split should be retrospectively reflected in the financial statements, selected financial data and elsewhere throughout the filing. If the transaction prevents the auditor from expressing an opinion on the financial statements at the time of filing, we will not object to the filing of a "draft report" in the form that it will be expressed at effectiveness. In this case, the draft report should be accompanied by a signed preface of the auditor stating that it expects to be in a position to issue the report in the form presented at effectiveness. No registration statement can be declared effective until the preface is removed and the accountant's report finalized.

In accordance with Regulation S-X, Rule 2-02, and various interpretive guidance (e.g., Section 4710 of the FRM), the auditor's report should be dated and signed by the auditor and should not contain restrictive language (e.g., "draft"). The SEC staff will generally not commence its review of a registrant's filing if the registrant has filed a registration statement that does not meet these requirements. However, if a transaction (e.g., a stock split) is expected to occur immediately before the registration statement is declared effective, the registrant may wish to give effect to the transaction before it occurs. When such an anticipated transaction has been included in the historical financial statements so as to prevent the auditor from expressing an opinion regarding the financial statements at the time of filing (because the filing took place before the transaction occurred and before the registration statement was declared effective), the SEC staff has accepted the filing of a "draft report" in the form in which it will be expressed at effectiveness. Such a report would include a preface indicating that the report will not be final until the transaction is completed. The SEC staff will remind registrants to remove the preface from a registration statement that was filed before being declared effective because no registration statement can be declared effective until the preface is removed and the accountant's report is finalized.

Dilution Disclosure

Examples of SEC Comments

- You have not disclosed a net tangible book value per share before the planned offering that is consistent with historical amounts shown in your consolidated balance sheet at December 31, 2013. Please explain to us your basis for concluding that this presentation of dilution per share to new investors conforms to guidance in Item 506 of Regulation S-K.
- Please explain to us why you are excluding from your calculation of dilution the impact of the [X] million shares to be issued upon fulfillment of the [restricted stock unit] liquidity event condition.

Under Regulation S-K, Item 506, certain disclosures (including net tangible book value per share before and after a distribution) are required when "common equity securities are being registered and there is substantial disparity between the public offering price and the effective cash cost to officers, directors, promoters and affiliated persons of common equity acquired by them."

Section 8300 of the FRM acknowledges that there is no authoritative definition of "tangible book value" but notes that the metric "is used generally as a conservative measure of net worth, approximating liquidation value." The interpretive guidance (1) indicates what tangible assets should exclude and (2) cites examples of when the SEC staff has allowed dual calculation of tangible book value. Accordingly, the staff may question a registrant's calculation of dilution and its related disclosures, particularly if net tangible book value reported in the dilution section of the registration statement appears to be inconsistent with the historical financial statements.

Other Deloitte Resources

December 24, 2013, *Deloitte Accounting Journal*, "FASB Defines a Public Business Entity."

Foreign Private Issuers

Foreign Private Issuers Using IFRSs

Currently, about 500 foreign private issuers (FPIs) reporting under IFRSs are registered with the SEC. The SEC staff's comments to FPIs have addressed a number of financial accounting and disclosure topics. Many of the comments are generally consistent with those issued to domestic filers and raise topics that are discussed in other sections of this publication (albeit financial statement topics refer to the IFRS "equivalent" of U.S. GAAP).

In addition to nearly all of the topics that have been identified as comment trends applicable to domestic filers, SEC staff comments to FPIs ask about (1) the presentation of financial statements; (2) accounting for expenditures related to the exploration for, and evaluation of, mineral resources (i.e., under IFRS 6); (3) references to the use of IFRSs as issued by the IASB; and (4) going-concern language in PCAOB audit reports. These topics are discussed below.

Presentation of Financial Statements

Examples of SEC Comments

- Since you present costs and expenses by function, please provide additional information about the expenses by nature in accordance with paragraph 104 of IAS 1.
- Please consider revising future filings to present additional line items on the face of the statement of income for total operating income and total operating expense. Refer to paragraph 85 of IAS 1.
- Please address what consideration was given to Basis for Conclusions paragraph 56 of IAS 1 in determining that . . . it was appropriate to exclude the costs included in other expenses, net line item from your determination of operating income.

The SEC staff's comments have often focused on missing disclosures about the nature of expenses when issuers used a functional presentation of expenses in the statement of profit or loss and OCI. The staff has also commented on the exclusion of certain expenses from amounts presented as results of operating activities. In addition, the staff has asked issuers to present additional line items in the statement of profit or loss and OCI when such presentation is relevant to an understanding of the issuer's financial performance.

Under IAS 1, an entity can present expenses either by nature or by function. According to IAS 1.104, an entity that presents expenses by function must provide additional disclosures about the "nature of expenses, including depreciation and amortisation expense and employee benefits expense." As explained in IAS 1.105, this is "because information on the nature of expenses is useful in predicting future cash flows." The use of the term "including" in IAS 1 implies that additional disclosures about the nature of expenses may not be limited to depreciation, amortization, and employee benefit expenses. Rather entities should disclose other expenses by nature if such information may be useful in predicting future cash flows. An entity that uses a functional format should ensure that all additional disclosures are included in the footnotes and should consider including them in a single footnote for greater transparency. IAS 1.IG6 illustrates income statements that are presented by nature and by function.

IAS 1.82 and IAS 1.82A each list line items that an entity should include, at a minimum, in its statement of profit or loss and OCI. Disclosure of the results of operating activities as a separate line item in the statement of profit or loss and OCI is not required; however, an entity that decides to present the results of operating activities (i.e., operating income) or a similar line item should refer to IAS 1.BC56, which notes, in part, that "it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice."

Further, IAS 1.85 requires an entity to present additional line items, headings, and subtotals on the face of the statement of comprehensive income "when such presentation is relevant to an understanding of the entity's financial performance." When including such line items and subtotals, an entity should consider providing transparent disclosures that clearly convey the relevance of the items to financial statement users. In such cases, an entity may amend the description of the line items and reorder them to explain the particular element of financial performance.

Exploration for, and Evaluation of, Mineral Resources

Examples of SEC Comments

- We note . . . that you rely on IFRS 6 guidance in capitalizing exploration expenditures. We also note . . . that capitalized exploration costs are classified as mine development assets and you are relying on the guidance in IAS 16. To help us better understand your accounting policy for capitalizing exploration expenditures, please address the following items:
  - Tell us why you consider it appropriate to classify the capitalized exploration costs as mine development assets under IFRS 6 paragraphs 10 and 25.
  - Tell us how you reclassify the capitalized exploration costs when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable under the guidance in IFRS 6 paragraph 17 if the related capitalized exploration costs have been recorded as mine development assets.
  - Tell us the amount of exploration costs capitalized by mine at [Mine A and Mine B].
- You indicate that you do not use free cash flow as a liquidity measure. In light of this, please further explain in your disclosures the reasons why you believe the presentation of this non-GAAP measure provides useful information to investors. Refer to Item 10(e)(1)(i)(C) of Regulation S-K.

The SEC staff has often requested more information about the issuer's accounting policy related to the types of expenditures that the issuer recognizes as exploration and evaluation assets, including whether such policy complies with IFRS 6. In addition, the SEC staff's recent comments to issuers in the mining industry have focused on non-GAAP financial measures, particularly on whether (1) those measures have been clearly labeled and described as non-GAAP measures and (2) the issuer's disclosures demonstrate the purpose of the measures and their usefulness to investors. See the Non-GAAP Financial Measures and Mining sections for further discussion.

IFRS 6 requires an entity to develop an accounting policy that specifies the types of expenditures it recognizes as exploration and evaluation assets and to apply that policy consistently — particularly because IFRS 6 does not require entities to capitalize exploration and evaluation expenditures. In addition, when specified conditions are met, IFRS 6 permits entities to continue applying the accounting policies they used to account for exploration and evaluation expenditures before adopting IFRS 6.

Under IFRS 6, an entity's assessment of which expenditures would qualify as exploration and evaluation assets is determined on the basis of how closely the expenditures are associated with finding specific mineral resources. IFRS 6 provides a nonexhaustive list of expenditures that an entity might consider including in the initial measurement of its exploration and evaluation assets. Such expenditures include those related to:

- Acquisition of rights to explore minerals.
- Topographical, geological, geochemical, and geophysical studies.
- Exploratory drilling.

- Trenching.
- Sampling.
- Activities related to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

However, in accordance with IFRS 6, entities should not recognize expenditures related to the development of mineral resources as exploration and evaluation assets; instead, entities are required to apply the *Conceptual Framework for Financial Reporting* and IAS 38 to determine an appropriate accounting policy for such amounts. Further, although the term "development" is not defined, IFRS 6.5(b) indicates that the development phase begins "after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable."

References to the Use of IFRSs as Issued by the IASB

Example of an SEC Comment

Please amend your filing to include an audit opinion that refers to and opines on International Financial Reporting Standards as issued by the International Accounting Standards Board or include a reconciliation to US GAAP. Refer to Item 17(c) of Form 20-F.

The SEC staff has requested that issuers amend their Form 20-F when they have not asserted, and the audit report has not stated, that the financial statements were prepared in accordance with "IFRSs as issued by the IASB."

As stated in paragraph 6310.2 of the FRM and similarly indicated in Item 17 of Form 20-F, the issuer's "accounting policy footnote must state compliance with [IFRSs] as issued by the IASB and the auditor's report must opine on compliance with [IFRSs] as issued by the IASB." An issuer that does not prepare its financial statements in accordance with IFRSs as issued by the IASB is required to reconcile its financial statements to U.S. GAAP. The SEC staff has reiterated that FPIs need to provide a statement of compliance with "IFRSs as issued by the IASB" to be eligible to omit the U.S. GAAP reconciliation.

Going-Concern Language in PCAOB Audit Reports

Example of an SEC Comment

As noted in the Audit Report and consistent with Instruction 2 to Item 8.A.2 of Form 20-F, the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board in the United States (PCAOB). As such, the audit opinion should comply with the PCAOB standard regarding going concern uncertainties. As previously requested, amend your filing to include a report that uses the term "substantial doubt." Refer to AU 341.12. Also refer to the related discussion at the International Practices Task Force meeting on November 22, 2011.

The SEC staff continues to request that issuers amend their going concern language in their PCAOB audit reports to include unconditional statement of "substantial doubt."

Paragraph 4230.1(c) of the FRM emphasizes the importance of the phrase "substantial doubt" by stating that "[g]oing concern opinions that do not use the words 'substantial doubt' when referencing a going concern matter do not comply with PCAOB standards/U.S. GAAS."

Further, AU Section 341.12 states that the “auditor’s conclusion about the entity’s ability to continue as a going concern should be expressed through the use of the phrase ‘**substantial doubt** about its (the entity’s) ability to continue as a going concern’ [or similar wording that includes the terms substantial doubt *and* going concern]” (emphasis added). In addition, Footnote 5 to AU 341.13 states that “the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity’s ability to continue as a going concern. [One example] of inappropriate wording in the explanatory paragraph would be, ‘If the Company continues to suffer recurring losses from operations and continues to have a net capital deficiency, there **may** be substantial doubt about its ability to continue as a going concern’ ” (emphasis added).

Industry-Specific Topics

Consumer and Industrial Products

Retail and Distribution

The SEC staff's comments to registrants in the retail and distribution industry have focused on topics such as the results of operations section in MD&A (including disclosures about metrics and online sales) and the revenue-recognition implications of customer loyalty programs.

In addition, registrants in this industry typically have multiple distribution channels (e.g., stores, catalogs, the Internet), customer segments, geographic locations, and store concepts and brands. Consequently, the SEC staff frequently asks registrants about the identification and aggregation of their operating segments, particularly when they disclose only one reportable segment. See the Segment Reporting section for additional information.

MD&A — Results of Operations

Examples of SEC Comments

- [Y]ou indicate that comparable store metrics are calculated on an annual basis, including relocations, using all stores open at least one year. In future filings, please provide the following:
    - Please revise your disclosures to clarify how your comparable store metrics take into account stores closed during the period; and
    - Please also disclose the percentage of your net sales that are online sales and state whether these online sales are included or excluded from comparable store metrics. If online sales are included in comparable store metrics, please address the extent to which online sales impacted the increase or decrease in comparable store sales from period to period in your MD&A.
- Fiscal years that contain 53 weeks should generally include a quantified analysis of the impact of the extra week on the comparability of your results.
- Since it appears that your online business has a significant impact on your results, please provide a quantified discussion of your online business as part of providing investors with a view of the company through the eyes of management.

The SEC staff frequently asks registrants to improve their MD&A (e.g., by including operational and statistical measures) to help investors see registrants' performance through the eyes of management. Many retailers consider same-store sales a key operating metric; accordingly, same-store sales are often discussed in MD&A to help explain fluctuations in results of operations. Because there can be variability in the way same-store sales are calculated, the SEC staff often asks registrants to enhance their disclosures about such metrics and elaborate on any factors that could affect year-to-year comparability. For example, a registrant that has a 53-week fiscal year should quantify how inclusion of the extra week in its analysis affects comparability with previous years' results. Recently, the staff has also asked registrants to clarify whether online sales are included in the calculation of same-store sales and, if so, to quantify their effect.

At the 2013 AICPA Conference, the SEC staff observed that registrants sometimes do not provide enough information about how online sales affect their strategies and financial results. It noted that registrants need to assess the materiality of Internet sales and provide MD&A disclosures about these sales if warranted. Specifically, it indicated that when a registrant's online sales are significant, the staff may ask the registrant to separately discuss (1) the impact of such sales on the results of operations, including changes in overall gross margin, and (2) any trends affecting online sales.

Many registrants in the retail and distribution industry separately use non-GAAP financial measures (e.g., EBITDA) to communicate results. Consequently, the SEC staff may challenge their related disclosures. See the Non-GAAP Financial Measures section for additional information.

For other considerations, including SEC staff views on the use of appropriate metrics that help registrants "tell their story," see the Management's Discussion and Analysis section.

Revenue Recognition — Customer Loyalty Programs

Examples of SEC Comments

- Please explain to us and expand your disclosure to clarify how you account for the points at the time of award and when the points are redeemed. Also please disclose whether the points expire or have a specific term.
- [T]ell us how the cash-back feature of [your cobranded credit cards is] recognized, measured and classified in your financial statements.

The SEC staff may ask registrants to clarify the key terms and related accounting for customer loyalty programs and cobranded credit card arrangements. In such cases, the staff often seeks to understand the registrant's income statement classification analysis under ASC 605-50 and its consideration of other factors for recognizing and measuring such incentives.

Transportation, Travel, Hospitality, and Leisure

The SEC staff's comments to registrants in the TTHL industry have focused on capital expenditure disclosures, long-lived asset impairments, and VIEs.

Capital Expenditures

Examples of SEC Comments

- Please expand your disclosure to include additional analysis of your capital expenditures by breaking down total capital expenditures between new development (as applicable), routine capital expenditures and other capital expenditures by year. The total of these expenditures should reconcile to the cash flow statement. In addition, please expand your narrative discussion of fluctuations from year to year to discuss any known trends or expectations for the future.
- Please revise your disclosure related to capital expenditures in future filings to discuss significant variances or trends in your expenditures, and in your response to us, please tell us the reason for the decrease in enhancements to existing properties from $[X] during 2011 to $[Y] during 2012 to $[Z] during 2013.

The SEC staff often asks TTHL registrants to clarify their capital expenditure activities by disclosing in MD&A information such as:

- The reasons for overall fluctuations in capital expenditures from year to year.
- Capital expenditures on a disaggregated basis (e.g., new development, renovations) in tabular form for each year presented to facilitate investor analysis of trends and enhance comparability. If it is not readily apparent, the SEC staff also may ask registrants whether (and how) total capital expenditures presented in MD&A reconcile to total capital expenditures in the cash flow statement.
- To the extent material, the methods used to allocate and capitalize soft costs (e.g., payroll) and a discussion of fluctuations in soft costs for the periods presented. Similarly, the SEC staff may ask TTHL registrants to clarify in the notes to the financial statements (1) the types and amounts of soft costs capitalized for each period presented and (2) the registrants' accounting policies regarding the capitalization of soft costs. Determining the types and amounts of soft costs to be capitalized frequently requires judgment, and such determinations may vary depending on whether the associated asset is considered inventory, a long-lived asset, or a leased asset.

Long-Lived Assets

> **Example of an SEC Comment**
>
> We [note that you] believe the market value of each of the vessels equals or exceeds its carrying value. In order to provide investors with additional information as to trends that could potentially impact your future results of operations, please revise future filings to include a comparative analysis of how the carrying values of your vessels compare to the fair market value of such vessels as of each balance sheet date presented in your financial statements. Also, please consider revising this table to include the date of acquisition, purchase price and carrying value at the balance sheet date for each of your vessels.

The SEC staff has encouraged shipping company registrants to provide tabular disclosures in the critical accounting policies section of MD&A that include information about assets at the individual-vessel level, especially if asset values are depressed. Consequently, the staff may ask such registrants to discuss more thoroughly the factors and conditions that would lead them to record an impairment loss.

In addition, the SEC staff has asked such registrants to disclose, on a comparative basis, the aggregate amount by which their vessels' carrying value exceeds the vessels' aggregate basic charter-free market value (or valuation for covenant compliance purposes). This disclosure is intended to highlight the potential for impairment, the trend in vessel values, and how that trend could affect future results of operations.

Further, the SEC staff may ask for more robust disclosures about the sensitivity of assumptions used in the test for impairment, particularly those used in the selection of historical average charter rates. Accordingly, registrants are encouraged to consider disclosing the margins by which estimated future undiscounted cash flows would exceed each vessel's carrying value if management were to use various historical trailing averages (e.g., those based on one-year, three-year, and five-year periods).

VIE Arrangements

> **Example of an SEC Comment**
>
> You have disclosed that your subsidiary has been granted the exclusive right to manage, operate and control [Entity A]. Please elaborate upon the notion of control and provide your analysis under ASC 810-10, including the specific rights held by you and [other] parties. Tell us how you have determined that you should consolidate this entity.

TTHL registrants may enter into arrangements that create variable interests (e.g., interests related to real estate investments, property management ventures, or investments in utilities that supply energy to property developments) that must be assessed in a consolidation analysis. The SEC staff often inquires about (1) the specific terms of such arrangements, (2) the initial determination and evaluation of the primary beneficiary under ASC 810-10, and (3) changes in circumstances (e.g., development plans) that could affect the primary-beneficiary status. The staff has asked registrants to discuss how they evaluated changes in circumstances to determine whether consolidation was warranted and may request revised and expanded disclosures that more thoroughly explain the nature of the arrangements and the registrant's evaluation of any changes in circumstances.

For more information, see the Consolidation section.

> **Other Deloitte Resources**
>
> December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Energy and Resources

Oil and Gas

The SEC staff's comments to registrants in the oil and gas industry continue to focus on (1) master limited partnerships (MLPs); (2) oil and gas reserves; (3) disclosures about drilling activities, wells and acreage data, and delivery commitments; and (4) non-GAAP financial measures.

MLP Considerations

Distributable Cash Flow and Maintenance Capital Expenditures

Examples of SEC Comments

- [You state] that Distributable Cash Flow provides investors with an approximation of Available Cash, as defined in your partnership agreement, prior to the establishment of any cash reserves. Please provide us with a comparison of the calculations of Available Cash and Distributable Cash Flow (e.g., tell us how capital expenditures are determined in calculating Available Cash). With your response, please tell us about the extent to which Distributable Cash Flow is considered by management and the board of directors in determining actual cash distributions. . . . As part of your response, explain how you evaluate, and how you believe investors should consider any excess or shortfall of Distributable Cash Flow over actual cash distributions for any given period.
- We note that a significant component of your distributable cash flow calculation is maintenance capital expenditures, which reduce the cash flow available for distribution to your unitholders. Since we understand that the definition of this term may vary within the industry, please tell us your definition of maintenance capital expenditures. Specifically, please clarify what you are maintaining: a specific level of net assets, throughput, capacity, profitability, etc. Since we understand that the definition of this term may vary, please also tell us how you considered clarifying this matter to your investors.

The partnership agreements of MLPs typically define distributable cash flow and often call for a distinction between capital expenditures associated with maintenance and those associated with growth. In turn, MLPs frequently disclose distributable cash flow and capital expenditure amounts. Consequently, because distributable cash flow is not determined on the basis of SEC rules or U.S. GAAP, SEC staff comments to industry registrants may focus on:

- Providing greater clarity about how distributable cash flow is calculated.
- How maintenance capital expenditures is defined and how it affects distributable cash flow.
- Describing the relationship between the calculated amount of distributable cash flow and actual distributions.
- Understanding liquidity ramifications related to requirements to distribute cash.
- Compliance with S-K Item 10(e) related to non-GAAP financial measures, including (1) how distributable cash flow is used by management and (2) the registrant's reconciliation of the non-GAAP measure to the appropriate GAAP measure (e.g., why distributable cash flow as a cash measure is reconciled to a profit measure, such as net income, instead of to operating cash flows).

EPU Considerations

MLPs are common structures used in the energy and real estate industries. Frequently, MLPs have differing classes of ownership units, such as general partner (GP) units, limited partner (LP) units, and incentive distribution rights, that participate in earnings on the basis of the contractual rights stipulated in the partnership agreement; therefore, in such cases, MLPs must apply the two-class method in ASC 260 to determine earnings per unit (EPU). MLPs also commonly engage in dropdown transactions, in which the GP of the MLP transfers assets to the MLP in exchange for a greater partnership interest in the MLP or cash (or both).

ASC 260 does not address how the MLP's presentation of historical EPU would be affected by a dropdown transaction that (1) occurs after the MLP's initial formation and (2) is accounted for as a reorganization of entities under common control. As a result, two common approaches have developed, as noted in a memorandum prepared for the EITF's deliberations on this issue at its September 2014 meeting:

- Restate historical EPU "by allocating the net income (loss) of the transferred business prior to the date of the dropdown transaction to the GP, LPs, and [other participating interest] holders."
- Allocate "the net income (loss) of the transferred business prior to the date of the dropdown transaction entirely to the GP." The memorandum indicates that "[u]nder this alternative, there is no retrospective adjustment to previously reported EPU."

Consequently, the SEC staff has asked registrants about the basis for their EPU calculations in dropdown transactions. To address the diversity in practice, the FASB issued a proposed ASU in October 2014 under which an MLP would perform the allocation by using the second approach described above. As a result, there would be no adjustment to historical EPU reported for LP units.

Oil and Gas Reserves

PUD Reserves

Example of an SEC Comment

You disclose that a significant percentage of your net undeveloped acreage will expire over the next three years. Please tell us the extent to which you have assigned any proved undeveloped reserves . . . to locations which are currently scheduled to be drilled after lease expiration. If your undeveloped reserves include any such locations, [tell] us the steps you will take regarding an extension of your legal right to these leases; otherwise, please remove these undeveloped reserves as proved reserves in your next filing.

Under Regulation S-X, Rule 4-10(a)(22), a registrant should be reasonably certain when estimating proved reserves that the reserves can be recovered in future years under existing economic conditions. In accordance with Rule 4-10(a)(31)(ii), "[u]ndrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances, justify a longer time."

The SEC staff may ask registrants to justify recorded proved undeveloped (PUD) reserves that will remain undeveloped for more than five years because a registrant's decision not to develop PUD reserves for such a long period may indicate uncertainty regarding development and ultimate recoverability. In accordance with Regulation S-K, Item 1203(d), a registrant may be asked to explain why the reserves have not been or will not be developed, why it believes that the reserves are still appropriate, and how it plans to develop the reserves within five years given the registrant's historical conversion rate. The SEC staff may also ask registrants to support engineering assumptions, such as terminal decline rates, used in proved reserve estimates, as well as assumptions used in future cash flow analyses (e.g., estimated future well costs).

Separate Disclosure of NGL Reserves

> **Example of an SEC Comment**
>
> We note you disclose proved reserves of crude oil, condensate and natural gas liquids (NGLs) as a single aggregated quantity in the tables . . . . The staff considers NGLs to be a separate product type under Item 1202(a)(4) of Regulation S-K; therefore, NGL reserves, if material, should be presented as separate quantities for disclosure under Item 1202(a)(2) of Regulation S-K. Please revise your disclosures to separately present, on a disaggregated basis, your NGL reserve quantities.

Although NGLs are not separately identified as a product type in Regulation S-K, Item 1202(a), they are discussed in ASC 932-235-50-4. Accordingly, the SEC staff may ask registrants to disclose NGLs separately if they aggregate significant NGLs with other product types in their disclosures of proved reserves.

Significant Changes in Reserves and Standardized Measures

> **Examples of SEC Comments**
>
> - Please revise your disclosure of changes in proved reserve quantities to include an explanation of significant changes that occurred during the periods presented. Refer to FASB ASC 932-235-50-5.
> - Please expand your disclosure of the changes in net quantities of proved reserves to include appropriate explanations of significant changes relating to extensions and discoveries, other additions and revisions of previous estimates, for each of the reporting periods shown, to comply with FASB ASC Topic 932-235-50-5.

The SEC staff has commented on registrants' disclosures about (1) changes in proved reserves and standardized measures and (2) their compliance with ASC 932-235-50. Accordingly, the SEC staff may ask registrants to describe the technical factors (e.g., the activities, findings, and circumstances) that led to significant changes in proved reserves; to address negatively revised estimates attributable to performance separately from those attributable to price reductions; to explain significant changes in extensions and discoveries; and to disclose prices used in the calculation of standardized measures. Further, the SEC staff may (1) ask industry registrants whether abandoned assets have been included in the standardized measure and, if so, to provide information about them and (2) refer registrants to guidance in a sample letter provided by the Division of Corporation Finance.

Reserve Reports

> **Example of an SEC Comment**
>
> Please file a third party report that complies with the requirements of Item 1202(a)(8) of Regulation S-K: (i) The purpose for which the report was prepared and for whom it was prepared; (ii) The date on which the report was completed; (iv) The data and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and; (x) The signature of the third party. Include the third party's responsible person's technical qualifications as required by Item 1202(a)(7) of Regulation S-K.

Under Regulation S-K, Item 1202(a)(8), a registrant must file a third-party report as an exhibit to its periodic report or registration statement when it "represents that a third party prepared, or conducted a reserves audit of, the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review." Accordingly, certain disclosures are required under Item 1202(a)(8). The SEC staff issues comments when these required disclosures are omitted. Often, the staff's comments are related to the requirement in Regulation S-K, Item 1202(a)(8)(iv), to disclose the "assumptions, data, methods, and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report."

Drilling Activities, Wells, Acreage, and Delivery Commitments

Examples of SEC Comments

- Please revise or otherwise expand your disclosure to present the total gross and net productive wells expressed separately for oil and gas as of a reasonable current date or as of the end of the current fiscal year pursuant to the disclosure requirements under Item 1208(a) of Regulation S-K.
- Please expand the disclosure of your present activities, such as the number of wells in the process of being drilled, completed or shut in awaiting infrastructure, to provide this information as of March 31, 2014. Please refer to the disclosure requirements in Item 1206 of Regulation S-K.

The SEC staff has continued to focus on registrants' disclosures about production information, drilling activities, wells and acreage data, and delivery commitments under Regulation S-K, Items 1204, 1205, 1206, 1207, and 1208. Additional disclosures that may be requested include (but are not limited to) the following:

- Production by geographic area and for each country and field that contains 15 percent or more of the registrant's total proved reserves.
- Drilling activities for each of the last three years by geographic area.
- Steps to be taken to meet significant delivery commitments.
- The number of wells that the registrant operates, including the total gross and net productive wells, expressed separately for oil and gas by geographic area.
- Information related to undeveloped acreage regarding minimum remaining terms of leases and concessions for material acreage concentrations, including significant undeveloped acreage that will be expiring over the next three years.

Non-GAAP Financial Measures

Registrants in the oil and gas industry commonly use derivative instruments to hedge their exposure to commodity price risk. However, registrants may elect not to apply hedge accounting for such derivative transactions. Accordingly, any mark-to-market adjustments are recorded in registrants' earnings (i.e., unrealized gains and losses are recorded in profit and loss in registrants' income statements). In addition, some registrants may present non-GAAP financial measures, such as adjusted EBITDA, as well as adjustments (in the required reconciliation to the most directly comparable GAAP measure) for the effects of such derivative transactions (e.g., excluding net unrealized gains/losses), which the SEC has indicated may not be in accordance with U.S. GAAP. As a result, the SEC staff has asked registrants to present two separate reconciling items within the non-GAAP reconciliation for (1) total net gains or losses in accordance with U.S. GAAP (i.e., total net realized and unrealized gains/losses) and (2) net cash receipts or payments for derivatives settled during the period (i.e., net realized gains/losses). See the Non-GAAP Financial Measures section for more information related to non-GAAP measures.

Power and Utilities

The SEC staff's comments to registrants in the power and utilities industry have continued to focus on (1) accounting for the impact of rate making; (2) regulatory disallowance of property, plant, and equipment; (3) identification of possible phase-in plans; and (4) parent and subsidiary dividend restrictions.

In addition, the staff continues to question whether registrants in the power and utilities industry have complied with requirements under ASC 450 to disclose their range of loss in connection with litigation and other contingencies and with segment reporting requirements under ASC 280. See the Contingencies and Segment Reporting sections for more information.

Because many utilities have both regulated and nonregulated businesses, the SEC staff has asked industry registrants to discuss their analysis for determining whether to separately disclose revenues and costs of revenues related to their nonregulated businesses. For additional information see the Financial Statement Classification, Including Other Comprehensive Income section.

Master limited partnerships (MLPs) are common structures used in the energy industry. See the Oil and Gas section for additional considerations related to MLPs.

Accounting for the Impact of Rate Making

Example of an of SEC Comment

You disclose that $[X] of regulatory assets [was] not earning a rate of return as of September 30, 2013. You subsequently disclose that a portion of the regulatory asset related to pensions and other postemployment benefits relating to the unfunded differences between the projected benefit obligation and plan assets also does not earn a rate of return, but do not disclose an amount. Please revise to disclose the total amount of regulatory assets for which you do not earn a rate of return. Refer to ASC 980-340-50-1.

The SEC staff continues to ask rate-regulated utilities to disclose (1) how their current regulated rates are designed to recover their specific costs of providing service; (2) the nature of all of their material regulatory assets and liabilities; (3) the anticipated recovery period of their regulatory assets, or the anticipated refund period of their regulatory liabilities; (4) whether a particular regulatory asset is earning a rate of return; and (5) their accounting policies for revenues subject to refund. In addition, the SEC staff may request supplemental explanations or separate detailed analysis and evidence that support the registrant's recognition of regulatory assets.

Regulatory Disallowance of Property, Plant, and Equipment

Example of an of SEC Comment

It is our understanding that you continued to recognize [certain] capital costs related to your recently completed administrative and operations buildings as of June 30, 2013. If our understanding is correct, please tell us the specific facts and circumstances you considered in continuing to recognize said capital costs after the draft decision was issued, and your consideration of ASC 980-360-35-12. Please also tell us what events you believe would trigger derecognition of said capital assets.

Recently, various public utility registrants have received comments from the SEC staff about how they applied ASC 980-360-35, which provides guidance on an entity's subsequent measurement and recognition of property, plant, and equipment. Registrants have been asked to explain considerations related to their derecognition of property, plant, and equipment in light of recent regulatory orders by state public utility commissions that limit a public utility entity's cost recovery. Also, given the increasing costs of capital projects and cost caps imposed by regulatory authorities at the time of approving large new capital projects, the SEC staff has requested disclosure regarding the estimated costs of capital projects and detail of the costs that could change during construction. SAB Topic 10.E states that "disallowed costs for recently completed plants [should] be charged to expense when the disallowance becomes probable and can be reasonably estimated."

Registrants can refer to the example in ASC 980-360-55-18 for assistance in applying the guidance on accounting for the disallowance of plant cost resulting from a cost cap.

Identification of Possible Phase-In Plans

> **Example of an of SEC Comment**
>
> Please supplementally explain the history of the regulatory asset relating to depreciation including why a portion of depreciation for financial reporting purposes was deferred. Tell us over what period it arose and the identity of the plant(s) to which it relates . . . including whether any plant(s) were recently completed. Tell us when you started amortizing this regulatory asset.

Since many regulators wish to keep rates down in a current rate proceeding, a regulator may decide to defer costs associated with a major new plant addition. A deferral of any costs associated with a major new plant addition could be a phase-in plan. In accordance with ASC 980-340-25-2, cost deferrals are not permitted for phase-in plans. To qualify as a phase-in plan, a method for recognizing allowable costs must meet three criteria outlined in ASC 980-360-20. Rate-making methods that can result in a phase-in plan include those under which:

- Rates for a new facility are levelized.
- Rates are based on the levelized lease payments under a capital lease (or power purchase agreement that meets the definition of a lease).
- A percentage of an overall rate increase that has been approved is deferred and included in rates in later years.
- The depreciation expense of a major new plant is deferred and included in rates in later years.

If a major newly completed plant is being included in rates for the first time and the regulator provides for a deferral of any costs associated with the new plant for inclusion in future rates rather than as part of cost of service in the current proceeding, those costs may not qualify as a regulatory asset under U.S. GAAP unless an exception applies, regardless of the probability that the incurred costs will be recovered in future rates.

Dividend Restrictions

The financial flexibility of registrants in the power and utilities industry and the nature of their relationships with affiliated parties, including the parent company, may be constrained by regulation. Subsidiaries often enter into financing agreements that may restrict (1) the transfer of assets in the form of advances, loans, or dividends to the parent company or another affiliated party or (2) other types of transactions with affiliates. The inability of a subsidiary to transfer assets to the parent company could, in turn, restrict the parent company's ability to pay a dividend to its shareholders. In addition, holders of significant noncontrolling interests in a subsidiary may influence the subsidiary's operations.

Various public utility registrants have received comments from the SEC staff about their compliance with Regulation S-X, Rules 4-08(e) and 5-04. The staff has questioned whether such registrants adequately considered the Federal Power Act as well as Federal Energy Regulatory Commission rules, state rules and regulations, and other regulations that restrict transfers of assets. In addition, the staff has asked public utility registrants whether, in the absence of regulatory restrictions, they have considered other limitations (e.g., debt agreement covenants), which could restrict the transfer of assets from a subsidiary to the parent company through dividends, loans, advances, or returns of capital.

As a result of the staff's comments, several power and utilities registrants have been required, or have agreed, to prospectively (1) expand their notes to the financial statements about potential dividend restrictions in accordance with Rule 4-08(e) and (2) include a Schedule I in their annual Form 10-K in accordance with Rule 5-04. A registrant must determine whether it needs to comply with Rule 4-08(e) independently of Rule 5-04 because compliance with one set of disclosure requirements does not satisfy the requirements of the other.

For additional considerations about dividend restrictions, see the Debt section.

Mining

Example of an SEC Comment

We note you present the non-GAAP measures of total cash costs per ounce of gold produced for fiscal years ended 2011 through 2013 on a mine-by-mine basis, computed after deducting by-product metal revenues. We understand your desire to convey the notion that sales of by-products offset part of your costs. However, to supplement your existing disclosure, please provide draft disclosure of the following information to be included in future filings:

- A measure presenting cash costs per ounce of gold produced before adjusting for by-product metal revenues;
- Transparent line item captions, i.e., cash costs per ounce of gold produced before by-product metal revenue and cash costs per ounce of gold produced net of by-product metal revenues;
- Description of the reasons why certain metals are considered by-products if the amount of by-product credits is material.

Recent SEC staff comments to registrants in the mining industry have focused on the registrants' use of non-GAAP financial measures. One such measure, which is often used in this industry, is total cash cost per ounce for the principal mineral the company produces. In their disclosures about the production of that mineral, registrants may identify by-products that generate revenue. The SEC staff has noted that registrants sometimes calculate the non-GAAP measure by netting the revenue earned from the by-products with the production cost of the principal mineral. This may result in a non-GAAP measure that is low compared with the gross production cost, or even negative, which could be confusing to investors.

At the 2013 AICPA Conference, the SEC staff emphasized that at a minimum, it expects full disclosure of what the non-GAAP measure represents and clear labeling of the measure to highlight that the cash costs per ounce have been reduced by the by-product revenues. To provide additional transparency, registrants may use a "with or without" measure that adjusts for the by-product revenues. The SEC staff also indicated that it may challenge the appropriateness of using the measure when by-product revenues materially affect the cost measure. The staff further emphasized that in cases involving multiple by-products, registrants should present any related revenues separately when material and reconcile such amounts to the total by-product revenue included in the non-GAAP measure.

In addition, recent SEC staff comments have asked registrants in the mining industry to (1) revise the titles of their non-GAAP measures throughout their filings to clarify that the measures are net of by-product credits, (2) disclose why management believes that presenting a cost measure net of revenue is useful to investors, and (3) explain why management considers other metals to be by-products when sales of such metals are significant.

See the Non-GAAP Financial Measures section for more information about non-GAAP measures.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Financial Services

Banking and Securities

The SEC staff's comments to registrants in the banking industry continue to focus on the estimation of allowances for loan losses, loan modifications, and TDRs. In addition, the SEC staff periodically asks registrants in the securities industry to provide more information about PCI and other acquired loans as well as quantitative and qualitative disclosures about market risk and VaR.

Allowance for Loan Losses

Qualitative and Quantitative Factors Used in Evaluating the Allowance for Loan Losses

Examples of SEC Comments

- [D]escribe in detail the qualitative or quantitative factors you track and consider in your allowance methodology and specifically discuss how those factors are able to track and incorporate the current loss trends in order to ensure your allowance is appropriately capturing all incurred losses.
- Please revise future periodic filings to provide a more robust and detailed discussion of how you determine this allowance for loan loss. Your disclosure should discuss, as appropriate, but not be limited to:
  a. how you group loans with similar characteristics (e.g. geography, past-due status, internal risk ratings, etc.);
  b. how forecasted probable losses are determined (e.g. historical loss rates adjusted for environmental factors, migration analysis, etc.);
  c. the key qualitative factors you considered and the impact on forecasted probable losses;
  d. the time frames over which you evaluate loss experience; and
  e. the interplay between the forecasted probable losses and the loss confirmation period.
- [You disclose] that you decreased the portion of your allowance for loan and lease losses (ALLL) related to qualitative and environmental factors to reflect improving credit quality trends and stabilizing economic conditions in some of your markets. Please revise your disclosure in future filings to address the following:
  - Clarify whether the reduction in the ALLL in each portfolio segment was driven solely by the portion related to qualitative and environmental factors . . . . In this regard, please also clarify whether more recent periods are more heavily weighted when determining historical loss rates.
  - Enhance your disclosure within MD&A to discuss the drivers of such reductions in each component of your ALLL in a more granular level of detail. . . . Please also ensure that your disclosure addresses both positive and negative credit quality trends and how they were impacted [by] the level of your ALLL.

Estimating the allowance for losses is an inherently subjective process that requires registrants to consider both quantitative and qualitative factors related to the loan loss reserve as well as the tendency of the reserve to change. Registrants have been asked to expand their disclosures about how they determine each element of the allowance for loan losses, including how they derive general and unallocated components.

Specifically, the SEC staff may ask registrants to disclose:

- How they group loans with similar characteristics to evaluate loan collectibility (such as loan type, past-due status, sector, and risk).
- How they determine loss rates (e.g., on the basis of historical loss rates that are adjusted for environmental factors or migration analysis), and what factors they consider when establishing appropriate time frames for the evaluation of loss experience.

- Qualitative factors (e.g., industry, geographical, economic, and political) that have affected loss rates or other loss measurements.
- How they consider housing price depreciation and homeowners' loss of equity in collateral when determining the allowance for loan losses related to residential mortgages and other loans collectively evaluated for impairment.
- The basis for assumptions used about housing price depreciation.
- How increases and decreases in expected cash flows on covered loans affect FDIC indemnification assets and allowance for loan losses, and how these changes are recognized in the income statement.
- How they consider write-downs recognized on real estate inventory transactions in determining the appropriate level of allowance for loan losses (both individually assessed and collectively assessed) for other loans with similar collateral.
- Where in the income statement they charge negative differences between carrying amounts of a loan and the fair value less costs to sell.
- Why certain types of loans have lower nonaccrual and charge-off statistics than others.

In addition, in light of improved economic conditions that have enabled banking institutions to reduce their allowances for loan losses, the SEC staff has asked registrants in the banking industry to provide expanded disclosures in MD&A about the factors that led to reductions in those allowances.

Further, SEC staff comments to registrants in the banking industry commonly cite the guidance in ASC 310-10-S99-4 and Chapter 9 of the AICPA's Audit and Accounting Guide for depository and lending institutions. The SEC staff's interpretive guidance in ASC 310-10-S99-4 states that when registrants change their method for determining the allowance for loan losses, the staff would normally expect them to maintain "documentation that describes and supports the changes." Accordingly, the SEC staff in such cases continues to request the following disclosures:

- The nature of, and reason for, the modification.
- The specific change(s) made.
- Why the change is necessary.
- Why the change is expected to result in a more appropriate allowance.
- The impact of the change on the level of the allowance for loan losses.

Credit Quality

Example of an SEC Comment

Please tell us and revise future filings to fully explain how you analyze how changes in the credit quality of your loan portfolio are considered when you determine the amount of your provision for loan loss recorded during the period and the amount of the allowance for loan losses at period end. For example, provide an analysis of each component of your allowance for loan losses (general, specific, unallocated, etc.) detailing how you determined that each component was directionally consistent with the underlying credit quality of the applicable loan portfolio.

To better understand the credit quality of a banking industry registrant's loan portfolio, the SEC staff has requested additional information (and enhanced discussions) about (1) changes in credit quality indicators, such as loan-to-value ratios and FICO scores, and (2) the impact of seasonality on the allowance for loan losses. In addition, if the credit quality of a registrant's loans changes significantly, the SEC staff expects the registrant to discuss (1) the components of the registrant's allowance for loan losses for each period and (2) how the effects of the change in credit quality are reflected in the financial statements. Registrants should also disclose other relevant information that clearly explains the reasons for the change in credit quality during the period (e.g., significant charge-offs recorded as a direct result of a regulatory examination) and how they measured the components of their allowance for loan losses.

The SEC staff may also comment if it appears that disclosures about credit quality in the notes to the financial statements are inconsistent with those in other parts of the registrant's filing or in other publicly available information (e.g., a press release or earnings call).

Collateral Appraisals

> **Example of an SEC Comment**
>
> Discuss how frequently you obtain appraisals for the underlying collateral for both loan origination and loan impairment analysis and the type of appraisal obtained (e.g., in-person full appraisals, drive-by appraisals or automated valuation models . . .). If the type of appraisal differs by loan product or value, discuss those differences.

To understand how registrants determine their allowance for loan losses, the SEC staff often asks them to disclose how frequently they obtain updated appraisals for impaired collateral-dependent loans and to describe the types of adjustments that are made to appraised values.

Disclosures About Credit Quality Under ASC 310-10

> **Example of an SEC Comment**
>
> Please revise future filings to disclose both the balance of your allowance for loan losses and your recorded investment in financing receivables by impairment method (e.g. collectively evaluated, individually evaluated, acquired with deteriorated credit quality) for each loan portfolio segment. Refer to ASC 310-10-50-11B(g) and (h) and the example disclosure in ASC 310-10-55-7 for guidance.

ASC 310-10 requires entities to enhance and disaggregate their disclosures about the credit quality of their financing receivables and their allowance for credit losses. The FASB's objective in requiring enhanced disclosures is to give financial statement users a better understanding of (1) the nature of an entity's credit risk associated with its financing receivables, (2) how the entity assessed that risk in estimating its allowance for credit losses, and (3) changes in the allowance and why they were made.

Specifically, ASC 310-10 requires disclosure of the following information about credit exposure and reserving methodology on the basis of disaggregated portfolio segments and classes of financing receivables:

1. Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables
2. The aging of past due financing receivables at the end of the reporting period by class of financing receivables
3. The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses

4. The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses

5. Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment.

PCI and Other Acquired Loans

Examples of SEC Comments

- Please revise, in future filings, to provide a loan summary table that addresses the loans by category that are self-originated and that have been acquired (both PCI and non-PCI loans) for each period presented.
- Please revise, in future filings, to also provide a rollforward of the activity in the allowance for loan losses for non-PCI loans for each of the periods presented. This will provide the reader with an enhanced understanding of the performance of the non-PCI loans given the continued significant growth of these types of loans.

The SEC staff has asked registrants whose loan portfolios have grown significantly as a result of acquired rather than self-originated loans to provide more granular disclosures about loan balances and corresponding loan loss allowances for (1) self-originated loans and (2) acquired loans (both PCI and non-PCI).

Loan Modifications and TDRs

Examples of SEC Comments

- We note your disclosure that you have created a number of loan modification programs to help borrowers stay in their homes and operate their businesses. You also state that in some of these cases, the restructure or loan modification fits the definition of a [TDR] as defined by current accounting guidance. Please tell us and revise future filings to provide a brief summary of your various loan modification programs, disclose the amount of loans modified that are not considered TDR's, disaggregated by loan portfolio segment, and explain how you determined the modifications did not meet the definition of a TDR pursuant to ASC 310-40-15-5.
- We note that corporate renegotiated loans and consumer renegotiated loans . . . declined year over year despite the increase in consumer U.S. mortgage loans . . . . Please tell us how much of the decline in renegotiated loans is due to loan sales, payments, charge-offs, removal from renegotiated/TDR loan status, or other factors, and confirm that you will revise your disclosure in future filings to separately address material trends in your renegotiated loans including any material offsetting amounts.

The SEC staff continues to request enhanced disclosures about loan restructurings. The staff has also inquired about whether such restructurings should be accounted for as TDRs and therefore should be included in the registrant's risk element disclosures required by SEC Industry Guide 3.

The SEC staff has suggested that registrants consider disclosing the following:

- How modifications affect the timing of the recording of the allowance for loan losses.
- A description of the key features of the registrant's loan modification programs, including whether the programs are government- or company-sponsored and whether they are short- or long-term.

- Quantification of the types of concessions made (e.g., rate reductions, payment extensions, forgiveness of principal, forbearance) and discussion of success with the different types of concessions.
- The accounting policy for restructured loans, including how and when a restructured loan is determined to be nonaccrual or accrual (i.e., noninterest accruing or interest accruing); the factors the registrant considered in determining whether the loan should accrue interest; the anticipated period and number of borrower payments for a restructured loan to return to accrual status; and whether any loan loss allowance has been recorded or any portion of the loan has been charged off.
- Confirmation of whether loan restructurings should be classified as TDRs under ASC 310-40 and, if so, separate disclosure of the loans in the nonperforming assets table under SEC Industry Guide 3, Item III(C)(1).
- TDRs by loan type, classified separately as accrual or nonaccrual.

In addition, if there are material changes in TDRs, the SEC staff may ask about such changes and request additional disclosures, including a rollforward detailing loan sales, payments, charge-offs, and loans that have been removed from TDR status.

Further, when a material amount of a registrant's loan modifications is not accounted for as TDRs, the SEC staff often requests disclosures that explain the following:

- Triggers and factors the registrant considered to identify loans to modify and to support its conclusion that modifications are not TDRs.
- Key features of the modification programs, including a description of the significant terms modified and the typical length of each modified term.
- Success rates of the modification programs.
- The amount of the loans modified in each period presented.
- Whether the modified loans are included in the company's impairment analysis of the general reserve (ASC 450-20) or individual reserve (ASC 310-10) and, if included in the general reserve analysis, whether a materially different amount would have resulted if the loans had been included in the individual reserve analysis.

In evaluating whether a loan modification represents a TDR, a registrant must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty and (2) the lender has granted a concession to the borrower.

ASC 310-40 outlines considerations for determining whether a borrower is experiencing financial difficulties (e.g., debtor default, debtor bankruptcy, and concerns about the borrower's ability to continue as a going concern). Further, it clarifies that a borrower not currently in default could be experiencing financial difficulties if default is probable in the foreseeable future.

Quantitative and Qualitative Disclosures About Market Risk and VaR

Example of an SEC Comment

We note that you use a [VaR] methodology to measure the market risk inherent in your trading activities. Please revise your future filings to provide the following additional disclosures:

- [S]pecify the confidence level and time horizon used in your VaR model;
- [D]isclose your average, high and low VaR by type of risk (e.g., interest rate, equity, energy, foreign exchange, etc.) for each period presented; and
- [Q]uantify the number of times that actual trading losses exceeded VaR during the periods presented. Refer to Regulation S-K Item 305.

The SEC has periodically asked registrants in the banking and securities industries to provide more information on quantitative and qualitative disclosures about market risk and VaR. In addition, the SEC staff may ask broker-dealer registrants to:

- Quantify the amount of the investment positions excluded from the VaR measure.
- Explain whether the VaR measure includes the market risk associated with securities sold but not yet purchased.
- Include comparative disclosures for the prior year, along with a discussion describing the reasons for material quantitative changes in market risk.

Insurance

In many of its comments to registrants in the insurance industry, the SEC staff has continued to focus on (1) transactions with captive subsidiaries; (2) reinsurance receivables; (3) assumptions used in establishing reserves and loss adjustment expense; (4) deferred acquisition costs; and (5) various other considerations, including those related to statutory disclosures, disclosures about dividend restrictions, and investments and financial instruments.

In addition to the insurance-related matters (discussed below), the SEC staff's comments to registrants in the insurance industry have focused on goodwill and income taxes. See the Impairments of Goodwill and Other Long-Lived Assets and Income Taxes sections for more information.

Captive Subsidiaries

Example of an SEC Comment

Please provide us the following information regarding your use of [Company A], your special purpose financial captive insurance company:

- The nature and the business purpose of transactions with [Company A] and, if applicable, other captives. Explain how you reinsure with [Company A] including whether, and if so, to what extent, [Company A] assumes reinsurance from third parties to whom you ceded policies.
- The amount of [Company A's] obligations and the nature and amount of assets and guarantees that secure the captives' obligations, apart from the line of credit with [Company B] . . . . Tell us the nature and amount of the [the holding company's) assets, guarantees, letters of credit or promises securing [Company A's] obligations.
- The effects in your GAAP consolidated financial statements of transacting with [Company A] directly and, if applicable, indirectly through third parties.
- Your consideration of disclosing the risks of employing your captives strategy.
- Any uncertainties associated with the continued use of this strategy and the expected effects on your financial position and results of operations if you discontinue this strategy.

Many insurance entities have captive subsidiaries, which insure specific risks for the parent entity and its affiliates. These captive subsidiaries allow entities to manage their own risks and also provide many advantages, including capital management benefits. The SEC staff has continued to request expanded disclosures about transactions between registrants in the insurance industry and their captive subsidiaries, such as the nature, purpose, and number of those transactions. Further, it has requested enhanced disclosures about the impact of captive subsidiaries on registrants' financial statements and about the risks and uncertainties associated with those subsidiaries.

Reinsurance Receivables

Example of an SEC Comment

Given the magnitude of your reinsurance recoverable assets in relation to your equity, please provide us proposed revised disclosure to be included in future periodic reports that specifically indicates how you manage your associated credit risk. In your disclosure, at a minimum, please include the following concepts provided in your response to [a previous comment]:

The criteria you use to qualify new reinsurers;

- How you monitor the financial strength ratings of existing reinsurers; and
- The amount of collateral you hold against these recoverable assets and how you have accounted for this collateral, including where it is classified on your balance sheet.

In addition to information about investments and financial instruments, the SEC staff has asked registrants about their disclosures related to the credit quality of financing receivables and allowances for credit losses associated with insurance-specific balances, such as reinsurance receivables (also known as "reinsurance recoverables"). The staff has also asked registrants to disclose how they manage credit risk related to those receivables.

Reserves and Loss Adjustment Expense

Examples of SEC Comments

- We refer to your disclosure . . . noting the updates to your loss development triangles based on the higher than expected reported losses, changes in loss development factors and other actuarial assumptions. Please tell us for each significant line of business and assumption the nature and extent of a) new events that occurred or b) additional experience/information obtained in the second quarter that led to the change in estimates of prior year unfavorable development of $[X] which resulted in an additional reserve of $[Y] recorded in the second quarter of 2013 and $[Z] recorded in the third quarter of 2013. Ensure your explanation clarifies the timing of the change in estimate such as why recognition occurred in the period that it did and why recognition in earlier periods was not required.
- Please identify and describe those key assumptions included in your underlying actuarial methodologies that materially affect the estimate of the reserve for loss and loss adjustment expenses. From your disclosures in the risk factors section it appears that the number of claims expected to be paid (frequency) and the average cost per claim (severity) are considered to be the key assumptions that materially affect your losses and loss adjustment reserve. When applicable, for each of your key assumptions quantify and explain what caused them to change from the assumptions used in the immediately preceding period.

The SEC staff continues to ask registrants to explain the key methods and assumptions used in deriving their loss adjustment expense and related reserves and to provide current disclosures that comply with the requirements of SEC Industry Guide 6. In addition, the staff has asked registrants to discuss the drivers of the estimate's change, including assumptions that have changed and assumptions that are reasonably likely to change, in the critical accounting policy section of their MD&A. Further, the SEC staff may comment on reserve disclosures related to catastrophes. See the Management's Discussion and Analysis section for more information about comments related to critical accounting policies.

Deferred Acquisition Costs

Examples of SEC Comments

- Please provide us revised disclosure to be included in future periodic reports that addresses the following requirements of ASC 944-30-50-1:
    - Please revise your policy disclosure to clarify that the nature of acquisition costs capitalized relates only to the costs associated with successful efforts;
    - Disclose the amount of acquisition cost amortized for the period; and
    - Clarify whether the policy acquisition expenses line-item on your statements of operations and comprehensive income includes expenses that are not capitalized and amortized.
- Please confirm that the ceding commission income you reflect as revenue in your statements of income includes reimbursement for the recovery of acquisition costs on the ceded premiums. If so, please tell us why you did not reflect that portion of your ceding commissions as a reduction of your deferred acquisition costs as required by ASC 944-30-35-64 and tell us for each period provided in your filing the portion of your ceding commission income that relates to the recovery of acquisition costs.

The SEC staff has asked registrants in the insurance industry to (1) provide disclosures about the composition of their deferred acquisition costs (and enhance their related accounting policy disclosures) and (2) discuss omitted disclosures when it appears that such disclosures may be material. Further, the staff has asked such registrants about the presentation in the statement of comprehensive income of ceding commission income that is essentially a recovery of acquisition costs.

Other Considerations

Statutory Disclosures and Disclosures About Dividend Restrictions

SEC staff comments to registrants in the insurance industry continue to focus on compliance with existing disclosure requirements about statutory capital, surplus, and dividend restrictions under ASC 944-505-50 and Regulation S-X, Rule 4-08(e). When registrants have used in their annual audited financial statements labels such as "Unaudited," "Approximate," or "Preliminary" to describe their statutory capital and surplus, the staff will remind them that these disclosures are required to be audited. Further, the staff has asked registrants to enhance disclosures on minimum capital and surplus requirements for both domestic and foreign subsidiaries.

In addition, the SEC staff has asked registrants in the insurance industry about their compliance with Regulation S-X, Rules 4-08(e) and 7-05(c),[1] when there appear to be restrictions on the payment of dividends. The staff has asked registrants to add information about the considerations underlying their determination of why they did not need to disclose information required under Regulation S-X, Rules 4-08(e) and 7-05(c). Also, the staff has reminded registrants that in applying Rule 4-08(e), they must consider foreign insurance operations and nonregulated subsidiaries in addition to U.S. domestic subsidiaries. See the Debt section for additional information.

Investments and Financial Instruments

Given the significance of investment portfolios to most registrants in the insurance industry, the SEC staff may ask such registrants about their investments and financial instruments and whether related disclosures portray their financial position accurately. Accordingly, the staff may concentrate on conclusions reached by management about the credit quality of investments and may ask registrants to summarize the procedures they performed (and other support they obtained) to make such determinations.

The SEC staff may also question registrants' disclosures about key drivers that affected their net derivative results. When there has been significant volatility in results for multiple periods, registrants may be asked to enhance their disclosures about the drivers of net derivative gains and losses.

Further, depending on the interest rate environment, the SEC staff may comment on effective interest rates and ask registrants to expand their disclosures about the expected effects of the interest rate environment and the impact of those effects on future financial information (e.g., financial position, results of operations, and cash flows).

See the Fair Value, Financial Instruments, and Other-Than-Temporary Impairment of Investments in Securities sections for more information.

[1] Rule 7-05(c) requires registrants in the insurance industry to file Schedule II if the rule's conditions are met. These conditions are identical to those under Regulation S-X, Rule 5-04, that govern whether a commercial company must file Schedule I. See the Debt section for information about Rule 5-04.

Investment Management

The SEC staff's recent comments to registrants in the investment management industry have continued to focus on topics such as fair value measurement, revenue recognition, risk oversight, and consolidation. The staff has also commented on executive compensation, quantitative and qualitative disclosures about market risk, and share-based payments. For more information on these topics, see the Disclosures About Risk, Executive Compensation and Other Proxy Disclosures, and Share-Based Payments sections.

In addition, in a June 2014 speech, Norm Champ, director of the SEC's Division of Investment Management (the "Division"), highlighted the examination priorities of the SEC's 2014 National Exam Program for investment advisers and investment companies, which include issues such as conflicts of interest and fund marketing and performance. Mr. Champ noted that under this program, the SEC staff "will continue to examine a significant percentage of the advisers who have been registered with the [SEC] for more than three years, but have not yet been examined by the National Exam Program." Another focus of the Division has been to continue the practice of issuing IM Guidance Updates[1] that summarize the Division's views regarding various disclosures and other regulatory and compliance matters.

Fair Value Measurements

Example of an SEC Comment

We note your disclosure that the valuations for corporate private equity and real estate investments may be derived by reference to observable valuation measures adjusted by management for differences between the investment and the referenced comparables, and in some instances by reference to option pricing models or other similar methods. Please revise your disclosure to discuss the type of adjustments and the factors and information you consider when determining the appropriate adjustment to make to the observable valuation measures of your corporate private equity and real estate investments. Also explain the situations when the fair value determination would be made by reference to option pricing models or other similar methods.

The SEC staff continues to focus on fair value measurement and related disclosures in comments to registrants in the investment management industry. In particular, the SEC staff will frequently ask registrants to disclose additional qualitative information about their processes for determining fair value. Specifically, it will ask a registrant for additional information about (and, potentially, additional disclosures related to) Level 3 inputs, adjustments to quoted market prices, and investments for which the registrant's net asset value per share does not represent fair value. Further, the SEC staff has asked registrants to disclose additional information about the procedures they use to validate values obtained from external sources (e.g., broker quotes). In addition, the SEC staff has often asked registrants to expand quantitative disclosures, such as a weighted average or range of inputs in the tabular disclosure of Level 3 unobservable inputs. For more information, see the Fair Value section.

1 See, for example, the Division of Investment Management's Guidance Update Nos. 2014-07, "Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows," and 2014-08, "Guidance Regarding Mutual Fund Enhanced Disclosure."

Revenue Recognition

Examples of SEC Comments

- We note your disclosure that investment management fees are recognized as earned over the period in which services are rendered and are generally determined based on a percentage of [assets under management (AUM)]. We also note your disclosures . . . regarding your sales and distribution fees including those paid by Rule [12b-1] plans where you pay substantially all of the fees to the financial advisers and other intermediaries. Please expand your revenue recognition policy in future filings to address the following:
  - Disclose how frequently these fees are calculated and paid, and identify the basis for the AUM in the calculation. For example, tell us whether the fee is based on a percentage of average daily or monthly AUM. In your response clarify any differences between investment management fees earned under contractual arrangements with your [sponsored investment products] versus the sub-advised products.
  - Tell us whether any portion of your investment management fee on sub-advised products is paid to another party, and if so, explain whether the fees are reported on a gross or net basis.
- Tell us the typical contractual terms of your consolidated funds with incentive income arrangements. For example, clarify whether there are typically hurdle rates or lock-up periods, and describe the typical type of waterfalls for the incentive income distributions for these funds.
- We note you present your assets under management (AUM) by investment objective and the average mix of AUM for the last three fiscal years . . . . We also note your discussion . . . for fluctuations in operating revenues and expenses that are driven by the mix or average of certain investment objective AUM. In an effort to provide more transparent disclosures regarding trends in revenue and expenses, please disclose your average AUM by investment objective.

The SEC staff guidance in EITF D-96 (codified in ASC 605-20-S99) provides two alternatives for recognizing performance-based management fees and requires disclosure of the accounting policy used with regard to these arrangements. Disclosure should also include (1) whether the company has recorded any revenue that is at risk as a result of future performance contingencies, (2) the nature of contracts giving rise to the contingencies, and, if material, (3) the amount of such revenues recorded. The SEC staff has asked registrants to discuss their revenue recognition policy disclosures and has also inquired about their contract terms, including (1) whether carried interest and incentive fees are based on a fixed percentage and (2) whether there are any hurdle rates or lock-up periods. In addition, registrants have been asked whether they report transaction and/or placement fees on a gross or net basis and to explain how they made that reporting determination. Further, registrants have been requested to provide more transparent disclosures about trends in revenue and expenses by disclosing average AUM by investment objective, which could include a sensitivity analysis that demonstrates the impact that changes in the fair value of managed assets could have on results of operations (e.g., revenues and net income).

Risk Oversight

Example of an SEC Comment

You disclose that each segment runs its own risk management process. Please describe your policies and procedures related to the reporting of risks from each segment to your Board of Directors, your Manager, your Managing Partners and other entities/individuals with risk management responsibilities.

An Exchange Act registrant is required to disclose its board's risk management policies and procedures under Regulation S-K, Item 407(h). The SEC staff may ask a registrant in the investment management industry to elaborate on its board's risk management oversight of investment vehicles and to disclose additional information about the risk management responsibilities of board committees (such as the audit and compliance committees).

Consolidation

Because VIEs are common in the investment management industry, the SEC staff continues to comment on management's conclusions regarding the consolidation or deconsolidation of VIEs and asks registrants to clarify why certain vehicles have been consolidated and others have not. The SEC staff frequently questions (1) the consolidation model applied to specific investments, (2) the qualitative and quantitative assessments used to determine the primary beneficiary, and (3) the related disclosures. For more information, see the Consolidation section.

Real Estate

The SEC staff's comments to registrants in the real estate industry have focused on topics such as whether real estate acquisitions represent acquisitions of businesses, assets, or real estate operations; leasing activities; capitalization of real estate development, construction, and leasing costs; non-GAAP financial measures; liquidity considerations associated with distributions; consolidation; and impairments.

In addition, the SEC staff typically expects registrants that qualify as a REIT to file Schedule III,[1] which requires them to present supplemental information about real estate investments and accumulated depreciation. Registrants that recently converted to a REIT but did not file Schedule III may receive comments from the SEC staff.

Master limited partnerships (MLPs) are common structures used in the real estate industry. See the Oil and Gas section for additional considerations related to MLPs.

Real Estate Acquisitions

Examples of SEC Comments

- Please provide us with an analysis of the acquisitions you have made in the past three years, and whether or not those acquisitions were treated as asset acquisitions or business combinations. For each of these transactions, tell us whether properties were purchased vacant, partially leased, fully leased or whether you entered into a lease in conjunction with the purchase, and what impact this had on your accounting. For the transactions accounted [for] as asset acquisitions, please tell us if you allocate any value to in-place leases, and tell us the amount of transaction costs you have capitalized.
- We note that your [acquisition] was significant and you filed [Regulation S-X, Rule] 3-14 financial statements . . . . Please tell us the extent of [your acquisition's operations that are] other than leasing real estate (i.e. property management or development) and how this factored into your determination that [Rule] 3-14 financial statements are more appropriate than [Regulation S-X, Rule] 3-05 financial statements.

[1] The schedule is required for certain real estate companies in accordance with Regulation S-X, Rule 12-28.

Regulation S-X, Rule 3-05, requires a registrant to provide full financial statements for significant acquired or to be acquired businesses. However, Regulation S-X, Rule 3-14, permits a registrant to file only abbreviated income statements (and pro forma financial information) for significant acquired or to be acquired real estate operations. Because the requirements of Rules 3-05 and 3-14 are different, it is important for a registrant to determine whether it acquired a real estate operation (see the SEC Reporting section for additional information about Rule 3-05). As a result, the SEC staff may ask a registrant to provide an analysis supporting its conclusion that its acquisitions are real estate operations under Rule 3-14.

In addition, the SEC staff has asked registrants with material acquisitions to elaborate on their process for determining whether the acquired assets, including acquired real estate (e.g., single-family homes) that is subject to a lease, qualify as a business or an asset acquisition under U.S. GAAP. To help entities make this determination, ASC 805-10-25-1 links to the Master Glossary's definition of a business. ASC 805-10-55-4 through 55-9 also contain guidance on what constitutes a business. This determination is important because the accounting for an asset acquisition differs from the accounting for a business combination. In acquisitions accounted for as business combinations, all transaction costs must be expensed as incurred. In asset acquisitions, however, transaction costs are capitalized as part of the purchase price. The SEC staff has asked registrants to enhance their disclosures to discuss the accounting policies they apply to property acquisitions, including policies for allocating value to identified intangible assets and for recognizing acquisition-related costs.

Leasing Activities

Triple Net Leases

> **Example of an SEC Comment**
>
> It appears that [Entity X] is a significant lessee of properties under a long-term triple-net lease. Please tell us how you determined it was not necessary to provide audited financial statements of [Entity X].

In a triple net lease, a lessee is typically required to pay costs that are normally associated with ownership, such as property taxes, insurance, utilities, and maintenance costs. In accordance with Section 2340 of the FRM, an investor may be interested in (or may need) the lessee's financial statements or other financial information when (1) a registrant leases (under triple net leases) one or more properties to a single lessee or tenant and (2) "such properties represent a 'significant' portion of the registrant's assets." That is, such lease arrangements with a single lessee or tenant may represent a significant concentration of risk that an investor would need to evaluate.

Further, Section 2340 notes that a registrant should provide full audited financial statements of the lessee (or guarantor) — for the periods required by Regulation S-X, Rules 3-01 and 3-02 — when the asset concentration exceeds 20 percent of the registrant's assets as of its most recent balance sheet. Accordingly, when an industry registrant enters into a triple net lease transaction, the SEC staff may ask it to provide additional information about whether a triple net lease is significant, particularly when it appears to the staff that such a lease may be significant but the registrant has not included the lessee's or tenant's financial statements.

Disclosures About Rental Performance

Examples of SEC Comments

- We note your disclosure regarding your weighted average net rental rates. In future Exchange Act periodic reports, please provide an explanation of whether these amounts are net of leasing costs, including free rent. In addition, please include a comparison of both rents on new leases to rents on expiring leases and rents on renewals and expansions to rents on expiring leases.
- Please provide additional information regarding the fluctuations in your rental income amounts. Specifically, please expand your disclosures to quantify the amount increased as a result of increased rental rates on renewed leases, including the average percentage increase and the amount of the increase associated with new leases signed during the period.

Over the past few years, as rental rates in many markets have fluctuated, the SEC staff has commented about registrants' disclosures in MD&A of lease rollover trends, including changes in rental rates on lease renewals and new leases in the reporting period. For space expected to be re-leased over the next 12 months, the staff has commented on the difference between existing rents and current market rents to better understand registrants' current and future performance trends.

The SEC staff has also requested information about activity related to new leases and lease renewals during the reporting period, including:

- Square feet leased.
- Average rents.
- Per-square-foot costs associated with leasing (e.g., leasing commissions, tenant allowances, and tenant improvements).

See the Leases section for additional staff comments on leasing transactions.

Capitalization of Real Estate Development, Construction, and Leasing Costs

Examples of SEC Comments

- We note your disclosure related to upcoming capital expenditures for the coming months. In future filings please include additional analysis of your capital expenditures that have occurred by breaking down total capital expenditures between new development, redevelopment/renovations and other capital expenditures by year. The total of these expenditures should reconcile to the cash flow statement. In addition please provide a narrative discussion for fluctuations from year to year and expectations for the future.
- [P]lease include the amount of soft costs (i.e., payroll costs, interest expense, etc.) capitalized for each year that are included in the table of capital expenditures below the table.

The SEC staff frequently asks registrants to enhance their disclosures about the capitalization of real estate development, construction, and leasing costs (including their accounting for these costs). For example, the SEC staff has asked registrants to clarify their accounting policy for capitalizing or deferring costs in accordance with ASC 835-20, ASC 840-20-25-16, and ASC 970-10. It has also requested quantitative disclosures of certain expenses that are being capitalized, such as soft costs (e.g., interest and payroll).

In addition, the SEC staff has asked registrants to expand their disclosures about capital expenditures (either on the face of the statement of cash flows or in MD&A) to highlight expenditures related to acquisitions, new development, redevelopment, and improvements to existing properties.

Non-GAAP Financial Measures

Examples of SEC Comments

- We note your use of funds from operations (FFO) and net operating income (NOI) in your press release. Please explain to us whether you consider these metrics to be key performance indicators. To the extent that you do consider FFO and NOI to be key performance indicators, tell us why you have not included a discussion of these metrics in your MD&A.
- We note your disclosure of operating statistics for your same store property portfolio . . . . In future Exchange Act periodic reports, please expand your analysis in the MD&A section to address any material period to period changes in same-store performance, including the relative impact of occupancy and rental rate changes, or advise.

The SEC staff has commented on inconsistencies between (1) the key performance measures identified in press releases, earnings calls, and analyst presentations and (2) the non-GAAP financial measures disclosed in registrants' SEC filings. Although the filings of most REITs include FFO as defined by NAREIT, REIT communications to shareholders and analysts may use other performance measures, such as modified FFO, adjusted FFO, core FFO, EBITDA, NOI, or core earnings.[2] In circumstances in which these key performance measures are provided in other communications to investors, the SEC staff may ask registrants why these non-GAAP financial measures were not disclosed in their periodic reports (e.g., Forms 10-K and 10-Q).

The SEC staff has also focused on non-GAAP performance metrics used in MD&A. The staff has requested clarification of how registrants define NOI to determine whether any additional property operating costs should be included. The SEC staff will often question whether the MD&A disclosure of period-to-period changes in rental revenue and expenses clarifies the impacts of same-store and non-same-store results and the impacts of changes in rental rates and occupancy. To improve transparency, disclosures of "same-store NOI" should be accompanied by an explanation of how the same-store pool is determined and should highlight any changes in the pool from the prior reporting period.

Recently, the staff has also requested further information and disclosure about backlog for those real estate companies involved in engineering and construction, such as home builders.

See the Backlog Disclosures, Management's Discussion and Analysis, and Non-GAAP Financial Measures sections for additional information.

Liquidity and Capital Resources — Distributions

Examples of SEC Comments

- In your tabular disclosure, please show the percentage of your distributions that were covered/funded by your cash flow from operations for each period presented.
- Please disclose your cumulative earnings or FFO since inception as compared to your cumulative distributions.

The SEC staff frequently requests disclosures that investors can use to evaluate the registrant's ability to maintain or increase its historical distribution yield. When GAAP cash flow from operations is insufficient to cover the total distributions paid during a particular period, the SEC staff may inquire about the cash resources used to cover the shortfall, such as offering proceeds. Registrants should adequately disclose the risks associated with paying distributions in excess of GAAP cash flow from operations. In addition, the SEC staff may request disclosures that compare earnings (or FFO) with paid distributions, including

[2] See Questions 102.01 through 102.03 of the C&DIs on non-GAAP financial measures for additional information about FFO and NAREIT.

amounts reinvested through a distribution reinvestment plan. The staff sometimes asks registrants to disclose these items on a cumulative basis so that financial statement users can better understand the relationship between earnings (or FFO) and distributions.

See the Management's Discussion and Analysis section for further discussion about liquidity and capital resources.

Consolidation

> **Example of an SEC Comment**
>
> We note that you have a [70-plus percent] interest in [a] joint venture and that you have determined that the joint venture is a variable interest entity. It appears that you have determined that you are not the primary beneficiary because you do not have the power to direct the activities that most significantly impact the VIE's economic performance. Please tell us which activities most significantly impact the VIE's economic performance and tell us what happens if a vote on a significant matter is deadlocked. In addition please tell us if either party is required to consent to any significant activity of the entity or [whether there are] any contractual clauses that determine how to break a deadlock. For reference see ASC 810-10-25.

The SEC staff continues to focus on registrants' involvement with VIEs and joint ventures and has inquired about consolidation assessments.

The staff also routinely asks for additional information and disclosures about non-VIE joint ventures, particularly when a registrant that has a majority ownership interest uses the equity method of accounting or when the qualitative disclosures about such arrangements are not robust. Disclosures about these arrangements should include a discussion of the governance provisions that led the registrant to conclude that it does not exercise control over the joint venture.

See the Consolidation section for further discussion.

Impairments

> **Example of an SEC Comment**
>
> We note that due to changes in cash flow estimates and hold periods, you have recognized [an] impairment charge on real estate held for investment. Please tell us and revise future periodic filings to include a description of the impaired real estate and the facts and circumstances leading to the impairment . . . . To the extent these facts and circumstances are different for each real estate holding, please discuss separately. Reference is made to paragraph 360-10-50-2 of the Financial Accounting Standards Codification. In addition, your MD&A disclosure should also be expanded to discuss these changes, potential variability from period to period, and to the extent any of these changes are attributable to an area of concentration risk.

The SEC staff has frequently asked registrants in the real estate industry to enhance their disclosures about (1) the timing of impairments, (2) the need for MD&A disclosures that warn of potential future impairments, (3) the inputs used in asset recoverability tests, and (4) the valuation techniques used to develop nonrecurring measurements of fair value. Comments on impairment issued to such registrants are consistent with those discussed in the Fair Value and Impairments of Goodwill and Other Long-Lived Assets sections.

Health Sciences

Life Sciences

The SEC staff's comments to registrants in the life sciences industry have focused on topics such as revenue recognition, MD&A disclosures, business combinations, contingencies, and segment disclosures.

Revenue Recognition

Collaborative Arrangements

Examples of SEC Comments

- [P]lease identify for us each significant accounting element in the arrangement, the character of each element (revenue vs. expense reimbursement), the units of accounting (i.e., which elements are separate vs. combined), and the accounting basis for the units of accounting (e.g., ASC 605-25).
- In order to help us understand more fully how your collaborative arrangements impact your financial statements for each period presented, please provide us a table showing amounts by year and by line item included in your statements of operations attributable to transactions arising from collaborative arrangements between you and the other participants and to third-parties. Please provide separate tables for this information for each of your significant collaborative arrangements and in the aggregate for all of your collaborative arrangements (i.e. the significant arrangements and all other arrangements).

Collaborative arrangements are common for biotech and pharmaceutical companies. ASC 808-10 provides guidance on the income statement presentation, classification, and disclosures related to collaborative arrangements but "does not address recognition or measurement matters related to collaborative arrangements, for example, determining the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met." As a result, the SEC staff often asks registrants in the industry about the nature of, and accounting for, their collaborative arrangements and has continued to probe them to better understand the basis for such accounting under U.S. GAAP. Inquiries to registrants have focused on:

- The overall effect of collaborative arrangements on the financial statements. For example, the SEC staff has asked that registrants prepare a tabular summary to provide the staff with a composite disclosure of the financial statement impact of all collaborative arrangements. For all periods presented, the staff may request a separate table for each significant collaborative arrangement and a table for all collaborative arrangements in the aggregate; in such tables, the staff may also ask that the registrant separately present amounts attributable to transactions with other participants and third parties that are presented net in a financial statement line item.
- The factors leading to the registrant's conclusion that a collaborative arrangement is (or is not) within the scope of ASC 808. For example, if an arrangement involving the manufacture of a drug to be sold to third parties began after the drug was FDA-approved for sale, the SEC staff may seek to understand the basis for the registrant's conclusion that it entered into a collaborative arrangement (since the parties' agreement did not include initial research activities).
- The registrant's conclusion about whether certain transactions with the collaboration partner represent true vendor-customer activities. Collaborative arrangements within the scope of ASC 808 are based on the premise that each party to the agreement assumes a proportionate share of risks and, therefore, a vendor-customer relationship does not exist. Even if the registrant concludes that it is a party to a collaborative agreement, however, there may be circumstances in which certain elements of the agreement represent activities that are similar to those in a vendor-customer relationship. Accordingly, the SEC staff seeks to understand the registrant's process for identifying, and allocating consideration to, such activities.

- The registrant's determination and disclosure of (1) the separation, allocation, recognition, and classification principles that were used to account for payments between collaboration partners and (2) the factors that led the registrant to conclude that it is the principal (or agent) in transactions with third parties.

The SEC staff also has requested enhanced disclosures about registrants' collaborative agreements. Staff requests for such disclosures have focused on clearly describing the material terms of a collaborative arrangement, such as (1) each party's rights and obligations under the arrangement, (2) potential payments, (3) the existence of royalty provisions, and (4) duration and termination provisions.

Further, the staff may also ask registrants to file a material collaborative arrangement as an exhibit to their filing in accordance with Regulation S-K, Item 601(b)(10). For more discussion, see the Material Contracts section.

Milestones

Examples of SEC Comments

- Regarding your development, license and supply agreement with [Entity A], please disclose the amount of the upfront payment received and how you accounted for the agreement. In addition disclose each substantive milestone and the related contingent consideration. Refer to ASC 605-28-50-2b.
- Please expand your disclosure . . . to disclose the factors that management considered in determining whether the milestone or milestones are substantive as required by ASC 605-28-50-2d. This comment also applies to your disclosure of new agreements in the interim financial statements.

The SEC staff often comments on disclosures about milestone recognition under ASC 605-28. When such disclosures apply, the staff will review filings to determine whether they contain the following disclosures outlined in ASC 605-28-50-2:

a. A description of the overall arrangement

b. A description of each milestone and related contingent consideration

c. A determination of whether each milestone is considered substantive

d. The factors that the entity considered in determining whether the milestone or milestones are substantive

e. The amount of consideration recognized during the period for the milestone or milestones.

Registrants in the industry will often make adjustments for milestones when determining non-GAAP income. For a discussion of adjustments made by registrants when determining their non-GAAP measures, see the Non-GAAP Financial Measures section.

Multiple-Element Arrangements

Examples of SEC Comments

- Please confirm that all of the disclosures required by ASC 605-25-50-2 have been made. For example, please assure that the performance-, cancellation-, termination-, and refund-type provisions of your [revenue] agreement have been disclosed. Clarify the reasons why your significant deliverables under the agreement do not qualify as separate units of accounting.
- Please revise your disclosure to state the reason why the license does not qualify for a separate unit of accounting. Refer to ASC 605-25-50-2f. Additionally, please clarify whether the initial supply of the compound of the license product represents a separate unit of accounting.

The SEC staff often asks registrants in the life sciences industry to expand or clarify their disclosures about multiple-element arrangements. Registrants could improve their required disclosures about the nature and terms of such arrangements by (1) separating the description of the obligations and rights from the discussion of how they were accounted for, (2) ensuring that such description is complete (i.e., that all material terms are disclosed), and (3) precisely describing the rights conveyed by the license. In addition, the staff has reminded registrants that they should explicitly identify each deliverable in the arrangement and explain why it represents (or does not represent) a separate unit of accounting. The staff has also suggested that registrants could improve their disclosures about the relative selling price method of allocating arrangement consideration by (1) quantifying the total arrangement consideration to be allocated, (2) identifying the amount of consideration allocated to each unit of accounting, and (3) explaining how the estimated selling price for each unit was determined (including the significant assumptions used). For more information about multiple-element arrangements and other revenue-related considerations, see the Revenue Recognition section.

Branded Pharmaceutical Drug Annual Fee

In July 2014, the IRS issued final regulations that indicate that an entity's obligation to pay its portion of the branded pharmaceutical drug (BPD) annual fee (under the Patient Protection and Affordable Care Act and the Health Care and Education Affordability Reconciliation Act of 2010) in any given calendar year is not triggered by the first qualifying sale in that calendar year but instead by the qualifying sales in the previous year. This accounting treatment differs from that previously prescribed in ASC 720-50 and will apply to financial reporting periods that include the July 28, 2014, effective date of the final IRS regulations. Accordingly, registrants should consider disclosing information about (1) the change in recognition of the BPD fee resulting from the final IRS regulations, (2) the impact of the catch-up adjustment recorded in the period, and (3) how the BPD fee will be accounted for prospectively. For additional information see Deloitte's October 13, 2014, Financial Reporting Alert 14-2.

MD&A Disclosures

R&D Expenses

Example of an SEC Comment

You state that you have made, and expect to continue to make, substantial investments in research and development to expand your product portfolio and grow your business. . . . Please provide us with the following information and revise your disclosures as appropriate:

- For your key research and development projects, please tell us the following:
  - The nature, objective, and current status of the project;
  - The costs incurred during each period presented and to date;
  - The nature of efforts and steps necessary to complete the project;
  - The risks and uncertainties associated with completing development;
  - The extent and nature of additional resources that need to be obtained if current liquidity is not expected to be sufficient to complete the project; and
  - Whether a future milestone such as completion of a development phase, date of filing [a new drug application (NDA)] with a regulatory agency, or approval from a regulatory agency can be reliably determined.
- For the remainder of projects not considered individually significant, tell us the composition of the total R&D expense for each period presented. This can take a variety of forms but is mainly driven by how many projects are managed and how they are reported within the organization. We believe disclosure of R&D by your divisional structure would be informative. Also distinguishing between discovery, preclinical and clinical development categories and further by late stage such as phase III development categories along with providing the number of projects in each category helps provide information necessary to understand the pipeline and trends by division. To the extent that management has information available by therapeutic class, we believe that further enhances the understanding of R&D expense and trends.
- If based on a known event, trend, demand, commitment or uncertainty, future R&D expense or the mix of R&D expense is reasonably likely to differ from current trends, please tell us the reasons for and the amount of the expected change.
- For projects that you disclose are in the late stage of development such as phase III, unless management believes that the expected effect on results of operations or financial position from the project when completed will be insignificant, please tell us the following about each project, even if the R&D expenses incurred on the project [have] not been material, in order to provide insight into expected effects on future operations, financial position or liquidity. Please include:
  - A description of the nature and its indication;
  - The phase the project is in at the end of the reporting period and the month and year it entered that phase;
  - Significant patents associated with the project and their expiration dates as well as other information about the exclusivity period related to the project;

Example of an SEC Comment (continued)

- o Significant developments of the project during the period such as significant milestones, filing for regulatory approval, approval and other responses from regulatory agencies; suspension or termination and their reasons;
- o Future expected milestones such as completion of a development phase, date of filing an NDA with a regulatory agency, or approval from a regulatory agency if it can be reliably determined. If the extent and timing of these future events cannot be reliably determined, please tell us the facts and circumstances that prevent their determination.

The SEC staff has asked registrants in the life sciences industry to expand their disclosures about internal R&D expenses and estimated future expenses beyond those required under ASC 730-10. In addition to disclosing the types of activities and elements included in R&D expenses and the amount of R&D expenses incurred during each reporting period, registrants may be asked to revise their MD&A and business sections to include information about each major R&D project. If registrants do not maintain information about R&D costs by project or program, they may be asked to explain why.

Registrants must carefully consider whether their R&D projects are significant enough to warrant disclosure and whether the timing of the costs associated with the projects can be reasonably estimated. Registrants involved in late-stage clinical trials should consider expanding their disclosures about such projects to reflect the uncertainty of ultimate regulatory approval and commercial success.

The SEC staff may also ask a registrant to include, in its contractual obligations table in MD&A, commitments to make payments for R&D contractual relationships. See the Management's Discussion and Analysis section for more information about the contractual obligations table.

Patents

Examples of SEC Comments

- [Please] include proposed disclosure about the type of protection offered by the patent covering [Formulation A] that expires in 2016. Please additionally disclose what effects such expiration could have on sales of [Product X], and what specific steps you plan to take to mitigate this loss of patent protection in your Management's Discussion and Analysis section. You should also provide proposed disclosure to this effect to be included [in] your risk factors section.
- Please expand your disclosure to provide the type of patent coverage (e.g., method of use, composition of matter) and the expiration date (or, if a patent application, the date filed).

The SEC staff has also regularly commented on life sciences registrants' disclosure of patents, particularly on patent exclusivity of their products and the impact of such exclusivity on revenues and overall operations. Patent expiration and challenges can affect not only a registrant's current-period earnings but also its future operations and liquidity, particularly if the patents are for core products. Registrants should consider Regulation S-K, Items 101 and 503(c), respectively, for guidance on (1) disclosing patent information in the business section of their periodic filings and (2) discussing patent expiration and challenges as possible risk factors in their annual reports. In addition, the SEC staff has requested information on the subject matter and jurisdiction of a registrant's patents.

Liquidity

> **Example of an SEC Comment**
>
> [P]lease disclose the amount of cash and investments that are currently held by your foreign subsidiaries that are considered permanently reinvested and its expected effect on your liquidity and capital resources. Refer to Item 303(a)(1) of Regulation S-K and Section IV of SEC Release 33-8350.

Life sciences companies typically have manufacturing and distribution sites, as well as holding company subsidiaries, domiciled in countries with favorable tax rates. If a life sciences registrant discloses that it will reinvest undistributed earnings of its foreign subsidiaries indefinitely, the SEC staff is likely to examine the registrant's liquidity disclosure to determine whether its cash holdings are sufficient to meet its long- and short-term liquidity needs. Therefore, the disclosures in the liquidity section of the MD&A about how the registrant plans to meet its funding obligations should be clear and robust. See the Income Taxes section for additional information.

Business Combinations

> **Example of an SEC Comment**
>
> As [Product X] was an approved product when you licensed it, please provide us with an analysis supporting your conclusion that the license of [Product X] was an asset acquisition and not a business combination. Please refer to [ASC] 805-10-55-4 to 9.

Since business combinations in the life sciences industry are typically complex and individually unique, the SEC staff frequently comments on registrants' disclosures about them. For example, the staff has asked registrants about their evaluation of whether a certain transaction constitutes a business combination under ASC 805. In addition, the staff has asked registrants how they determined the useful life of their intangible assets. Because the intangible assets acquired are typically the patent rights to a product or potential product, most life sciences companies begin their analysis by considering the patent life of the underlying product. However, useful life could be affected by other factors, such as the risk of competition from branded or generic products before the registrant's patent expires or a high barrier to market entry even after the registrant's patent expires. Therefore, the staff has asked registrants to provide additional analysis that explains the basis for their conclusions about their intangible assets' useful life. For additional accounting and reporting considerations related to acquisitions, see the Business Combinations section.

Contingencies

> **Examples of SEC Comments**
>
> - Please further clarify your policy in which you record "at least the minimum estimated liability related to those claims where a range of loss has been established," given the requirements of paragraph 450-20-30-1 of the FASB Accounting Standards Codification.
> - We note the accruals for product liability contingencies involve a large number of small individual claims of a similar type. Please tell us your consideration of providing a roll forward within MD&A of the outstanding claims including the number of claims pending at each balance sheet date, the number of claims filed each period presented, the number of claims dismissed, settled, or otherwise resolved for each period, and/or including the average settlement amount per claim as discussed in Question 3 to SAB Topic [5.Y].

The SEC staff often comments on life sciences registrants' disclosures about legal contingencies. Pharmaceutical and medical device companies alike must often defend against various claims related to their products, including potentially both product liability and patent infringement claims. In addition, further legal exposure may arise from an entity's potential noncompliance with applicable government regulations (e.g., FDA and FCPA). The SEC staff commonly asks registrants in the industry to explain (1) how their accounting and reporting for a loss contingency complies with the recognition, measurement, and disclosure requirements in ASC 450 and (2) their consideration of the disclosure requirements in SAB Topic 5.Y. Also, the SEC staff often asks such registrants to quantify, in the risk factors section, the amount of product liability coverage they maintain. For additional accounting and disclosure considerations related to contingencies, see the Contingencies section.

Segment Disclosures

Example of an SEC Comment

We note your disclosure with respect to Medicare. Please tell us how you considered FASB ASC 280-10-50-42 which states that you should consider a group of entities under common control as a single customer (for example, the federal government). This comment also applies to your interim information.

Many life sciences companies have a diverse portfolio of products that are sold throughout the world. The SEC staff may question how a registrant's segment disclosures comply with the requirements in ASC 280 regarding disclosures that are disaggregated by products and services, geography, or major customer. The staff, for example, routinely reminds registrants of the requirement to disclose revenue information pertaining to groups of similar products and services, and it objects to an overly broad definition of "similar." For additional discussion of segment disclosure requirements, see the Segment Reporting section.

Health Plans

The SEC staff's recent comments to health plan registrants have focused mainly on (1) the provision for adverse deviation and (2) statutory disclosures. Like other registrants, health plan registrants have also continued to receive comments related to contingencies, goodwill impairment, and revenue recognition. For more information on these topics, see the Contingencies, Impairments of Goodwill and Other Long-Lived Assets, and Revenue Recognition sections.

In addition, because health plan registrants are primarily engaged in offering health care insurance products, SEC staff comments to registrants in the insurance industry may also apply to health plans. For more information, see the Insurance section.

Provision for Adverse Deviation

Example of an SEC Comment

You state . . . that for the three and six months ended June 30, 2013, there were no material reserve developments related to prior years. You state in [your Form 8-K] that you had a favorable development of $[X] for the six months ended June 30, 2013. Please provide proposed disclosure to be included in your next [Form] 10-Q to clarify the reserve development relating to prior years and the reasons for the development. You state in [your Form 8-K] that the majority of the adjustments to reserves relate to variables and uncertainties associated with actuarial assumptions. Please clarify in the proposed disclosure what assumptions changed, why the assumptions changed and how it affected your reserve.

For most health plans, the provision for adverse deviation represents a significant estimate involving assumptions that are often highly subjective and that are, or could be, material to the plan's financial condition or operating performance. Accordingly, the SEC staff expects registrants to disclose information that would allow users to clearly understand (1) what the provision for adverse deviation represents, (2) how this reserve is established, and (3) the amount of the provision and changes in the provision for each period presented. The staff also asks registrants how the provision complies with the requirements of ASC 944-40-25.

Statutory Disclosures

> **Example of an SEC Comment**
>
> Although you disclose that your regulated subsidiaries currently exceed the minimum capital requirements, please provide us proposed disclosure to be included in future filings that states the amount of statutory capital and surplus necessary to satisfy regulatory requirements if significant in relation to actual statutory capital and surplus, as required under ASC 944-505-50-1b. If not significant, please clarify in the disclosure.

Specifically, the SEC staff has commented when registrants' disclosures required by Regulation S-X, Rule 4-08(e), and ASC 944-505 (e.g., disclosures about statutory requirements related to minimum capital standards and certain restricted accounts or assets that may limit payment of dividends) are incomplete or missing. In addition, the SEC staff reminds registrants that such ASC 944-905 disclosures should not be labeled unaudited. For more information, see the Debt and Insurance sections.

Technology, Media, and Telecommunications

Technology

In 2014, SEC registrants in the technology industry have seen an increase in SEC staff comments. This increase is partly attributable to the continued strength of the markets, which have prompted more IPOs, but it has also resulted from the complexity of, and significant judgments necessary to apply, the accounting guidance on topics such as revenue recognition. As it did in the prior year, the SEC staff continues to focus on software and nonsoftware multiple-element arrangements. More recently, it has also focused on registrants' considerations related to gross versus net revenue reporting, accounting for nonrefundable up-front fees, and disclosures about key metrics in MD&A. See the Revenue Recognition section for more information about SEC staff comments on revenue-related topics.

In addition, SEC staff comments to registrants in the technology industry, like those received by registrants in other industries, have concentrated on disclosures about contingencies, income taxes, segment determination, and share-based compensation. See the Contingencies, Income Taxes, Segment Reporting, and Share-Based Payments sections for additional information about such comments.

Revenue Recognition — Multiple-Element Arrangements

Multiple-Element Arrangement Accounting Policies and Disclosures

Examples of SEC Comments

- We note that for multiple element arrangements that include non-software elements, you allocate revenue to all deliverables based on their relative selling prices. Please tell us how you determine the selling price of the deliverables in your multiple deliverable arrangements including the significant factors, inputs, assumptions and methods used to determine the selling price. Please also tell us what consideration was given to disclosing this information. Refer to ASC 605-25-30-2 and ASC 605-25-50-2(e).
- Please tell us what consideration was given to the application of the provisions of ASC 985-605-15-3 to determine whether your software element is essential to the functionality of your hardware. In this regard, please explain whether the hardware has substantive functionality without the software such that a customer could reasonably be expected to purchase the hardware without the software.

Under ASC 605-25, consideration in a multiple-element arrangement must be allocated to the deliverables on the basis of their relative selling price. To determine the selling price of each deliverable, entities apply a hierarchy that requires them to use VSOE if available, TPE if VSOE is not available, or their best estimate of the selling price if neither VSOE nor TPE is available. The SEC staff focuses on how technology registrants allocate consideration to elements in such arrangements and may request additional information about the factors, inputs, and assumptions used to determine the selling price of each element.

In addition, given the prevalence of multiple-element arrangements in the industry, when the SEC staff reviews the filings of technology registrants, it may comment on the manner in which revenue is measured and recognized in such arrangements as well as on the related disclosures. Historically, registrants have been asked to clarify the descriptions of the elements or deliverables in an arrangement, how they determined that components have stand-alone value, and the timing of each element's delivery or performance.

For multiple element arrangements that include tangible products containing software, the staff may ask registrants to clarify the accounting guidance they applied and how they determined whether the software components and nonsoftware components of the tangible product function together to deliver the tangible product's essential functionality (and are therefore outside the scope of the guidance in ASC 985-605). Accordingly, registrants should carefully consider all facts when determining the appropriate accounting guidance to apply to arrangements that involve tangible products containing software and should clearly and adequately disclose the guidance they applied to such arrangements.

Disclosures About VSOE

> **Example of an SEC Comment**
>
> We note that, for multiple element arrangements that contain software products and related services, you allocate the total arrangement consideration to all deliverables based on VSOE of fair value. Please describe for us, in detail, your methodology for establishing VSOE for each of the elements in your multiple element arrangements. For example, if VSOE of your subscription services is based on stated renewal rates please provide the range of renewal rates and tell us what percentage of your customers actually renew at such rates. Alternatively, if VSOE is based on stand-alone sales, then provide the volume and range of stand-alone sales used to establish VSOE. Also, please tell us what consideration was given to disclosing the significant factors, inputs, and assumptions used to determine VSOE. Refer to ASC 605-25-50-2(e).

Establishing VSOE of fair value can significantly affect how revenue is recognized under ASC 985-605. To recognize revenue for a delivered element (e.g., a software license) in a software arrangement, a vendor must first establish VSOE for any undelivered elements (e.g., PCS or professional services). If the vendor cannot establish VSOE of fair value for undelivered elements, it generally must defer all revenue in the arrangement until VSOE is established, the undelivered elements are delivered, or the last remaining deliverable is PCS.

The SEC staff continues to focus on this topic and frequently asks registrants that have multiple-element arrangements within the scope of ASC 985-605 — many of which are undergoing IPOs — to expand their disclosures about how they determined VSOE. The additional information may include:

- The percentage of customers that renew at contractually stated rates for PCS and how the rates are substantive when contractually stated renewal rates are used to establish VSOE.
- An explanation of how the registrant determined VSOE if it does not use stated renewal rates or a bell-curve analysis of stand-alone sales to establish VSOE.
- A description of the process used to evaluate the various factors that affect VSOE.
- A quantitative description of the volume and range of stand-alone sales used to establish VSOE and how the registrant accounts for contracts whose sales volume falls outside that range.
- A description of how VSOE is determined when different levels of renewable rates exist.
- An explanation of why the registrant believes that it cannot determine VSOE for its undelivered elements if it accounts for software arrangement elements ratably because they are not separated.
- An explanation of why the registrant could not determine VSOE in prior years and, in cases in which VSOE is first established or is reestablished, what changes arose in the current year.

Revenue Recognition — Gross Versus Net Reporting

Under ASC 605-45, an entity should report revenue on a gross basis when it is acting as the principal of the transaction and on a net basis when acting as an agent to the transaction; applying this guidance often requires careful consideration and judgment. Although ASC 605-45 references eight indicators of gross reporting, the SEC staff has placed a higher emphasis on (1) which party is the primary obligor to the transaction and (2) which party has general inventory risk.

Determining the principal in an online transaction is challenging for technology companies, particularly those engaging in transactions related to software as a service (SaaS), online gaming, or online advertising, since there is no tangible product (and, in some instances, transactions are executed almost instantaneously). Because these types of arrangements have become more prevalent, they are topics of increased SEC staff focus.

SaaS and Online Gaming

Examples of SEC Comments

- You indicate that in certain instances, your partners are considered the primary obligors for providing subscription services and at other times you are considered the primary obligor. Please tell us how the criteria of ASC 605-45 regarding principal-agent considerations [were] considered in your analysis.
- [Y]ou indicate that for all your types of games, you are able to release game updates and special editions through [your network]. In addition, we note . . . that your cloud-based server and network infrastructure enable you to deliver games and that you routinely deliver massive amounts of content to millions of users across your platform. In light of these disclosures, please clarify your statement that developers are responsible for providing the game product desired by the game players used in your evaluation of principal agent considerations.

SaaS and online gaming companies often use operator or reseller partners to target new markets. Questions arise about which party is the primary obligor (i.e., the party responsible for providing the product or service desired by the customer). The SEC staff has challenged the conclusions of various SaaS and online gaming companies (and their resellers) about the appropriateness of gross or net reporting for their transactions and has asked such registrants to provide additional analysis with an emphasis on the factors outlined in ASC 605-45-45. The staff may also request additional disclosures about the nature of these transactions and the role of each of the parties.

Online Advertising

Like other forms of advertising, online advertising often involves at least three parties:

- An owner/operator of the online content (a "publisher") that provides the online space or search engine results in which advertising content may be placed.
- A party (an "advertiser") that desires to place the advertising content.
- A third-party service provider (e.g., an advertising agency).

In addition, there are many companies that offer various technologies and solutions to help advertisers and publishers in what is commonly referred to as the "ad tech" industry. These include "ad networks" or "demand-side platforms,"[1] "ad exchanges,"[2] and "supply-side platforms."[3]

A registrant that has entered into an online advertising arrangement needs to evaluate the terms of the arrangement and the responsibilities of each of the parties to the agreement to determine whether it should report revenues on a gross or net basis. As a result, the SEC staff may review the contractual terms and marketing materials related to the transaction to determine the nature of the deliverable and the party ultimately responsible for fulfillment. For example, it may be challenging for an ad exchange to conclude that it is the primary obligor (and therefore the principal) if it cannot demonstrate that it is responsible for displaying the advertising content but instead appears to be acting as an agent by matching advertisers with the publishers. On the other hand — to understand whether, for example, a demand-side platform is the principal — the SEC staff often seeks to understand contractual terms (among other factors) to determine whether there are sufficient economic and fulfillment risks analogous to inventory risk. Accordingly, the SEC staff may review the contractual agreements with advertisers to understand whether the demand-side platform provided a firm commitment to deliver a certain amount of advertising space at fixed pricing by means of contractual insertion orders (a common contractual form used in the online advertising industry).

[1] Ad networks or demand-side platforms are companies that interact closely with an advertiser to develop the strategy and scope of an advertising campaign and use their technologies to take control of executing such a campaign.

[2] Ad exchanges are companies that provide an auction process (generally in a real-time bidding (RTB) environment) and partner with various parties representing advertisers and publishers that participate in the RTB auction.

[3] Supply-side platforms are companies that interact closely with a publisher to develop an optimal strategy for making advertising space available to bring about the greatest monetary return on such advertising space.

Because of the complexity and judgments associated with determining whether to record revenues on a gross or net basis, technology registrants should (1) thoroughly document the basis for their conclusions and (2) consider whether additional disclosures would be appropriate for investors.

Revenue Recognition — Accounting for Nonrefundable Up-Front Fees

Example of an SEC Comment

We note that revenue from non-refundable upfront fees is deferred and recognized over the term of the related arrangement or the estimated customer life. Please tell us whether the non-refundable upfront fees have standalone values and are considered separate units of account. Refer to ASC 605-25-25-5(a). Also, please tell us how you determine whether the fees are recognized over the arrangement term versus over the estimated customer life.

SAB Topic 13.A.3(f) provides guidance on the accounting for nonrefundable up-front fees. In the technology industry, up-front fees often exist in hosting or SaaS arrangements. These fees, which are typically charged together with a subscription fee for the hosting or SaaS services, cover items such as training, connection services, data migration, and other implementation services. Entities entering into such arrangements are generally required to determine whether the activities associated with the up-front fees and those related to the ongoing hosting or SaaS services are separate units of accounting in a multiple-element arrangement under ASC 605-25. To make this determination, entities must assess whether the activities associated with the up-front fees have stand-alone value and can therefore be regarded as a separate unit of accounting. In assessing stand-alone value, entities need to consider whether such activities are sold separately by any vendor or whether the customer can resell any products or services received.

When the activities associated with an up-front fee and the hosting or SaaS services are treated as a single unit of accounting under ASC 605-25, registrants apply the guidance in SAB Topic 13.A.3(f) to determine an appropriate accounting policy for recognizing revenue related to the up-front fees. Under that guidance, "[u]nless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process," revenue is typically deferred and recognized over the period in which the up-front fees are earned, which may extend beyond the initial contract term.

Footnote 39 of SAB Topic 13.A.3(f) states that the "revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee." The SEC staff has asked registrants about their accounting policies for recognizing revenue in these circumstances. Specifically, it has focused on the period during which registrants recognize revenue for up-front fees, particularly when revenue is recognized either immediately or over the initial contract period despite indications that the relationship with the customer may extend beyond that period.

Disclosures About Key Metrics in MD&A

Examples of SEC Comments

- We note that in your earnings calls you discuss the weighted average duration of new contracts signed in the quarter. Please tell us what consideration was given to disclosing this metric in MD&A. Also, tell us whether the weighted average duration of new contracts signed is a key performance indicator for your business. Refer to Section III.B.1 of SEC Release 33-8350.
- We note your response [that] the number of your end customers is [not] a key metric used by management to evaluate your business. Please explain why you believe the number of your end customers is not a key metric in spite of the prominence you provide such figures [in] your prospectus.

Technology registrants often use metrics to convey information to their investors. Because there are various types of registrants in the industry (i.e., offering a broad range of products and services), there is diversity in metrics discussed in registrants' earnings calls, registration statements, and periodic filings. Examples of metrics common to registrants in the technology industry include (1) number of "likes," (2) revenue per user, (3) daily or monthly active users, and (4) weighted average duration of contracts. The SEC staff has questioned registrants when certain metrics are not explained in MD&A, changes are not appropriately quantified, and it is unclear whether metrics represent key performance indicators. Accordingly, the staff may ask registrants to provide a detailed quantitative and qualitative discussion and analysis of the impact of changes in their key metrics disclosed in MD&A, in a manner consistent with Sections III.B.1 and III.B.2 in SEC Release No. 33-8350 and Regulation S-K, Item 303(a)(3)(iii). In addition, registrants that have not already done so are asked to provide disclosures in MD&A to discuss why the metrics were chosen, how they are used, and any inherent limitations in the metrics selected.

Because of the vast volume of the metrics used, the SEC staff has been concerned that (1) metrics may not be presented with appropriate context and (2) the link between registrants' key metrics and their income and future profitably may not be clear. Registrants should review their metrics to ensure that the metrics portray a balanced discussion and remain relevant. If that is not the case, registrants should consider removing metrics (or replacing them with new ones).

Telecommunications

The SEC staff's comments to registrants in the telecommunications industry have focused on topics such as revenue recognition and long-lived asset impairment.

Revenue Recognition

Examples of SEC Comments

- While your disclosure addresses the basic revenue recognition criteria related to product sales, it is not clear when delivery typically occurs and when the related revenues are typically recognized. . . . Please tell us what consideration was given to disclosing the general timing of delivery or performance of service and the general timing of revenue recognition for product sales. Please refer to ASC 605-25-50-2.
- Tell us and explain why [Product A shipments] were not recognized as revenues. It is unclear from the Critical Accounting and Estimates section of the MD&A what revenue recognition criteria were not met. In addition, tell us in detail the nature of your sell-through to end users and how you are accounting for such sales.

The SEC staff often asks telecommunications registrants to expand or clarify their disclosures about revenue recognition. Customer arrangements in the industry often involve multiple deliverables. Accordingly, the disclosure requirements under ASC 605-25 are intended to help financial statement users understand the nature of each deliverable, how it is valued, and how revenue is recognized.

In addition, the SEC staff may ask registrants for details about their compliance with the four criteria for revenue recognition contained in SAB Topic 13. The staff has indicated that registrants must carefully monitor these criteria when selling products to resellers and distributors and, in particular, should evaluate whether the substance of an arrangement is such that the price is not fixed or determinable until the product is sold to the end customer. When revenue is deferred because a criterion was not satisfied, registrants should specify which criterion was not met and disclose how and when the transaction will be recognized.

As the industry continues to evolve, telecommunications registrants must consider the revenue recognition implications of new business practices and ensure transparent disclosure. Wireless operators, for example, are increasingly offering subscribers more flexible handset-purchase options, such as installment plans and exchange rights. Such offerings can have significant revenue recognition implications. New offerings also may trigger a requirement for telecommunications registrants to provide financial statement disclosures not previously considered significant. These could include disclosures about financing receivables for which registrants may not have historical information to appropriately predict an allowance for credit losses, credit quality indicators, and potential guarantee liabilities that arise from the various handset-purchase options. New business practices are likely to draw SEC staff scrutiny if the registrants' relevant revenue recognition policies and considerations are not clearly disclosed.

In addition, given the complexity of accounting for contracts that contain multiple deliverables, the staff may also request a registrant's analysis of whether it is a principal or an agent in a transaction.

For information on multiple-element arrangements and other revenue-related considerations, see the Revenue Recognition section.

Long-Lived Asset Impairment

> **Example of an SEC Comment**
>
> We note that you have made significant success-based capital investments, which include building out fiber to new wireless towers and replacing copper facilities with fiber facilities to wireless towers that you already serve. Tell us how you evaluated the remaining economic life of copper facilities that you already serve and the impact on depreciation expense in subsequent periods.

The SEC staff continues to question registrants in the telecommunications industry about the recoverability of their long-lived assets, including physical network assets and spectrum licenses. For example, the staff inquires about the reasonableness of the useful-life estimates used by registrants to determine whether their long-lived assets are potentially impaired. Such assets may be subject to a greater risk of impairment as a result of the rapid rate of technological innovation. In addition, the staff has asked registrants to disclose the carrying values of significant types of assets and the methods used to estimate the assets' useful life. For additional information, see the Impairments of Goodwill and Other Long-Lived Assets section.

Appendixes

Appendix A: SEC Staff Review Process

The SEC's Division of Corporation Finance (the "Division") selectively reviews filings made under the Securities Act and the Exchange Act. In January 2009, the SEC staff issued an overview that explains its filing review and comment letter process.[1] The overview aims to increase transparency in the review process and expresses the staff's willingness to discuss issues with registrants. For example, the overview indicates that the "[staff] views the comment process as a dialogue with a company about its disclosure" and that a "company should not hesitate to request that the staff reconsider a comment it has issued or reconsider a staff member's view of the company's response to a comment at any point in the filing review process."

The overview is divided into two main sections:

- *The filing review process* — This section explains that the Division comprises 12 offices staffed by experts in specialized industries, accounting, and disclosures. The section includes background on the different types of review (required and selective) and covers the comment process, indicating that "[m]uch of the [staff's] review [process] involves reviewing the disclosure from a potential investor's perspective and asking questions that an investor might ask when reading the document." The section also addresses how to respond to staff comments and close a filing review.
- *The reconsideration process* — This section emphasizes that "staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a company and its legal, accounting, and other advisors." In addressing a registrant's potential request for the SEC staff to reconsider a staff member's comment or view on a registrant's response, the staff emphasizes that registrants do not have to "follow a formal protocol." However, the staff explains where registrants should start and the steps involved in the normal course of the reconsideration process. The staff also specifies contact information for each office for both accounting and financial disclosure matters and legal and textual disclosure matters.

Registrants may involve the SEC's Office of the Chief Accountant (OCA) during any stage of the review process. Unlike the Division's role, which is to address matters related to the age, form, and content of registrants' financial statements that are required to be filed, the OCA's role is to address questions concerning a registrant's application of GAAP. Guidance on consulting with the OCA is available on the SEC's Web site.

A registrant that receives an SEC comment letter should generally respond within the time frame indicated in the letter. See Appendix B for more information about responding to SEC comment letters. The registrant should continue to respond to any requests for more information until it receives a letter from the Division stating that the Division has no further comments. A registrant that does not receive a completion letter within a reasonable amount of time after submitting a response letter should call its SEC staff reviewer (named in the letter) to ask about the status of the review. If the review is complete, the registrant should request a completion letter.

To increase the transparency of the Division's review process, comment letters are made public, via the SEC's Web site, no more than 20 days after the review is completed. See Appendix C for tips on searching the SEC's comment letter database.

[1] An overview of the legal, regulatory, and capital markets offices is also available on the SEC's Web site.

Appendix B: Best Practices for Managing Unresolved SEC Comment Letters

The best practices below are intended to help registrants resolve any staff comment letters in a timely manner. Unresolved comments may affect a registrant's ability to issue financial statements and an auditor's ability to issue the current-year audit report. In addition, when responding to staff comment letters, registrants should be mindful of their responses because all responses to staff comment letters are made publicly available and become part of a registrant's "total mix of information" and disclosure records (i.e., investors may read such responses similarly to how they interpret a registrant's other filings and publicly available information).[1] A registrant should therefore do the following:

- Consider the impact the comment letter may have on its ability to issue the financial statements.
- Consult with its SEC legal counsel about the impact the comment letter may have on the certifications contained in its Form 10-K.
- Consult with its auditors to discuss the impact the comment letter may have on their ability to issue the current-year audit report.
- Review the comment letter immediately and respond to the SEC staff reviewer (named in the letter) within the time indicated in the comment letter (usually 10 business days). If possible, the registrant should not request an extension, since this may delay resolution of the comment letter. However, in certain circumstances, the registrant should consider requesting an extension to provide a more thorough and complete response that addresses all of the staff's comments.
- If the registrant does not fully understand any specific comment, the registrant should contact its SEC staff reviewer quickly for clarification so that it can provide an appropriate response.
- Include in the response a discussion of supporting authoritative accounting literature and references to the specific paragraph(s) from the standard(s).
- Because some comments may request disclosure in future filings, the registrant should consider including such disclosure in the response letter to potentially eliminate additional requests from its SEC staff reviewer.
- If an immaterial disclosure is requested, the registrant should consider explaining why the disclosure is immaterial instead of including the immaterial disclosure in future filings.
- Maintain contact with its SEC staff reviewer and make the reviewer aware of the registrant's required timing (on the basis of its current-year filing deadlines).
- If the registrant has not received a follow-up letter or been contacted within two weeks of filing the initial response letter, the registrant should contact its SEC staff reviewer to determine the status of the comments. The registrant should promptly address any follow-up questions.
- If the registrant is uncertain about whether its review has been completed without further comments, it should ask the SEC staff reviewer about the status of the review. If the review is complete, the registrant should ask the reviewer for a completion letter.

Oral Comments

In certain circumstances, the SEC staff may provide oral comments to a registrant instead of a written comment letter. The registrant should ask the SEC staff reviewer how he or she would like to receive the registrant's response to the oral comments. If the reviewer requests a response via EDGAR, a registrant should respond with a written letter. If the reviewer requests an oral response or identifies no preference, a registrant should still, although it is not required to do so, consider responding to the staff's comments with a letter to formally document the registrant's understanding of the staff's comments and the discussions held as well as the registrant's response.

[1] The SEC staff discussed this topic at the 2012 AICPA Conference. Refer to Deloitte's December 11, 2012, *Heads Up* for more information.

Disclosure Requirements

Under the Securities Offering Reform, large accelerated filers, accelerated filers, and well-known seasoned issuers must disclose in their Forms 10-K the substance of any material unresolved SEC staff comments that were issued 180 or more days before the end of the current fiscal year.

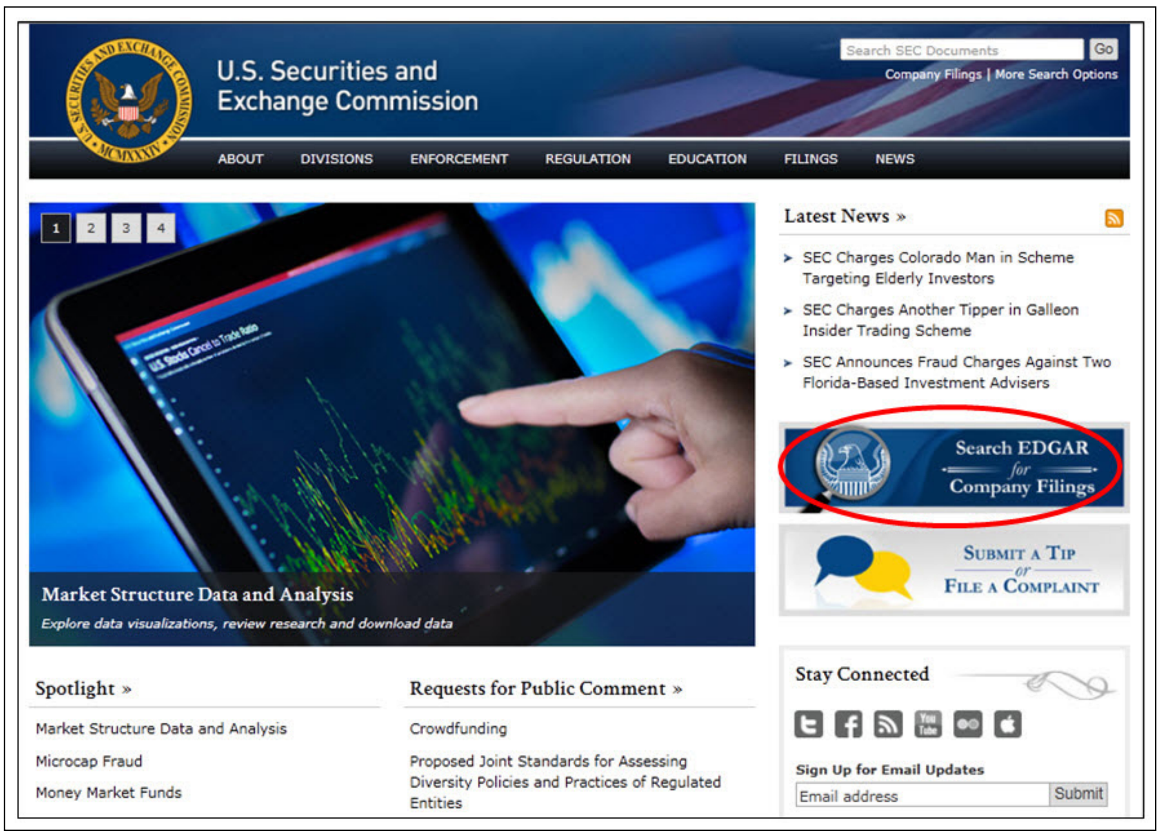
Appendix C: Tips for Searching the SEC's Database for Comment Letters

The SEC adds comment letters (and responses from registrants) to its EDGAR database no earlier than 20 days after its review of a filing is complete. Registrants can refer to such comments as part of their financial statement review process and to improve their own accounting and overall disclosure.

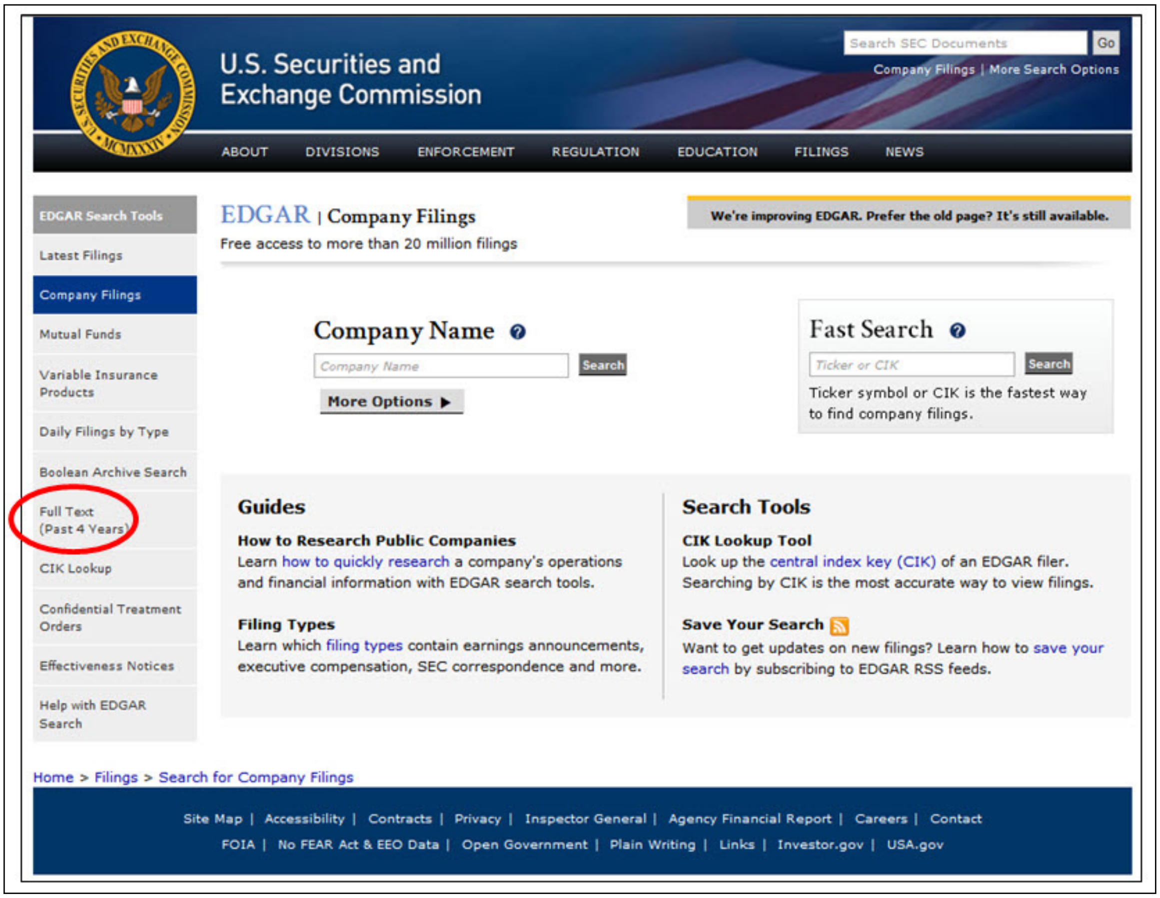
Although the SEC has recently updated the EDGAR search engine to simplify searches of corporate filings, users may still wish to use the "full-text" search feature to find the text of specific comment letters posted within the last four years and to generally narrow their search results. The process of performing a full-text search is discussed below.

Full-Text Searching

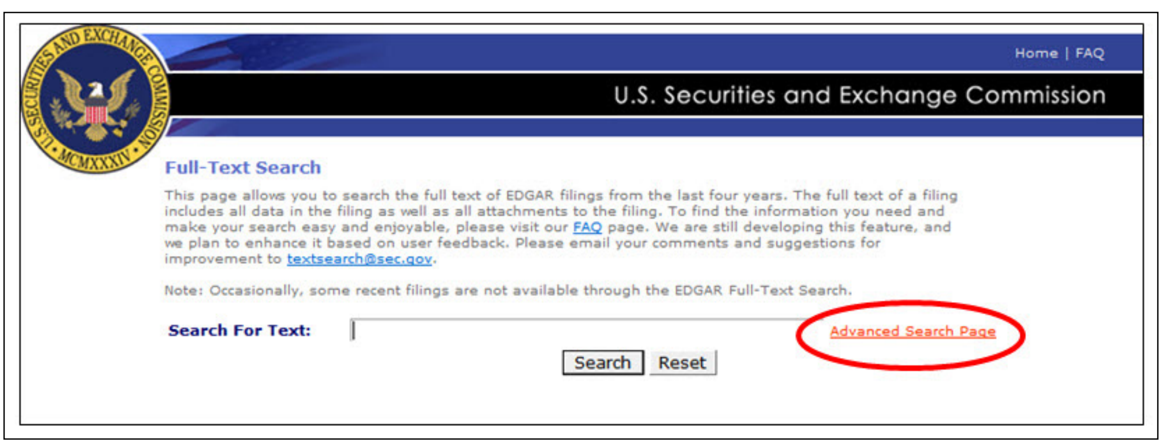
To perform a full-text search, first go to the SEC's home page (www.sec.gov) and click the "Search EDGAR for Company Filings" image:



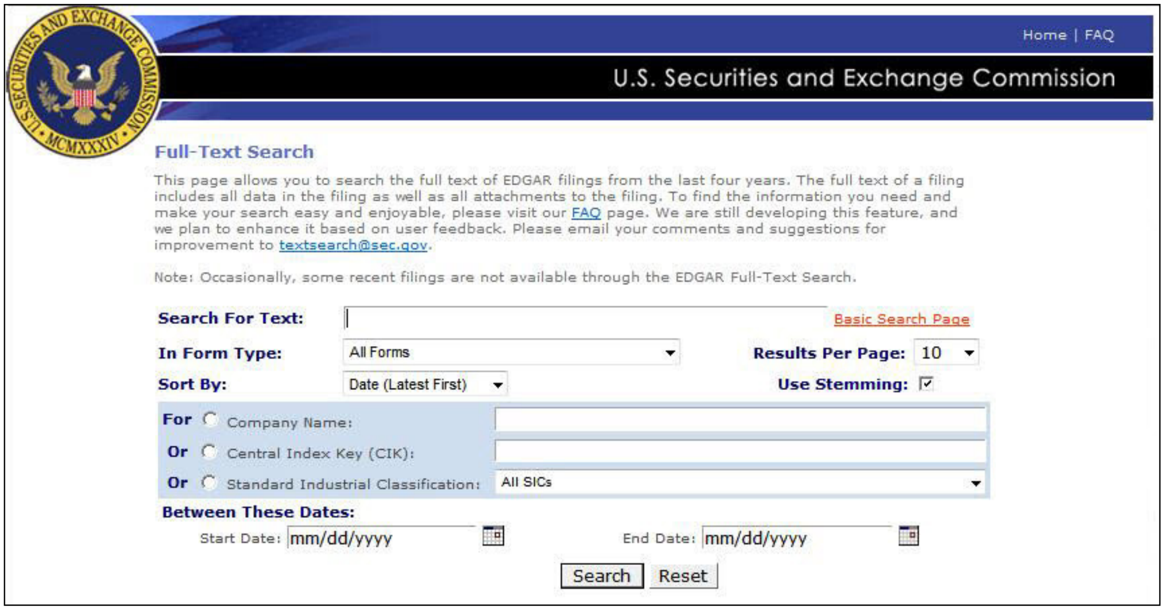
Then, click the "Full Text" link in the left sidebar on the "EDGAR | Company Filings" page:



On the "Full-Text Search" page, select "Advanced Search Page":



This brings up the following form:



In the form, limit the search results to SEC comment letters by using the drop-down menu next to **"In Form Type"** and choosing "UPLOAD" (or select "CORRESP" to include registrant responses as well).

Then, enter search terms in the **"Search for Text"** field. The documents found will contain at least one of the words entered as well as variations of the key word(s). To search for specific phrases, enclose the phrase in quotation marks (e.g., "management's discussion and analysis"). Results will include documents that contain the quoted phrase as well as conceptually related phrases, such as "managerial discussion & analysis."

Enhancing Search Results

Searches can be further refined by using Boolean operators such as AND, OR, and NOT (capitalization of these terms is required). For an operator to work effectively, a key word or phrase generally must be included before and after it (e.g., investments AND temporary). Searches in which operators are used will produce results as follows:

- *AND* — Documents will contain **all** terms connected (but not necessarily in the same sentence or paragraph) by the AND operator. The terms can appear in any order in the document.
- *OR* — Documents will contain **any** terms connected by the OR operator.
- *NOT* — Documents will contain one term but **not** another term.

Using wildcards or the "nearness" feature can also enhance search results:

- *Wildcards* — While certain variations of key words are automatically included in search results, using an asterisk (*) can ensure that all variations are included. For example, the wildcard "impair*" can be used to find documents that contain the words impair, impaired, impairing, impairment, or impairs.

- *Nearness* — Key words or phrases within a certain distance of each other can be searched by stipulating a range. The range is determined by using the term "NEARn," with "n" representing the maximum number of words in the range (e.g., "impairment NEAR5 test" would find documents with impairment and test within five words of each other).

Advanced search features can frequently be combined. For example, quotations used to find a specified phrase can be combined with Boolean operators (e.g., investments AND "temporary decline").

Note that numbers are ignored in searches. Thus, a search for "Final Rule 108" will only locate documents that contain the terms "Final" and "Rule." Searches can, however, be sorted by other criteria, such as dates, as discussed below.

Sorting by Dates and Other Specific Criteria

On the full-text search form, selections can also be made to limit results to a specified:

- Company name.
- Central index key (CIK).[1]
- Standard industrial classification (SIC) code.[2]
- Date range.

Note that clicking the SIC code in the list of search results will display a list of additional companies that have the same SIC code:

Example


Example

08/13/2013 SC 13G/A for CAPITALSOURCE INC

COMPANY NAME(s) - [CAPITALSOURCE INC (CIK - 1241199 /SIC - 6022), WELLS FARGO COMPANY MN (CIK - 72971 /SIC - 6021)]

UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549 SCHEDULE 13G Under the Securities

Controlling and Displaying Search Results

The **Results Per Page** drop-down list can be used to limit the number of search results that display. To open a comment letter, click on the underlined title of the form to the right of the date. The comment letters will include any attachments or exhibits.

Example of the Benefits of Using Full-Text Search Features

Assume that a user is interested in SEC comments issued over the past two years that are related to results of operations in the hotel industry. By searching for the words "results" and "operations" with "All Forms" selected and no dates specified, the user would obtain over 8,000 results, many of which are not relevant.

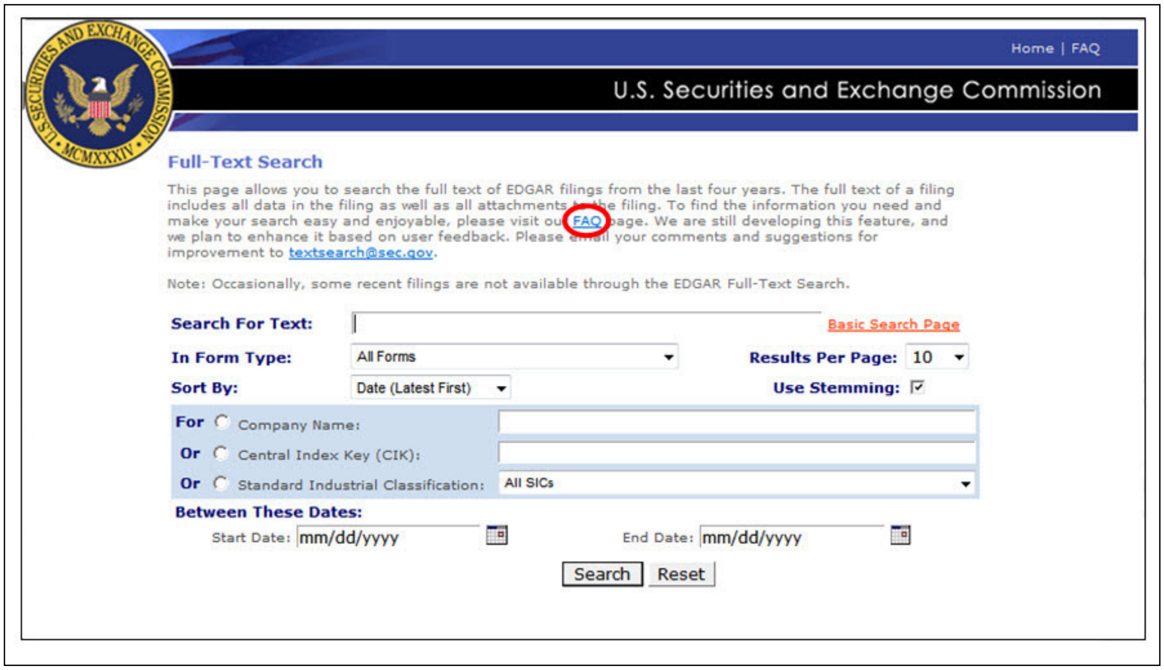
However, if the user narrowed his or her search by (1) selecting the form type UPLOAD, (2) entering the search term "results of operations" in quotation marks, (3) entering the industry code for the hotel/motel industry (SIC 7011), and (4) providing a date range spanning the last two years, the number of results will be more relevant and manageable.

1 According to the SEC's Web site, "a CIK is the unique number that the SEC's computer system assigns to individuals and corporations who file disclosure documents with the SEC. All new electronic and paper filers, foreign and domestic, receive a CIK number."

2 A SIC code is an industry designation. Note that some of the SIC code descriptions are similar, so narrowing results by SIC code may not include certain issuers that are in a similar industry yet have a different assigned SIC code.

Additional Information

For more information about full-text searching, click the FAQ link on in the search form:



Appendix D: Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

AICPA Audit and Accounting Guide

Depository and Lending Institutions

Valuation of Privately Held Company Equity Securities Issued as Compensation ["Cheap Stock Guide"]

AICPA Accounting and Valuation Guide

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

CAQ Alerts

Alert No. 2012-16, "Reference to the Standards of the PCAOB in Auditors' Reports"

Alert No. 2011-04, "SEC Staff Reminds Auditors of Requirement to Sign EDGAR Audit Reports"

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

FASB — Other Literature

See the FASB's Web site for titles of:

- Accounting Standards Updates.
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

PCAOB Auditing Standards

See the Standards page on the PCAOB's Web site for titles of its auditing standards.

SEC ASR

Accounting Series Release No. 268, "Presentation in Financial Statements of 'Redeemable Preferred Stocks'" (Rule 5-02.28 of SEC Regulation S-X)

SEC C&DI Topics

Exchange Act Rules

Exchange Act Sections

Non-GAAP Financial Measures

Regulation S-K

Securities Act Rules

SEC Division of Corporation Finance Disclosure Guidance

Topic 2, "Cybersecurity"

SEC Concept Release

33-8860, *Mechanisms to Access Disclosures Relating to Business Activities in or With Countries Designated as State Sponsors of Terrorism*

SEC Division of Corporation Finance FRM

Topic 1, "Registrant's Financial Statements"

Topic 2, "Other Financial Statements Required"

Topic 3, "Pro Forma Financial Information"

Topic 4, "Independent Accountants' Involvement"

Topic 6, "Foreign Private Issuers & Foreign Businesses"

Topic 7, "Related Party Matters"

Topic 8, "Non-GAAP Measures of Financial Performance, Liquidity, and Net Worth"

Topic 9, "Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)"

Topic 10, "Emerging Growth Companies"

Topic 13, "Effects of Subsequent Events on Financial Statements Required in Filings"

SEC Final Rule

33-8176, *Conditions for Use of Non-GAAP Financial Measures*

SEC Industry Guides

Guide 3, "Statistical Disclosure by Bank Holding Companies"

Guide 6, "Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters"

SEC Interpretive Release

33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*

33-8810, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*

SEC Regulation G

SEC Regulation S-K

Item 10, "General"

Item 101, "Description of Business"

Item 103, "Legal Proceedings"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

Item 305, "Quantitative and Qualitative Disclosures About Market Risk"

Item 307, "Disclosure Controls and Procedures"

Item 308, "Internal Control Over Financial Reporting"

Item 402, "Executive Compensation"

Item 404, "Transactions With Related Persons, Promoters and Certain Control Persons"

Item 407, "Corporate Governance"

Item 503, "Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges"

Item 506, "Dilution"

Item 512, "Undertakings"

Item 601, "Exhibits"

Item 1202, "Disclosure of Reserves"

Item 1203, "Proved Undeveloped Reserves"

Item 1204, "Oil and Gas Production, Production Prices and Production Costs"

Item 1205, "Drilling and Other Exploratory and Development Activities"

Item 1206, "Present Activities"

Item 1207, "Delivery Commitments"

Item 1208, "Oil and Gas Properties, Wells, Operations, and Acreage"

SEC Regulation S-T

Rule 302, "Signatures"

Rule 405, "Interactive Data File Submissions and Postings"

SEC Regulation S-X

Rule 1-02, "Definitions of Terms Used in Regulation S-X"

Rule 2-02, "Accountants' Reports and Attestation Reports"

Rule 3-01, "Consolidated Balance Sheets"

Rule 3-02, "Consolidated Statements of Income and Changes in Financial Position"

Rule 3-03, "Instructions to Income Statement Requirements"

Rule 3-04, "Changes in Stockholders' Equity and Noncontrolling Interests"

Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

Rule 3-12, "Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement"

Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired"

Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered"

Rule 4-08, "General Notes to Financial Statements"

Rule 4-10, "Financial Accounting and Reporting for Oil and Gas Producing Activities Pursuant to the Federal Securities Laws and the Energy Policy and Conservation Act of 1975"

Article 5, “Commercial and Industrial Companies”

Rule 5-02, “Balance Sheets”

Rule 5-03, “Income Statements”

Rule 5-04, “What Schedules Are to Be Filed”

Rule 7-05, “What Schedules Are to Be Filed”

Article 8, “Financial Statements of Smaller Reporting Companies”

Article 10, “Interim Financial Statements”

Article 11, “Pro Forma Financial Information”

Rule 11-02, “Preparation Requirements”

Article 12, “Form and Content of Schedules”

Rule 12-04, “Condensed Financial Information of Registrant”

Rule 12-28, “Real Estate and Accumulated Depreciation”

SEC SAB Topics

SAB Topic 1.B, “Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity”

SAB Topic 1.M, “Materiality” (SAB 99)

SAB Topic 1.N, “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements” (SAB 108)

SAB Topic 5.J, “New Basis of Accounting Required in Certain Circumstances”

SAB Topic 5.M, “Other Than Temporary Impairment of Certain Investments in Equity Securities”

SAB Topic 5.P, “Restructuring Charges”

SAB Topic 5.Y, “Accounting and Disclosures Relating to Loss Contingencies”

SAB Topic 6.K, “Accounting Series Release 302 — Separate Financial Statements Required by Regulation S-X”

SAB Topic 10.E, “Classification of Charges for Abandonments and Disallowances”

SAB Topic 11.B, “Depreciation and Depletion Excluded From Cost of Sales”

SAB 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” (SAB 74)

SAB Topic 13, “Revenue Recognition” (SAB 101 and SAB 104)

SAB Topic 13.A, “Selected Revenue Recognition Issues”

SAB Topic 14.F, “Classification of Compensation Expense Associated With Share-Based Payment Arrangements”

Securities Act of 1933 Rules

Rule 405, "Definitions of Terms"

Rule 436, "Consents Required in Special Cases"

Securities Exchange Act of 1934 Rules

Rule 13a-15, "Issuer's Disclosure Controls and Procedures Related to Preparation of Required Reports"

Rule 15d-15, "Controls and Procedures"

Appendix E: Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
AICPA Banking Conference	AICPA National Conference on Banks and Savings Institutions
AICPA Conference	The annual AICPA Conference on Current SEC and PCAOB Developments
ALLL	allowance for loan and lease losses
ASC	FASB Accounting Standards Codification
ASR	SEC Accounting Series Release
ASU	FASB Accounting Standards Update
AU	PCAOB Interim Auditing Standard
AUM	asset under management
BCF	beneficial conversion feature
BPD	branded pharmaceutical drug
CAQ	Center for Audit Quality
C&DI	SEC Compliance and Disclosure Interpretation
CD&A	Compensation Discussion and Analysis
CEO	chief executive officer
CF-OCA	SEC's Division of Corporation Finance, Office of the Chief Accountant
CFDG	Corporation Finance Disclosure Guidance
CFO	chief financial officer
CIK	central index key
CODM	chief operating decision maker
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPA	certified public accountant
DCP	disclosure controls and procedures
DTA	deferred tax asset
DTL	deferred tax liability

Abbreviation	Description
EBIT	earnings before interest and taxes
EBITDA	earnings before interest, taxes, depreciation, and amortization
EDGAR	SEC's Electronic Data Gathering, Analysis, and Retrieval system
EGC	emerging growth company
EITF	Emerging Issues Task Force
EPS	earnings per share
EPU	earnings per unit
FASAC	Financial Accounting Standards Advisory Council
FASB	Financial Accounting Standards Board
FAQs	frequently asked questions
FCPA	Foreign Corrupt Practices Act
FDA	Food and Drug Administration
FDIC	Federal Deposit Insurance Corporation
FFO	funds from operations
FICO	Fair Issac Corporation
FPI	foreign private issuer
FRM	SEC Financial Reporting Manual
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
GP	general partner
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
ICP	Internet content provider
IFRS	International Financial Reporting Standard
IPO	initial public offering
IRS	Internal Revenue Service

Abbreviation	Description
LP	limited partner
MD&A	Management's Discussion and Analysis
MLP	master limited partnership
NAREIT	National Association of Real Estate Investment Trusts
NCI	noncontrolling interest
NDA	new drug application
NEO	named executive officer
NGL	natural gas liquid
NOI	net operating income
OCA	SEC's Office of the Chief Accountant
OCI	other comprehensive income
OTTI	other-than-temporary impairment
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCI	purchased credit-impaired
PCS	postcontract customer support
PUD	proved undeveloped
R&D	research and development
REIT	real estate investment trust
SaaS	software as a service
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SG&A	selling, general, and administrative expense
SIC	standard industrial classification
TDR	troubled debt restructuring

Abbreviation	Description
TTHL	transportation, travel, hospitality, and leisure
TPE	third-party evidence
VaR	value at risk
VIE	variable interest entity
VSOE	vendor-specific objective evidence
XBRL	eXtensible Business Reporting Language

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
JOBS Act	Jumpstart Our Business Startups Act
Sarbanes-Oxley Act	Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 14, 2014

Ms. Susan Cosper
Technical Director
File Reference No. 2014-200
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2014-200, Exposure Draft: *Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Financial Accounting Standards Board's (FASB or the Board) *Exposure Draft: Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements* (the Exposure Draft).

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 $783 billion at April 30, 2014. Of these companies, 168 were equity REITs representing 91.2% of total U.S. listed REIT equity market capitalization (amounting to $714 billion)[1]. The remainder, as of April 30, 2014, was 41 publicly traded mortgage REITs with a combined equity market capitalization of $69 billion.

EXECUTIVE SUMMARY

NAREIT supports the Board's objective to improve the effectiveness of disclosures in the notes to the financial statements by clearly and concisely communicating the information that is most relevant to users of financial statements. NAREIT further welcomes the potential benefit of reducing superfluous, duplicative and/or irrelevant disclosures as a consequence of a sharper focus on what users of financial statements value most in evaluating the prospects of future cash flows of public companies. However, we do not believe that the disclosure framework included in the Exposure Draft would achieve the project's objective. Rather than improving disclosure effectiveness and eliminating redundancy, we believe that the proposed framework could expand possible disclosure requirements significantly because it does not provide clear direction. Thus, we do not believe that the framework would prove operational for Board members as they develop disclosure requirements in future standards setting. NAREIT offers a number of recommendations that we believe would assist the Board in developing an effective and efficient disclosure framework.

NAREIT RECOMMENDATIONS

Following are NAREIT recommendations that should assist the Board in developing an effective framework that would promote consistent decisions and the proper use of discretion by the Board:

- **Re-evaluate and reconcile the purpose of the Exposure Draft with the root cause that triggered the project**
- **Ensure that disclosures address each of the financial statements, not just the balance sheet**
- **Focus disclosure requirements on the elements of the financial statements, rather than financial statement line items only**
- **Coordinate efforts to address the problem of "disclosure overload" with the IASB**
- **Address materiality as a key element to the Exposure Draft**
- **Develop a financial reporting model that delineates which disclosures belong in the notes to the financial statements as opposed to MD&A**

[1] http://www.reit.com/sites/default/files/reitwatch/RW1405.pdf at page 21.

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

- **Further engage and collaborate with all interested constituents, including regulators (*i.e.*, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)), preparers, analysts, and auditors, in field testing of the revised Exposure Draft**

Re-evaluate and reconcile the purpose of the Exposure Draft with the root cause that triggered the project

NAREIT concurs with the Exposure Draft's explanation that "The primary purpose of notes to financial statements is to supplement or further explain the information on the face of financial statements by providing financial information relevant to existing and potential investors, lenders, and other creditors for making decisions about providing resources to the entity."[2] Further, NAREIT understands that the "objective and primary focus of this project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements."[3] However, NAREIT fears that the Board is not meeting the project's objective based on the contents of the Exposure Draft. Rather than adding specificity about the type of information that the Board would require in the notes, the Conceptual Framework "would identify, by design, a broad range of possibilities for the Board to consider when deciding on the disclosures related to a particular topic that is required under U.S. GAAP."[4] The Board would rely on individual standard-setting projects to then narrow the disclosure requirements.

Based on this approach, NAREIT has significant concern that the Exposure Draft provides Board members with a framework that would expand disclosure requirements, rather than narrowing the focus of disclosure to be both useful and relevant to users of financial statements. Such an unfettered approach would exacerbate future standard setting in continually starting from a wide-ranging view of potential disclosures where the sky is the limit, rather than focusing on the type of information that users of financial statements actually need. In our view, an underlying principle to the Conceptual Framework should be the consideration of decision-usefulness of information to users of financial statements at a reasonable cost before considering the infinite realm of potential disclosure. Without a holistic view of and a sound foundation for the purpose

[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs at page 5, par. S2.

[3] http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156344894

[4] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs at page 3, par. P13.

of notes to the financial statements, the Board might perpetuate the piece-meal approach that has resulted in voluminous disclosure historically.

Ensure that disclosures address each of the financial statements, not just the balance sheet

In NAREIT's view, the Exposure Draft is driven by balance sheet disclosure. NAREIT observes that the Board should consider expanding the disclosure framework to include the income statement and the statement of cash flows. Based on feedback that we have received from users of financial statements, the information included in the income statement and statement of cash flows is critical for their financial analysis in developing valuations for our member companies. These valuations are the basis for buy or sell recommendations that impact capital allocation decision and ultimately have a direct impact on share price.

Focus disclosure requirements on the elements of the financial statements, rather than financial statement line items only

NAREIT recommends that the FASB refocus the Exposure Draft to view disclosure as an extension of the economics of transactions, rather than specific line items in the financial statements. NAREIT observes that the FASB has historically developed standards with transactions in mind (*e.g.*, leases and revenue recognition that are relevant to the real estate industry), rather than a focus on financial statement line items alone. A transaction and economics-based view of disclosure will place non-accountants on a level playing field to understand the implications on risk, volatility and the future prospects of a company resulting from elements of the financial statements.

Coordinate efforts to address the problem of "disclosure overload" with the IASB

NAREIT understands that the idea of enhancing and synthesizing disclosure requirements is not just a U.S. phenomenon. For example, the International Accounting Standards Board (IASB) recently commenced its own Disclosure Initiative that is intended to explore how disclosures in International Financial Reporting Standards can be improved. In a speech titled "Breaking the Boilerplate," Chairman Hans Hoogervorst stated that "For many companies, the size of their annual report is ballooning. The amount of useful information contained within those disclosures has not necessarily been increasing at the same rate. The risk is that annual reports become simply compliance documents, rather than instruments of communication."[5]

Especially in light of recent remarks made by Securities and Exchange Commission Chairman Mary Jo White[6] in reference to the future possibility of IFRS reporting in the U.S., NAREIT believes it would be prudent for the FASB to coordinate its efforts toward developing a disclosure framework in conjunction with the IASB's efforts on its Principles of Disclosure. These efforts would potentially reduce disclosure requirement gaps between U.S. GAAP and

[5] http://www.ifrs.org/Alerts/Conference/Documents/2013/HH-Amsterdam-June-2013.pdf
[6] http://www.iasplus.com/en/news/2014/05/sec-speech

IFRS in future standard setting, which could be especially useful to issuers who need to file both in the United States and in IFRS jurisdictions.

Address Materiality as a key element to the Exposure Draft

The FASB might also benefit from collaboration with the IASB on the materiality phase of the IASB's Disclosure Initiative. While the FASB has not considered materiality in the Exposure Draft, the IASB is currently researching how materiality is utilized in preparing financial statements. In NAREIT's view, the FASB should evaluate how the consideration of a materiality principal would enhance future disclosure requirements. We recognize that developing materiality thresholds for disclosure is somewhat abstract and challenging from a qualitative perspective. However, absent a consideration of materiality in the Exposure Draft, preparers will be faced with proving why disclosure is not material to auditors and the Public Company Accounting Oversight Board (PCAOB). In our view, preparers may not believe that reducing disclosure for materiality sake is worth the time, effort, and level of second-guessing to be endured. As a result, preparers may simply default to the "check-list" safe-harbor approach to disclosure that has developed in the U.S. over time.

Develop a financial reporting model that delineates which disclosures belong in the notes to the financial statements as opposed to Management's Discussion and Analysis (MD&A)

NAREIT is concerned that new disclosures that are *prospective* in nature and akin to financial analysis would be required to be included in the notes to the financial statements. Today, information typically included within the financial statements is primarily *historical*, while *forward-looking* information is generally included in MD&A. Beyond NAREIT's concern that blending financial analysis with historical information embedded in the notes to financial statements would cause confusion to financial statement users, NAREIT questions whether audit firms would be able to render unqualified audit reports on financial statements that include this information.

NAREIT suggests that the Board develop a model that delineates which disclosures belong in the notes to the financial statements as opposed to MD&A. One possible way of accomplishing this would be to develop a principle that historical information is included within the financial statements, while forward looking information is generally included in MD&A. In so doing, NAREIT suggests that the FASB work with the SEC in studying existing disclosure requirements in the notes to financial statements and in MD&A and **seek to eliminate redundancies**.

In order to effectuate a financial reporting model that clearly requires historical information in the financial statements and forward-looking information in MD&A, NAREIT suggests that the Board move the following paragraph from the Basis for Conclusions (*i.e.*, paragraph BC16) to the forefront of the "Future-Oriented Information" section of the final conceptual framework:

> [A]lthough disclosures may be oriented toward the future, the information in those disclosures is appropriate if it is either dictated by a current known condition or

> embedded within a current measurement used within the financial statements. Furthermore, expectations and assumptions about the future that were not within a current measurement would not be appropriate for requirement in notes.[7]

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[8]) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers).[9] In NAREIT's view, each interim period is an integral part as opposed to a discrete part of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for material changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively incorporated both relevant and meaningful disclosure for interim reporting periods, while eliminating duplicative disclosure. NAREIT believes that the FASB could achieve its objective by taking a similar approach.

Further engage and collaborate with all interested constituents, including regulators (*i.e.*, the SEC and the PCAOB), preparers, analysts, and auditors, in field testing of the revised Exposure Draft

In order to increase the likelihood of the success of the project, NAREIT believes that it would be prudent for the Board to further engage and collaborate with all interested constituents in the process of field testing the revised Exposure Draft by preparing and evaluating "real life" examples of financial statements. Without obtaining the perspectives of all interested parties at the forefront, the Board runs the risk of having preparers default to a check list of disclosure requirements so as to reduce the possibility of being second-guessed by auditors and regulators. While NAREIT understands that many preparers and auditors take comfort in knowing that they complied with the "letter of the law" by following rules and ensuring compliance with the said rules through the use of check-lists, the success of this project hinges on a fundamental change in mindset amongst *all* constituents. By obtaining consensus at the commencement of the project,

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[7] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs at page 39.
[8] http://www.sec.gov/answers/form10q.htm
[9] http://www.sec.gov/answers/form10k.htm

there would be significantly less probability that current extensive disclosures are simply carried forward into the future. NAREIT would welcome the opportunity to participate in field testing and in coordinating a broad spectrum of constituents from the preparer, auditor, and financial statement user community focused on the real estate sector.

* * * *

We thank the FASB for the opportunity to comment on the Exposure Draft. 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 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Delivered Electronically

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (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 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 193 companies representing an equity market capitalization of $659.6 billion[1] at September 30, 2013. Of these companies, 154 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $598.5 billion). The remainder, as of September 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $61.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices 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 appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, Notice of Roundtable, (PCAOB Release No. 2011-003, June 21, 2011, PCAOB Rulemaking Docket Matter No. 34*[2]*)* (the Concept Release) that discussed alternatives for changing the auditor's reporting model. In particular, NAREIT supports the PCAOB's decisions to retain the current pass/fail model of auditor reporting and to reject the requirement for an auditor's discussion and analysis. However, NAREIT does not support a requirement for the auditor to report on "critical audit matters" (as that term is defined in the Proposal). In our view, such a requirement would not meet the PCAOB's objective of providing users of financial statements with additional meaningful information. As discussed further below, it is our view that the PCAOB's proposal for auditor reporting of critical audit matters would largely result in generic disclosures that are duplicative of information that is provided by management while simultaneously increasing audit cost.

NAREIT Comments on Critical Audit Matters

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand;

- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

- Duplicate information already disclosed by the issuer;

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[1] http://returns.reit.com/reitwatch/rw1310.pdf at page 21
[2] http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf

- Increase audit fees for, among other things, the senior level time the auditor would incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee; and,

- Exacerbate existing time pressures to meet financial reporting deadlines.

Each of these concerns is further discussed below.

Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand

In reporting critical audit matters, auditors would likely feel compelled to describe the audit procedures they performed, consistent with the examples in the proposal. NAREIT questions whether the substantial majority of financial statement users are likely to understand a discussion of audit procedures. When the auditor discusses its audit process with the audit committee, the auditor has the opportunity to answer questions and provide additional information to the audit committee members, thus limiting the risk of confusion or misunderstanding about the nature and extent of audit procedures performed. Further, when the audit committee and auditor are discussing the audit work in discrete areas, they are doing so in the context of the audit taken as a whole. In this context, there is no potential for confusion about whether the auditor is, in some way, effectively providing a piecemeal opinion on an individual line item within the financial statements.

NAREIT believes that users would likely be confused by the discussion of audit procedures in an audit report not only because they lack an understanding of the audit process as a whole but because they lack the context for the discussion of discrete audit procedures on an individual financial statement line item. We are therefore concerned that the Proposal would widen the existing expectation gap regarding the nature and extent of audit work required by the PCAOB's auditing standards.

Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

One of the examples in the Proposal (Hypothetical Auditing Scenario #3) illustrates a fact pattern in which the auditor discloses a "control deficiency less severe than a material weakness noted in the Company's internal control system."[3] This information is part of the auditor's required communication to the issuer's audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

[3] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77

The Proposal acknowledges a fact pattern whereby control deficiencies that are not material weaknesses would be disclosed by the auditor. For example, Appendix V of the Proposal states:

> Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.[4]

This would mean that the auditor would be disclosing sensitive information that is not otherwise required to be reported by the issuer. Furthermore, unlike the existing audit requirement to discuss such matters with the audit committee, the information is being presented to users of financial statements with limited context and no opportunity for the clarifying discussion that occurs during most audit committee meetings.

We strongly believe that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Proposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

Duplicate information already disclosed by the issuer

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the critical accounting policies and estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover critical accounting policies and estimates provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the Financial Accounting Standards Board (FASB) evaluate this aspect of financial reporting and provide additional guidance through the comment letter process. Another possibility would be to request that the FASB evaluate these disclosures as part of its Disclosure Framework Project.

Increase audit fees for, among other things, the senior level time the auditor will incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee

[4] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-32

NAREIT acknowledges that the current audit standards require the auditor to identify and communicate significant audit matters to the audit committee. However, NAREIT believes that requiring the auditor to report critical audit matters in the audit opinion would lead to increased audit fees. At a minimum, each and every audit engagement team would incur additional senior level time in order to determine the critical audit matters (CAMs) for purposes of drafting the proposed disclosure and discussing both the CAMs and the related disclosure with management and the audit committee.

Further, given the significant degree of subjectivity involved in determining which significant audit matters are “the most critical” and the inevitable second guessing of that determination by audit committees, management, PCAOB inspection teams, SEC staff and litigators, NAREIT anticipates that audit partners would need to consult others in the firm regarding both the selection of CAMs as well as the report language. The added time and related increased risk incurred by the audit firm would directly translate into an unnecessary and avoidable increase in annual audit fees. Further, we believe that there is a risk of inconsistent disclosure of CAMs both within and among the audit firms. We sense that the added disclosure in the audit report would open both audit firms and issuers to increased litigation risk, the cost of which will be passed on to issuers (and thus investors) in the form of increased audit fees.

Exacerbate existing time pressures to meet reporting deadlines

Given the nature of the audit process, auditors are unlikely to be able to conclude definitively on “the most” significant, judgmental or complex audit matters until substantially all the audit work has been completed. That necessarily places the decisions and discussions surrounding CAMs into the very final stages of the audit and just prior to the release of the audited financial statements on Form 10-K. If the Board moves forward with this Proposal, NAREIT foresees the addition of a very time consuming step into the late stages of what is already a tight deadline for many issuers.

In light of time pressures, liability concerns and fee issues, audit firms may feel compelled to develop standardized audit report language for common critical audit matters. Thus, stepping back and looking at the sum total of our concerns, we believe there is a significant risk that the PCAOB’s proposal will result in boilerplate, duplicative disclosures that add to the cost of the audit without adding to the information available to users of financial statements.

NAREIT Comments on Auditor Tenure

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer’s public filings. However, NAREIT does not support the Proposal that auditors report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that does not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only. A statement regarding auditor tenure placed in the audit report would provide no information about how the audit committee assesses the quality of the audit work and determines that a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report. If users of financial statements believe this information would provide significant value, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments.[5]

NAREIT Comments on Other Information

We do not understand the purpose of expanding the audit report to explicitly address information that is not audited and that is often outside the expertise of an auditor. More importantly, NAREIT believes the proposed language that would be included in the audit report regarding other information would mislead users into believing that the auditor has an authoritative basis to conclude on the sufficiency, accuracy or completeness of the other, unaudited information. This, in turn, would cause auditors to do additional work and invest additional resources into the reading of the unaudited information beyond what may be required by the standard because they would be perceived as being more closely associated with that information. Inevitably, this exercise would increase the cost of the audit as well as the cost of preparing the unaudited information. The result would be more cost to shareholders without additional assurance to those same shareholders.

In NAREIT's view, there is no need to change the existing audit standard related to other information contained in a report that includes audited financial statements. We are unaware of any evidence indicating that auditors are either not meeting their existing (albeit very limited) responsibilities for other information or that users are misinformed about which elements of an SEC filing are audited and which are not. In fact, in its Proposal, the PCAOB notes that "investors generally were not supportive of auditor assurance on other information outside the financial statements."[6] To the extent that the audit committee or external third parties (*e.g.*, underwriters, institutional investors, or analysts) believe it is appropriate to obtain additional assurance on other information included in SEC filings, the PCAOB's existing standards provide auditors with the tools to meet those requests. Accordingly, nothing more is needed.

[5] In its Proposal, the PCAOB notes that the UK-listed companies are "required to provide information about auditor tenure in a separate section of the annual report" (page A5-16.) The approach used by the UK is consistent with our view that information about auditor tenure, while potentially of interest to investors, is a matter of corporate governance.
[6] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 25

The PCAOB states that

> The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit.[7]

NAREIT views these requirements as largely consistent with the existing audit standard which states that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."[8] However, the proposed changes to the standard, and the related proposed language in the audit report, suggest that the auditor's responsibility should extend beyond what has been historically required. Specifically, under the Proposal the auditor would be required to state that, "in addition to auditing the financial statements and the Company's internal controls over financial reporting," the auditor would also be required to "evaluate" the other information in the filing, an evaluation that was "based on relevant audit evidence obtained and conclusions reached during the audit." What level of assurance is provided by an "evaluation?" Absent clarification by the PCAOB, users of financial statements could mistakenly perceive the audit firm's work and the level of assurance provided surrounding other information as something substantial, with no meaningful understanding as to the distinction between an "evaluation" and an "audit." This perception gap could have severe ramifications on the investment community as well as the audit profession. Instead of adding more clarity to the audit report and narrowing the expectation gap, we view this Proposal as significantly obfuscating the nature and scope of an audit and dramatically widening the expectation gap.

In NAREIT's view, this aspect of the Proposal is fraught with many issues involving each financial statement users' perspectives, and would likely lead auditors by default to performing a far more significant amount of unnecessary work on other information than under current standards due to the lack of clarity regarding the nature and scope of the auditor's responsibility. This would cause increases in audit fees when there is absolutely no demand or requirement for any type of assurance on this information and could lead to less useful information being provided to investors.

Summary

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report, disclosure of auditor tenure, and the auditor's responsibility for other information are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of

[7] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 7
[8] See AU 550.04

financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Proposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

In the event that the PCAOB decides to move forward with the Proposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community in order to fully assess both the costs and the benefits of the Proposal. This would provide the Board with evidential matter in evaluating whether the Proposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Proposal's objectives could actually be achieved.

* * *

We thank the PCAOB 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 1-202-739-9432, or Christopher T. Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

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®

October 31, 2014

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Delivered Electronically

Re: Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements, August 19, 2014* (the Staff Paper).

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 209 companies representing an equity market capitalization of $789 billion[1] at September 30, 2014. Of these companies, 169 were Equity REITs representing

[1] http://www.reit.com/sites/default/files/reitwatch/RW1410.pdf at page 21

91.8% of total U.S. listed REIT equity market capitalization (amounting to $724.5 billion). The remainder was 40 publicly traded Mortgage REITs with a combined equity market capitalization of $64.5 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices 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 appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted.

Why is a change to the existing audit framework for auditing estimates warranted?

NAREIT is not persuaded that a change to the audit framework for auditing estimates is necessary. In NAREIT's view, a single standard for auditing estimates and fair value measurements is an unworkable solution given the multiple iterations of accounting estimates in U.S. Generally Accepted Accounting Principles (GAAP). Additionally, NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to auditing estimates fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on the number of deficiencies found in the inspections process. While NAREIT acknowledges that PCAOB inspection reports have identified shortcomings in the audit work surrounding estimates, we observe that these criticisms could be caused by a number of factors:

- Auditors are not following the current standards;

- Auditors are performing the required procedures but are not adequately documenting the work that they perform;

- Auditors lack sufficient knowledge with respect to quantitatively sophisticated methods of developing estimates used by their clients or third party specialists and therefore are not capable of designing appropriate audit procedures to test the estimates; or,

- The expectations of the PCAOB inspection teams do not reflect the inherent uncertainties and imprecision that underlies estimates, including estimates of fair value measurements.

NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by erroneous estimates in recent history that would necessitate standard setting by the PCAOB. NAREIT questions whether the PCAOB's inspection findings in the areas of estimates, including estimates of fair value measurements, are more likely driven by auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves.

As illustrated by FASB Member Larry Smith and former FASB Chairman Robert Herz[2] at the October 2, 2014 PCAOB Standing Advisory Group Meeting, estimates are prevalent throughout financial statements prepared under U.S. GAAP. Further, accounting estimates extend above and beyond fair value measurements and the GAAP hierarchy for fair value measurements that was introduced by FAS 157 *Fair Value Measurements*. Examples of accounting estimates within the real estate industry include: depreciation and amortization, asset impairment, reserves for tenant receivables, accrued expenses, deferred revenues, commitments and contingencies, contingent rental revenue, unrealized gains and losses on derivatives, foreign currency translation adjustments, changes in value for available-for-sale securities, etc. Developing estimates and fair value measurements is not new to the accounting profession. NAREIT fails to see where audits have failed to assess the reasonableness of the financial statements in accordance with U.S. GAAP.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the portions of the Staff Paper that suggest expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's testing of the accuracy of information provided to the third party is appropriate. Additionally, NAREIT considers the evaluation of information provided by third parties to be sufficient in accordance with current audit literature. However, we disagree with requiring the auditor to "test the information provided by the specialist as if it were produced by the company"[3] or to "evaluate the audit evidence obtained [from the third-party source] as if it were produced by the company.[4]" The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting*

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[2] http://pcaobus.org/News/Events/Documents/10022014_SAG/Herz_slides.pdf
[3] Staff Paper, page 38, Management's Use of a Specialist
[4] Staff Paper, page 44, Use of Third Parties

Estimates acknowledges that “[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.[5]” Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; or (ii) the company’s management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties’ processes and controls as if they were part of the company itself would exacerbate the company’s resource constraints in the first scenario and potentially discourage the company’s efforts in the second scenario. As indicated earlier, in NAREIT’s view, the costs of implementing such audit requirements would far outweigh any incidental benefits.

Isn’t an accounting estimate, by its very nature, merely one possibility in a range of reasonable outcomes?

While NAREIT understands the importance of auditing estimates, we have to wonder whether the Staff Paper is attempting to reach a level of precision via the audit process that contradicts the inherent nature of the subject being audited.

Estimates, including fair value measurements, are used extensively in the preparation of real estate entities’ financial statements. Preparers, auditors and, most importantly, investors and other users of this financial information understand the imprecision that results from the use of estimates. In the context of financial reporting, management’s responsibility is to use its judgment regarding available information in making accounting estimates. AU 342.03 notes that “[m]anagement's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.” The auditor’s responsibility is *not* to conclude whether the estimate is right or wrong, but to assess whether management’s accounting estimate is *reasonable.* Auditing Standard No. 14 *Evaluating Audit Results* states: “If an accounting estimate is determined in conformity with the relevant requirements of the application financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement.[6]”

[5] http://pcaobus.org/standards/auditing/pages/au342.aspx
[6] http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_14.aspx

NAREIT's recommendation: Focus on targeted improvements to identified problems

In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach instead of wholesale changes to the audit framework for estimates. For example, if there are shortcomings in the use of the work of specialists, the PCAOB might consider focusing on auditing the work of specialists to further evaluate the expertise and/or objectivity of the specialist or auditing the inputs provided by the company to the specialist. Alternatively, if the shortcomings stem from inadequate documentation or insufficient subject matter knowledge, the PCAOB could consider steps that would target those issues.

As a starting point, NAREIT recommends that the PCAOB address how proposed changes to auditing literature would impact the auditor's consideration of materiality. NAREIT observes that the Staff Paper is silent on the assessment of materiality. The intersection of where estimates and materiality meet would appear to be a fundamental starting point for the PCAOB's focus in making targeted improvements to audit literature.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites fair value as a common area of "significant audit deficiencies[7]", NAREIT fails to see where these deficiencies have translated into restatements of previously reported financial results. Thus, NAREIT questions whether the Staff Paper simply represents rule-making for the sake of rule-making, without a clearly articulated underlying problem. As indicated above, in the event that the PCAOB concludes that further standard setting is required, NAREIT recommends that the Board make targeted improvements to specific sections of audit guidance as opposed to wide-ranging changes to the entire audit framework.

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We thank the PCAOB for the opportunity to comment on the Staff Paper. 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 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

[7] Staff Paper, page 3, Introduction

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

FASB Simplification Initiative

Goals and Facts:

1) To make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects.
2) Intended to improve or maintain the usefulness of the information reported to investors while reducing costs and complexity in financial reporting.
3) Initiative is a natural offshoot of the FASB Disclosure Effectiveness project.
4) Projects impact all financial statement users, not just private companies.

Completed Projects Impacting REITs:

1) Extraordinary Items – Eliminates from GAAP the concept of extraordinary items, which was rarely used in practice yet still sometimes required significant time spent on the assessment (for instance following the events of 9/11). Effective 1/1/16 for calendar year-end companies with early adoption permitted as long as it is applied in the first quarter of the adoption year.

Note: The FASB website and more specifically the section called "Simplifying Accounting Standards" has been used as a source for this presentation.

FASB Simplification Initiative (continued)

Current Projects Impacting REITs:

1) Presentation of Debt Issuance Costs – Would require that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the corresponding debt liability, consistent with debt discounts (contra liability as opposed to an asset). Final standard expected in Q2 2015.
2) Share Based Payments:
   a) Accounting for Forfeitures – For share-based payments with only service conditions, companies could elect to account for forfeitures as they occur or continue to estimate forfeitures upfront and true-up the estimates over time as is currently required.
   b) Minimum Statutory Withholding Requirements – The amount of shares withheld/repurchased to satisfy the minimum statutory income tax withholding obligation could be up to the maximum marginal tax rate in a given jurisdiction without triggering liability/fair value classification for the entire stock award.

   Final standard is expected in 2015.
3) Clarifying Certain Existing Principles on Statement of Cash flows – The FASB is looking to reduce diversity in practice through the clarification of certain existing principles for classifying cash flows. Examples of issues noted include the following:
   - Insurance proceeds, including from company-owned captives
   - Debt prepayment or extinguishment costs
   - Classification of changes in restricted cash
   - Classification of dividends from equity method investees
   - Classification of cash flows from securitizations

   No timetable for this project was listed on the FASB's website.

FASB Simplification Initiative (continued)

Current Projects Impacting REITs (continued):

4) Accounting for Income Taxes – Intra-Entity Asset Transfers – Would eliminate the exception for recognition of income taxes on intercompany transactions. Instead, recognition of the current and deferred income tax consequences of an intra-entity asset transfer would be required when the transfer occurs as opposed to waiting until the assets have been sold to a third party. Final standard is expected in Q2 2015.

The FASB Simplification Initiative contains various other projects that could have an impact on selected REITs with defined benefit pension plans and classified balance sheets and/or for those REITs that are considered private companies. More information can be obtained on the FASB website in the section called "Simplifying Accounting Standards".

pwc

No. US2015-03
February 26, 2015

What's inside:

New consolidation standard

The new FASB guidance allows early adoption now

At a glance

On February 18, 2015, the FASB issued a final standard that amends the current consolidation guidance. The amendments affect both the variable interest entity (VIE) and voting interest entity (VOE) consolidation models. The changes are extensive and apply to all companies. The need to assess an entity under a different consolidation model may change previous consolidation conclusions.

The standard is effective for public reporting entities in fiscal periods beginning after December 15, 2015, and fiscal periods beginning after December 15, 2016 for non-public business entities. Early adoption is permitted.

Background

.1 On February 18, 2015, the FASB issued Accounting Standard Update 2015-02, *Consolidation – Amendments to the Consolidation Analysis* (the "ASU"). Once effective, the ASU will apply to the consolidation assessment of all entities.

PwC observation:

The changes introduced by the ASU are not limited to any particular industry. All reporting entities that hold a variable interest in other legal entities will need to re-evaluate their consolidation conclusions and potentially revise their disclosures. This process may be time consuming, particularly for reporting entities with large numbers of VIEs and for those that need to apply an entirely new consolidation model to the assessment (for example, many limited partnerships and reporting entities that hold variable interests in investment companies previously subject to an indefinite deferral of certain provisions of the consolidation guidance). Changes may be required to systems, processes, and controls to analyze and continuously monitor applicable relationships for presentation and disclosure purposes.

.2 The ASU concludes the FASB's project to rescind the indefinite deferral of the VIE guidance in ASU 2009-17[1] (FAS 167[2]) for reporting entities with variable interests in legal

[1] ASU 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
[2] FAS 167, *Amendments to FASB Interpretation No. 46(R),* codified in ASC 810, *Consolidation*

entities that have the attributes of an investment company that meet certain criteria (ASU 2010-10[3]). The ASU also makes changes to the VOE consolidation model.

. 3 Prior to the issuance of ASU 2009-17, the consolidation guidance for VIEs (FIN 46(R)[4]) required a reporting entity to consolidate a VIE if it was exposed to a majority of the VIE's expected losses, expected residual returns, or both through its variable interests. ASU 2009-17 shifted the consolidation analysis from a risks and rewards-based approach to a model that defines control as a combination of having (i) the power to direct the most significant activities that impact an entity's economic performance, and (ii) potentially significant economic exposure. As an unintended outcome, ASU 2009-17 would have required many asset managers to consolidate the investment funds they manage, which most practitioners (preparers and users alike) believed would not provide useful financial information. As a result, the FASB issued ASU 2010-10, which required entities meeting the deferral criteria to continue to apply the risk and rewards approach.

. 4 The FASB undertook a project to consider changes to the consolidation model for the express purpose of rescinding the deferral and eliminating the risk and rewards approach. Their initial proposal was issued in late 2011. Under that proposal, a decision-maker with a variable interest in an entity would perform a separate analysis to determine whether it was using its decision-making authority in the capacity of a principal or an agent. A principal would consolidate the entity while an agent generally would not.

. 5 Numerous changes were made to the 2011 proposal in response to comment letter feedback received from constituents. Most notably, the FASB abandoned the requirement for a separate principal versus agent analysis, opting instead to embed the concepts underlying that analysis throughout the VIE model. The FASB also abandoned its proposal to align the definition of participating rights between the VIE and VOE models.

Key provisions

. 6 The ASU does not change the general order in which the consolidation models are applied. A reporting entity that holds an economic interest in, or is otherwise involved with, another legal entity (has a "variable interest") should first determine if the VIE model applies, and if so, whether it holds a controlling financial interest under that model. If the entity being evaluated for consolidation is not a VIE, then the VOE model should be applied to determine whether the entity should be consolidated by the reporting entity. Since consolidation is only assessed for legal entities, the determination of whether there is a legal entity is important. It is often clear when the entity is incorporated, but unincorporated structures can also be legal entities and judgment may be required to make that determination. The ASU contains a new example that highlights the judgmental nature of this legal entity determination (see paragraphs .48 –.51 for further information).

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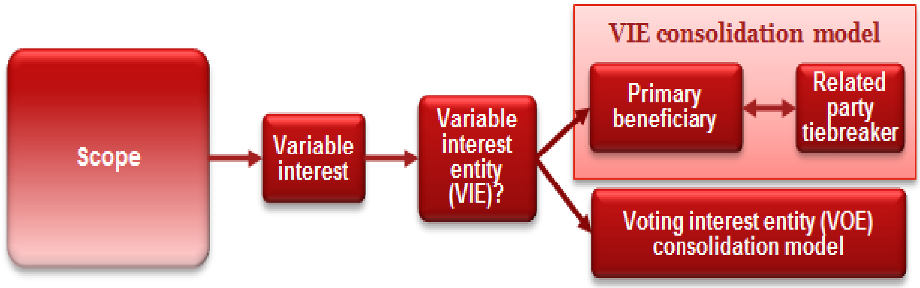
[3] ASU 2010-10, *Consolidation (Topic 810), Amendments for Certain Investment Funds*
[4] FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

Scope



Money market funds

.7 The ASU does not remove or amend any of the existing scope exceptions. It does, however, provide a new scope exception pertaining to certain money market funds. The consolidation guidance will no longer apply to money market funds registered with the SEC pursuant to Rule 2a-7 of the *Investment Company Act of 1940* (registered money market funds) and "similar" unregistered money market funds. This scope exception is responsive to concerns of financial statement users and preparers that the consolidation of money market funds by the asset manager does not result in decision-useful financial information.

.8 The scope exception applies to all reporting entities that hold interests in registered and similar unregistered money market funds, including investors, sponsors, asset managers, and any other interest holders. None of the interest holders will need to assess these funds for consolidation under any consolidation model (VIE or VOE). Reporting entities will be required to provide new disclosures about financial support (see paragraph .74 for further details).

PwC observation:

Once it has been determined that the scope exception applies, it will not be necessary to establish whether the investment advisor to the fund has a decision making fee that is a variable interest, since the VIE disclosure requirements would not apply. However, reporting entities involved with funds subject to this exception are required to provide certain disclosures irrespective of whether they have explicit variable interests. These disclosures are a subset of those required for reporting entities that have a variable interest in a VIE and are therefore considerably less onerous.

.9 During redeliberations, the Board acknowledged the challenge of amending the VIE model to create an outcome where a sponsor would not consolidate a registered money market fund. Specifically, financial support provided by the sponsor to prevent the fund from "breaking the buck" through, for example, the waiver of management fees and purchases of securities at prices in excess of fair value created unique challenges that could not be solved by amending the model. The Board ultimately determined that the most effective way of addressing stakeholder concerns without creating unintended consequences for other entities was to provide a scope exception.

.10 Unregistered money market funds that operate in a manner similar to registered money market funds are also subject to the scope exception. Determining whether an unregistered money market fund is similar to a registered money market fund will require judgment. Registered money market funds are required to invest in securities issued by entities with minimal credit risk with a short duration (considering individual securities and the average maturity of the portfolio). In addition, they are subject to constraints related to credit risk and diversification.

.11 The unregistered money market fund's purpose and design, as well as the risks it was designed to create and pass along to its interest holders, should be considered in assessing whether the fund operates in a manner similar to a registered money market fund. Specifically, the fund's portfolio quality, maturity, and diversification should be considered when making this determination. The structure and intended outcome of the fund may also be relevant factors to consider.

Exhibit 1: Points of focus when assessing whether an unregistered fund is similar to a registered money market fund

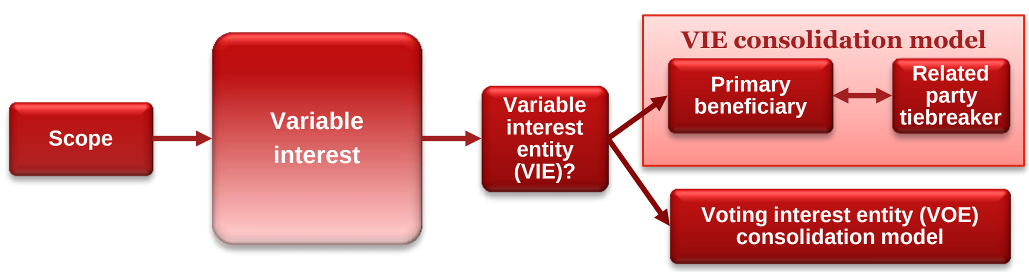
Characteristic	Description
Portfolio quality	Does the fund invest in high-quality, short-term securities with credit risk similar to those held by registered money market funds?
Portfolio maturity and diversification	Are the fund's objectives regarding (1) credit quality of its eligible investments, (2) the diversification of the portfolio, (3) maximum maturity of eligible investments, and (4) average maturity of the portfolio, consistent with the objectives of a registered money market fund?

PwC observation:

Unregistered money market funds that operate in a manner similar to registered money market funds are currently subject to the indefinite deferral. These unregistered money market funds may or may not be eligible for the scope exception. Sponsors of unregistered money market funds will need to evaluate and document their assessment of whether each of their unregistered funds is in fact similar to a registered money market fund based on the guidance contained in the ASU.

Variable interest determination

.12 The ASU also does not change the general approach for applying the VIE model. A reporting entity would first determine whether it holds a variable interest in the legal entity being evaluated for consolidation. If the reporting entity holds a variable interest, it must determine (a) whether the entity is a VIE, and (b) if the entity is a VIE, whether the reporting entity is the VIE's primary beneficiary. The reporting entity would perform the analysis of whether the entity is a VIE when it initially becomes involved with the entity and subsequently if one of the defined reconsideration events occurs. In contrast, the analysis of who is the primary beneficiary of the entity is an ongoing assessment.



.13 The ASU does not alter the definition of a variable interest. A variable interest continues to be defined as an economic arrangement that gives a reporting entity the right to the economic risks and/or rewards of another entity. Sometimes it may be obvious that the reporting entity has a variable interest, such as when it holds a debt or equity interest in an entity. In other cases, the nature of the interest (e.g., contracts) may require judgment to determine if a variable interest exists. Only those interests that absorb changes in the fair value of an entity's net assets are considered variable interests.

.14 When a legal entity's shareholders or governing body outsources all or certain decision-making over the entity's activities through a contractual arrangement, the decision maker or service provider must assess its fee arrangement to determine whether it qualifies as a variable interest. Currently, a decision maker fee arrangement is not a variable interest if all six criteria in ASC 810-10-55-37 are met. This determination requires judgment and should consider all relevant facts and circumstances.

.15 The ASU removes three of the six criteria that must be considered when determining whether a decision maker fee arrangement is a variable interest. If all three of the retained criteria, presented in Exhibit 2a, are met, the fee arrangement will not be a variable interest.

Exhibit 2a: Retained criteria to determine whether a fee paid to a decision maker or service provider is a variable interest (ASC 810-10-55-37)

Ref.	Criterion
A	The fees are compensation for services provided and are commensurate with the level of effort required to provide those services
C	The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns
D	The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length

.16 The three criteria removed by the ASU are listed below.

Exhibit 2b: Removed criteria to determine whether a fee paid to a decision maker or service provider is a variable interest (ASC 810-10-55-37)

Ref.	Criterion
B	Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the VIE that arise in the normal course of the VIE's activities, such as trade payables
E	The total amount of anticipated fees are insignificant relative to the total amount of the VIE's anticipated economic performance
F	The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE's anticipated economic performance

PwC observation:

It is expected that fewer fee arrangements will be considered variable interests under the ASU since the three criteria that have been removed have historically caused many decision maker fee arrangements to be variable interests. In particular, fee arrangements with a performance-based element that is *more than insignificant* (i.e., the fee's relative size and/or variability are *significant* to the entity) and/or where all or part of the fee is subordinated to other interests (i.e., paid after the entity's normal operating liabilities are settled) may no longer be variable interests under the ASU. If a reporting entity's decision maker fee arrangement no longer qualifies as a variable interest, and that reporting entity holds no other variable interests in the entity, it will not be required to further evaluate that entity for consolidation under the VIE model, or consider the applicability of the VIE disclosures. If a reporting entity's fee arrangement is not a variable interest, but it has other insignificant variable interest(s) in the entity, the reporting entity would still need to determine whether the entity is a VIE for disclosure purposes. Refer to PwC *Financial Statement Presentation Guide*, Chapter 18, for the disclosure requirements for reporting entities that have a variable interest in an unconsolidated VIE.

.17 As depicted in the Exhibit 2a above, the new analysis will continue to include the requirement that the decision maker fee arrangement is arms-length and contains customary terms and conditions ("at market" – see D in Exhibit 2a above) and represents compensation that is considered fair value for the services provided ("commensurate" – see A in Exhibit 2a above) to not be a variable interest. The ASU notes that the magnitude of the fee does not on its own mean that the fee arrangement is not at market or commensurate.

.18 To determine whether the fee arrangement is at market and commensurate, a reporting entity should consider external fee arrangements involving other third party decision makers for the same or similar services. However, the lack of any comparable arrangements does not necessarily mean that the fee arrangement is not at market or commensurate. For example, there may not be a comparable arrangement when the arrangement being assessed involves a new product or strategy, or a new service offering.

PwC observation:

The existence of comparable fee arrangements does not necessarily mean the fee arrangement is at market and commensurate. A fee arrangement that enables the decision maker to obtain substantially all of the residual returns of an entity is common in certain structures and likely would not be at market and commensurate. Examples of such arrangements include physician practice management entities, certain television/radio broadcasting structures, as well as entities in jurisdictions that restrict foreign equity ownership. The ASU includes a new example to illustrate this point.

.19 Other fee arrangements that expose the reporting entity to principal risk of loss are excluded from the at market and commensurate evaluation and would be considered variable interests. For example, fees for guarantees of an entity's outstanding debt or liquidity arrangements, for obligations to fund the entity's operating losses, or those relating to derivatives that absorb variability would still be considered variable interests. The FASB considered asset management fee arrangements to be different from other fee arrangements as the asset manager's downside exposure is limited to the risk that the fees collected will be less than expected (i.e., an opportunity cost). In contrast, a reporting entity is exposed to principal risk of loss when it could lose its existing investment or be required to fund losses of the entity or other investors.

.20 The ASU retains the criterion requiring consideration of the level of other economic interests held by the decision maker ("other economic interests" – see C in Exhibit 2a above). Holding other variable interest(s) in the entity that result in the decision maker absorbing more than an insignificant amount of variability would cause the decision maker fee arrangement to be a variable interest. In addition, certain related party interests will need to be considered in this assessment (see paragraph .23 below for further details). The assessment of whether the decision maker's collective other interests expose it to more than insignificant variability will continue to be both qualitative and quantitative, and require the exercise of judgment.

.21 If the decision maker does not hold other economic interests, directly or indirectly through its related parties, which absorb more than an *insignificant* amount of the entity's expected variability, and the fee arrangement is at market and commensurate, then the fee arrangement will not represent a variable interest.

PwC observation:

The reduction in the criteria reflects the FASB's belief that a decision maker with an at market and commensurate fee can still act in an agency capacity, notwithstanding the relative size or variability of its fee or the fact that its fee has subordination or residual-like characteristics.

By removing the three criteria that often caused a decision maker fee arrangement to be a variable interest (see Exhibit 2b), the ASU increases the focus on the determination of whether the fee is at market and commensurate. Historically, it was often clear that one of the other criteria was not met and, therefore, the arrangement was a variable interest.

Related party interests – the new "indirect" interest concept

.22 Today, for the purposes of assessing the "other economic interests" criterion, a decision maker includes all economic interests held by its related parties. Depending on whether the reporting entity is subject to the deferral, the interests of employees or employee benefit plans may be excluded. Including interests of employees and employee benefit plans, together with any other interests, often gives rise to these interests being more than insignificant.

.23 The ASU limits the extent to which related party interests are included in the other economic interest criterion to the decision maker's effective interest holding. A decision maker would need to have a direct economic interest in its related party, which in turn, has to have an economic interest in the entity being evaluated for consolidation. The decision maker would then include its effective share of that indirect economic interest as if it was held directly in the entity when applying this criterion. However, if the reporting entity and the related party are under common control, then the commonly controlled related party's entire economic interest should be attributed to the decision maker. In some cases, this may cause the decision maker's fee arrangement to be a variable interest.

PwC observation:

We believe the term “indirect interest” is intended to mean indirect *variable* interest. To have an indirect interest, a decision maker should have a direct variable interest in a related party that, in turn, has a direct and/or indirect variable interest in the entity being evaluated for consolidation. For example, a reporting entity with a fee arrangement with a related party that is not a variable interest would not need to consider any interests held through that fee arrangement as an indirect interest (assuming it holds no other variable interests in the related party). Our rationale is based on the notion that it would be counterintuitive for a fee arrangement with a related party that is not a variable interest to carry greater weight in the analysis than if that fee arrangement existed directly with the entity being evaluated for consolidation.

.24 To illustrate the concept, consider a decision maker that owns a 30% equity interest in a related party that in turn, holds a 60% equity investment in an entity. Further assume that the decision maker’s fee arrangement is at market and commensurate, and that the decision maker and its related party are not under common control. The decision maker would treat its effective 18% indirect equity interest in the entity (i.e., its 30% interest in the investee multiplied by the investee’s 60% interest in the entity) as if it were a direct variable interest when assessing the significance of other economic interests held by the decision maker. However, if the decision maker and the related party were under common control, then the decision maker would include the related party’s entire 60% interest in the analysis.

PwC observation:

Although this requirement may appear straightforward, this analysis will become more complex when the economic interests held deviate from “plain vanilla” common equity held by the decision maker in the related party, and/or by the related party in the entity being evaluated for consolidation. For example, the decision maker may hold a convertible preferred equity investment in the related party that in turn holds a debt investment in the entity being evaluated for consolidation.

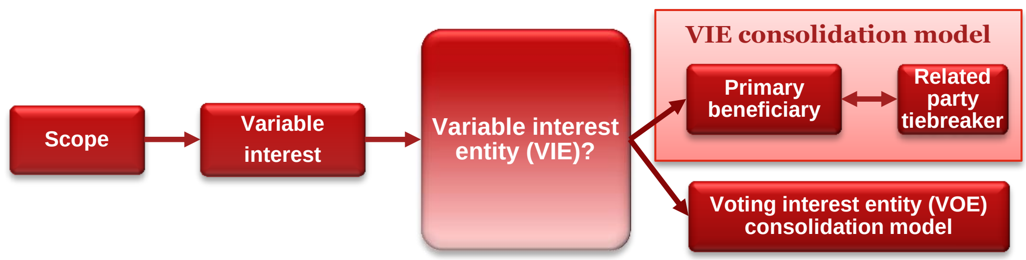
Companies will need to implement systems, processes, and controls to identify changes in the reporting entity’s indirect interests in VIEs. Changes to indirect interest percentages may be frequent for entities that have ongoing changes in investors and investment amounts. For example, a related party investor’s interest in a fund may change constantly as new investments are made or as interests are redeemed by third parties.

.25 A decision maker’s employees or employee benefit plans may hold variable interests in the entity being evaluated for consolidation. However, those interests would only be included in the indirect interest assessment if they are being used to circumvent the VIE guidance.

PwC observation:

When evaluating whether a decision maker has an indirect interest through its employees and employee benefit plans, the guidance does not specifically state that the portion of any interest financed by the decision maker should be considered as an indirect interest. This differs from the guidance prescribed in the primary beneficiary analysis which specifically indicates that a decision maker should include the effective portion of any employee interests that it has financed as an indirect interest (see paragraph .60). Although not explicit, we would generally expect the guidance in the primary beneficiary analysis to also apply when assessing whether a decision maker fee is a variable interest. Note that in its basis for conclusions to the ASU, the FASB does not draw a distinction between these two analyses.

Determining whether an entity is a variable interest entity



.26 The ASU retains the five main characteristics of a VIE described in ASC 810-10-15-14. As is the case today, if a reporting entity holds a variable interest in an entity that fails to qualify for one of the VIE scope exceptions described in ASC 810-10-15, then the reporting entity should determine whether that entity is a VIE.

.27 The ASU introduces a separate and different analysis specific to limited partnerships and similar entities (e.g., a limited liability company governed by a managing member as opposed to a board of directors). In addition, the ASU changes the manner in which a reporting entity that is not a limited partnership assesses whether the equity holders at risk lack decision making rights under ASC 810-10-15-14(b)(1).

Separate requirement for limited partnerships and similar entities

.28 The ASU introduces a new requirement to be applied only to limited partnerships and similar entities. This requirement was added based on the unique purpose and design of a limited partnership as compared to a corporation. Entities that are determined to be "similar" to limited partnerships would also be subject to this new requirement. For example, as noted above, some limited liability companies may be more like limited partnerships than corporations.

PwC observation:

Consistent with today's practice, judgment should be applied to determine if an entity should be evaluated as a corporation or as a limited partnership subject to the new requirement. Some limited partnerships are currently evaluated as corporations on the basis that they have a governance structure more akin to a corporation, such as when the general partner interest is vested in a board of directors elected by the investors.

Under the ASU, the determination of whether entities such as limited liability companies are similar to, or the functional equivalent of, limited partnerships will continue to focus on the entity's governance structure. In practice, limited liability companies that have a managing member and separate partner capital accounts are typically evaluated as limited partnerships.

.29 The ASU requires limited partners of a limited partnership, or the members of a limited liability company that is similar to a limited partnership, to have, at minimum, kick-out or participating rights to demonstrate that the partnership is a voting entity. Any of these rights, if present, are considered analogous to voting rights held by corporate shareholders that provide those shareholders with power over the entity being evaluated for consolidation. A limited partnership may be a VIE under one of the other characteristics even if these rights are present.

.30 The definition of kick out rights is amended by the ASU to include both removal and liquidation rights. Liquidation rights are now broadly defined as the ability to dissolve the entity.

.31 The kick-out rights must be substantive to demonstrate the partnership (or similar entity) is not a VIE. Kick-out rights will only be considered substantive if they are exercisable by a simple majority vote of the entity's limited partners (exclusive of the general partner, parties under common control with the general partner, and other parties acting on behalf of the general partner) or a lower threshold (i.e., as low as a single limited partner). The substance of kick-out rights granted to an entity's limited partners may be called into question when there are economic or operational barriers such as:

- Conditions that make it unlikely that the rights will be exercised
- The kick-out rights are subject to financial penalties or operational barriers to exercise
- There is an inadequate number of qualified replacements, or the level of compensation paid to the decision maker is inadequate to attract a qualified replacement
- No explicit mechanism exists, by matter of contract or law, that would allow the holder to exercise the rights or obtain the information necessary to exercise the rights

PwC observation:

Many limited partnerships require the general partner to make a substantive investment of more than 1% of total partnership capital. Under today's guidance, when a general partner contributes substantive equity, that general partner is grouped with the other investors to determine whether the equity investors as a group have decision making over the most significant activities. As a result, in these situations the limited partnership is typically a voting interest entity (assuming no other characteristics of a VIE are met), and would be evaluated for consolidation under ASC 810-20 (formerly, EITF 04-5). In contrast, the ASU disregards the level of equity provided by the general partner and instead focuses on the voting rights of the limited partners.

We expect this change to cause more partnerships to be considered VIEs, as limited partners often do not hold kick-out or participating rights.

.32 Substantive participating rights held by one or more of the limited partners would also demonstrate that the partnership is a voting entity. For this purpose, the ASU defines participating rights as rights to block or participate in significant financial and operating decisions that are made in the ordinary course of business, consistent with the definition in the VOE model. Additional guidance already exists for assessing whether these rights are substantive.

.33 Redemption rights held by the limited partners are not considered equivalent to kick-out or participation rights under the ASU. The ability of an individual investor to require a limited partnership to redeem its interest is not considered by the ASU to provide the holder with the ability to remove the decision maker or liquidate the partnership. During redeliberations, the FASB acknowledged that a scenario could exist where the exercise of a redemption right could lead to liquidation (e.g., when an entity has a single investor that holds a redemption right) although that scenario was believed to be rare.

.34 If a limited partnership is determined to be a variable interest entity and the general partner meets both the "power" and "economics" tests (see paragraph .52), then a single party kick-out or participating right over all of the entity's most significant activities would be needed for the general partner to avoid consolidation. That is, the right must be unilaterally exercisable and not exercisable solely by a simple majority of limited partners.

Assessing if equity holders at risk lack decision making rights for entities that are not limited partnerships or similar entities

.35 The ASU changes the evaluation of whether the equity holders at risk lack decision making rights when decision making is outsourced. In particular, the changes apply if there is a single decision maker that is subject to a contractual fee arrangement separate from (not embedded in) a substantive equity investment in the entity, and that arrangement conveys power to the decision maker to direct the activities that most significantly impact the economic performance of the entity.

.36 The change in how outsourced activities are to be assessed resulted from the FASB's consideration of whether a registered mutual fund that outsources decision making to a third party manager should be considered a VIE in the absence of single party kick-out or participating rights. The rights of shareholders and boards of mutual funds registered in accordance with the *Investment Company Act of 1940* ("the 1940 Act") convinced the Board that these entities should generally be considered voting interest entities. The Board determined that rights exercisable by a registered mutual fund's shareholders, either directly or through the entity's independent board of directors, are not substantively different from rights held by shareholders of a public company (which would generally not be a VIE).

.37 The new guidance shifts the focus to a fund's shareholder rights and, if substantive, considers these rights to effectively constrain the manager's level of discretion and decision-making authority. Thus, the new guidance concludes that the shareholders, rather than the manager, have the power to direct the fund's most significant activities if these rights are substantive.

.38 Although this concept was discussed in the context of a registered mutual fund, it applies to all entities that outsource decision making power. Entities would apply this approach only if they are not subject to the separate requirement for limited partnerships and similar entities.

.39 The new approach can be summarized in the following three steps.

Step 1 – Determine if the decision-maker's fee arrangement is a variable interest

.40 If the decision maker fee arrangement is not a variable interest, then the equity investors as a group would not lack the power to direct the activities of the entity that most significantly impact its economic performance. The nature of that arrangement would suggest the decision maker is acting as an agent and is therefore presumed to lack power over the entity's most significant activities. As a result, the entity would not be a VIE under this characteristic and steps two and three would not apply. See paragraphs .15–.25 for a discussion of how to determine if a fee arrangement is a variable interest.

PwC observation:

As fewer fee arrangements will be variable interests under the ASU, certain entities may no longer be VIEs, since the equity investors would not lack decision making power.

Step 2 – Assess the rights of shareholders

.41 The need to assess the rights of shareholders is a new step required by the ASU if the decision maker's fee arrangement is a variable interest. Under current guidance applicable to companies not subject to the deferral, the equity investment at risk is not considered to have decision making rights over the outsourced activities unless there is a single party that is able to unilaterally exercise a substantive kick out or participating right.

.42 The ASU requires that the reporting entity first consider the rights of the equity investment at risk before determining whether substantive single party kick out or participating rights exist. If the shareholders have substantive rights, then the entity would not be a VIE and step three would not apply.

.43 The ASU contains an example to illustrate some of the rights that may suggest the equity investment at risk has decision making power. The example is written in the context of a series mutual fund, and points to various shareholder rights as being present, including the ability to remove and replace the board members and the decision maker, and to vote on the decision maker's compensation. However, the basis for conclusions to the ASU notes that this concept is intended to be applied broadly to all entities.

PwC observation:

The FASB introduced this concept to differentiate between typical voting corporations (where the shareholders have rights over the most significant activities of an entity) and entities where shareholders have limited or no rights.

The example does not point to any particular right as being determinative since it will depend on the specific facts and circumstances. It will generally be the *aggregate* rights that provide the shareholders with the ability to exercise power over the entity. However, the inability of shareholders or the entity's board of directors to remove and replace the decision maker and approve its compensation will likely be determinative that the equity holders lack decision making under this step.

The rights listed in the example are not intended to be all-inclusive. As such, other rights may exist that should be considered when determining whether the equity holders lack the power to direct the activities of the entity that most significantly impact its economic performance.

.44 The existence of these shareholder rights alone does not indicate that an entity's shareholders have power. The reporting entity would also need to consider if these rights are substantive when determining if the entity's shareholders have power.

.45 The following example illustrates the application of this concept in a non-fund scenario.

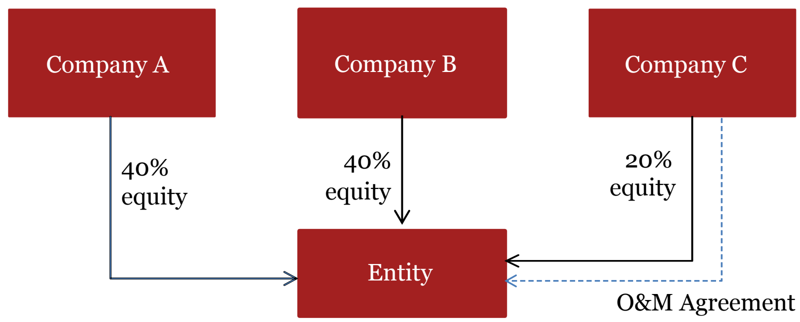
Example: Assessing shareholder rights

Three unrelated companies established an entity to invest in shipping vessels. Company A and B each provide 40 percent of the financing in exchange for equity interests and Company C provides the other 20 percent of equity financing. The entity operates subject to the supervision and authority of its board of directors. Each party has the ability to appoint members to the entity's board and shares in the entity's profits and losses in proportion to their respective ownership interests. The purpose, objective, and strategy of the entity is established at inception and agreed upon by the shareholders pursuant to the entity's formation agreements. The three companies identified and jointly agreed to the specified shipping vessels in which the entity would invest at formation.

A number of decisions require simple majority board approval. These include:

- The removal and replacement of the Operating and Maintenance (O&M) manager, without cause
- Changes in the O&M manager's compensation
- The acquisition of new ships
- The sale of existing ships
- A merger and/or reorganization of the entity
- The liquidation or dissolution of the entity
- Amendments to the entity's charter and by-laws
- Increasing the entity's authorized number of common shares
- Approval of the entity's periodic operating and capital budgets

Company C performs all of the daily operating and maintenance activities over the shipping vessels under an O&M agreement. The decisions relating to the operation and maintenance of the vessels are determined to be the activities that would most significantly impact the entity's economic performance. Company C receives a fixed annual fee for services provided to the entity that is at market and commensurate. However, the fee arrangement is determined to be a variable interest because Company C has another significant variable interest in the entity (equity financing).



Do the equity holders as a group lack decision making rights (is the entity a VIE)?

Analysis – current guidance

The entity would be a VIE as the equity holders would be deemed to lack decision making power to direct the entity's most significant activities. This is because the O&M agreement (the decision maker fee arrangement) is a variable interest, is not embedded in the equity of Company C, and no single equity holder is able to remove Company C as the O&M manager.

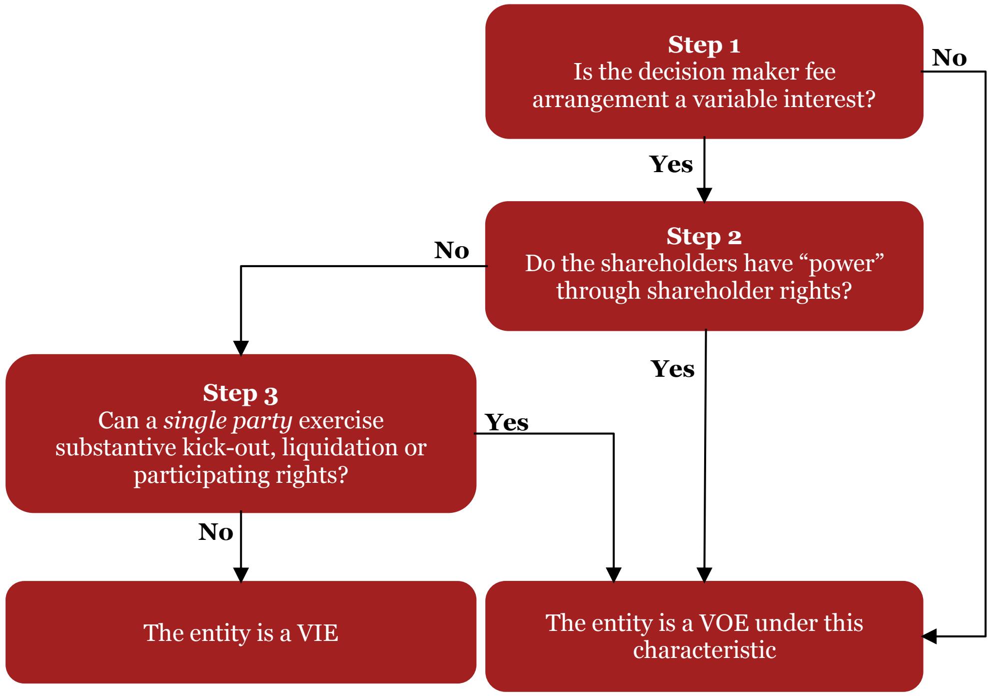
Analysis – amended guidance contained in the ASU

Under the ASU, the entity would not be a VIE despite the decision making fee arrangement being a variable interest. The board is actively involved in making decisions about the activities that most significantly impact the entity's economic performance. Among other rights, the board is able to remove the O&M manager without cause and approve its compensation. As the board is elected by the shareholders and is acting on their behalf, the shareholders in effect have power to direct the activities that most significantly impact the economic performance of the entity.

Step 3 – Determine if there is a unilateral kick out or participating right

.46 Finally, if the decision maker's fee arrangement is a variable interest under the first step, and the shareholders do not have certain rights as discussed in the second step (or such rights are not substantive), the reporting entity would need to determine if there is a single party that can exert substantive kick out or participating rights. Only if there is a single party with these rights would the entity not be a VIE under this characteristic. This step is consistent with current guidance applicable to companies not subject to the deferral.

.47 The decision tree for this characteristic applicable to entities that are not limited partnerships or similar entities can be illustrated as follows:



Series fund structures

.48 Series fund structures, which are common in the asset management industry, are structured with one umbrella legal entity that is typically a trust or corporation. Each series fund is represented by a separate share class of the trust/corporation and the proceeds from the issuance of the share class are invested in assets according to the strategy of the series fund. The trust/corporation is governed by a single board of directors that is responsible for overseeing the operations of each series fund. Many series funds are mutual funds registered in accordance with the 1940 Act.

.49 A question could be raised as to whether each individual series fund should be evaluated for consolidation as a separate legal entity, or instead, if the trust or corporation should first be evaluated. If the trust or corporation should be evaluated first, the determination of whether each series fund is a silo, subject to consolidation, would be required only if the trust/corporation is a VIE. The ASU includes an example that clarifies that each series fund that is a mutual fund subject to the 1940 Act should be treated as a separate legal entity. The rights of the entity's equity holders (series funds' shareholders), as opposed to the decision maker, are then considered to determine if the equity holders have the power to direct the entity's most significant activities (see the step discussed in paragraphs .41 – .45 for further information).

.50 The question of whether series funds are legal entities and VIEs is not new and there are differing views in practice today. However, because these series fund structures were subject to the indefinite deferral, the threshold for consolidation is generally the same (a majority) irrespective of whether they are viewed as VOEs or VIEs. By rescinding the deferral, these structures will potentially be subject to the "power" and "economics" consolidation model (see paragraph .52) for the first time. This model has a lower economic threshold for consolidation (potentially significant) and, therefore, this question becomes more important.

.51 The series fund example in the ASU includes specific factors that make 1940 Act series funds legal entities for purposes of the consolidation analysis. However, during Board redeliberations, the FASB staff noted that these factors are often not present in international series structures, and as a result, a different conclusion may be reached.

Exhibit 3: Factors noted as indicating that series mutual funds are legal entities

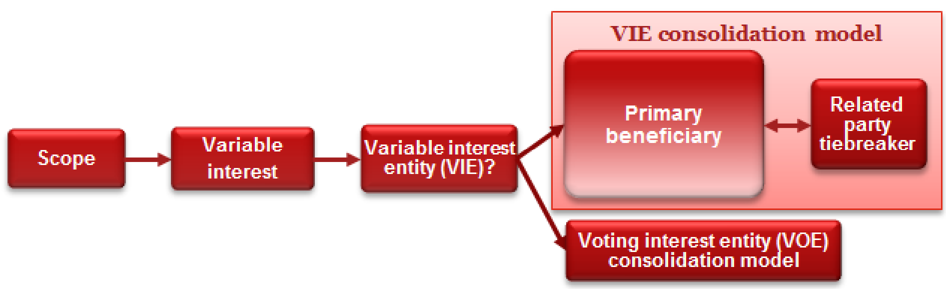
The fund has its own investment objectives and policies
The fund has its own custodial agreement
The fund has its own shareholders separate from other series funds
The fund has its own unique tax identification number
The fund files separate tax returns with the Internal Revenue Service
Separate audited financial statements are prepared for the fund
The fund is considered a separate investment company for investor protections in virtually all circumstances

PwC observation:

Asset managers expressed concern that by removing the deferral, the ASU would cause them to consolidate many series funds for a longer period than they do today after establishing a new fund and providing the initial seed capital. This is because the threshold for consolidating VIEs subject to the deferral (majority) will be lower upon adoption of the ASU (reduced to potentially significant). By concluding that each mutual series fund is a separate legal entity and focusing on each series' shareholder rights, the FASB expects that these funds will be considered VOEs. However, funds that continue to be VIEs on adoption of the ASU will be consolidated by asset managers for a longer period than today.

Variable interest entity model

Primary beneficiary determination



.52 A reporting entity with a variable interest in a VIE consolidates that VIE if it has both the power to direct activities that most significantly impact the economic performance of the entity ("power") and the right to receive potentially significant benefits or the obligation to absorb potentially significant losses ("economics").

.53 The ASU changes how the "economics" test is performed in two ways. First, the ASU reduces the circumstances when decision maker fees are included in the economics test. Second, the ASU changes the extent to which related party interests are considered in the test and also when related party relationships are considered in the VIE model.

Considering decision maker fee arrangements in the economics test

.54 The analysis to determine whether a reporting entity meets the economics test is not solely quantitative, but is also qualitative and should consider the VIE's purpose and design. Consequently, there is no bright line in today's guidance to indicate when a reporting entity's variable interests are potentially significant. In some cases, this analysis can be complex and highly judgmental.

PwC observation:

Upon adoption of the ASU, reporting entities will apply the "power" and "economics" VIE control model to entities that previously were subject to the deferral. Determining whether the economic interests are "potentially significant" is an area of significant judgment that is not probability-based; it considers all possible scenarios. During its redeliberations, the Board considered, but chose not to provide a new bright line that would indicate when economic interests are potentially significant.

.55 The ASU provides some relief to reporting entities applying the economics test. Under current GAAP, decision maker fees with a performance-based element would likely cause a decision maker with stated power to consolidate a VIE because the fee inuring to the decision maker could be potentially significant to the VIE. The ASU requires a decision maker to disregard the economics it absorbs through the fee arrangement when evaluating the economics test, provided the arrangement is at market and commensurate (see paragraph .15 for the definition of at market and commensurate).

PwC observation:

Under the ASU, the assessment of at market and commensurate is considered for the fee as a whole. Many fee arrangements include a fixed and a performance fee element. If the total fee is not at market and commensurate, then the entire fee should be included in the economics test. It would not be appropriate to only include that portion of the fee determined to be off-market or not commensurate.

.56 Although a decision maker's exposure to a VIE's economics through a fee arrangement will be disregarded if the arrangement is at market and commensurate, other variable interests held by the decision maker should be considered when applying the economics test. In addition, as discussed in paragraph .19, fees that expose a decision maker to a principal risk of loss would not be subject to the at market and commensurate assessment and would also be included in the economics test.

PwC observation:

The relief for at market and commensurate fees will not be helpful in the economics test if a decision maker's fee arrangement is considered a variable interest because this conclusion will likely stem from the fact that the decision maker holds other variable interest that are more than insignificant. The existence of a more than insignificant variable interest would generally be considered "potentially significant" under the economics test.

Certain funds that continue to be VIEs may now need to be consolidated by their asset manager due to the existence of other economic interests held by the manager. Entities subject to the deferral would have been consolidated by a party under the VIE model that either (1) absorbs a majority of the entity's expected losses or residual returns, or (2) was deemed the "most closely associated" under the related party tiebreaker test. Because the economic threshold (potentially significant) is lower in the "power" and "economics" VIE model, some funds that are determined to be VIEs may need to be consolidated despite the ability to exclude the asset manager's fee from the economics test.

.57 The ASU does not distinguish between the form of a decision maker's compensation (e.g., cash compensation or equity). A decision maker may receive an equity allocation based on performance of the entity, typically referred to as a "carried interest." Carried interests are commonly used in the alternative asset management industry, including for hedge funds and private equity funds.

PwC observation:

A question arises about whether a carried interest should be included in the economics test. Oftentimes that interest is subject to future reversal if performance of the entity declines. Until such time as that interest is no longer subject to reversal (i.e., the fee is crystallized), we believe that it should be excluded from the economics test. However, once the interest is no longer subject to reversal, it would be included in the economics test on the basis that it is no different from a direct equity investment made by the decision maker. The carried interest does not crystallize at the same times for all asset managers. Assuming it is determined to have power, an asset manager that continually reinvests its crystallized fee in a fund would need to consolidate that fund at the point when its cumulative interests meet the economics test threshold (i.e., becomes potentially significant).

Considering related party interests in the economics test – the new "indirect" interest concept

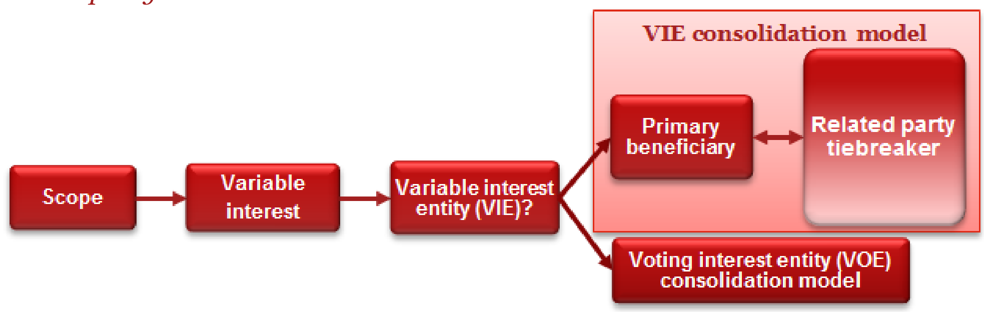
.58 Under current guidance, a reporting entity first performs the power and economics tests on a standalone basis. Only if the reporting entity does not meet both tests on a standalone basis does the reporting entity consider related parties in the analysis. At that time, the entire variable interest held by the reporting entity and its related parties are considered in determining if the related party group collectively meets the power and economics tests.

.59 The ASU changes the order in which related party interests are considered, and also the extent to which they are considered in many instances when the power test is met by a single party. The ASU brings forward the consideration of related party interests when analyzing whether the reporting entity with power meets the economics test on a stand-alone basis. Note, however, that the manner in which related parties are considered remains unchanged when the power test is not met by a single party (i.e., if power is shared).

.60 Under the ASU, the reporting entity that meets the power test will includes its indirect interests in the VIE together with its own direct interests when determining whether it meets the economics test on a standalone basis. An indirect interest exists when the reporting entity has a direct economic interest in a related party that in turn holds an economic interest in the VIE. Consistent with the analysis for whether a decision maker fee arrangement is a variable interest, the indirect interest represents the reporting entity's effective economic interest in the entity through its direct investment in the related party (see paragraph .24 for an example of how to calculate the indirect interest). Consistent with that analysis, when the indirect interest is held by an affiliate under common control, the full economic interest of the affiliate should be included. In addition, if the decision maker financed any portion of an employee's interest, it would need to determine and include its effective economic interest in the entity through that financing.

.61 Related parties to be considered in this context include those defined in ASC 850, *Related Party Disclosures*, as well as parties deemed to be "de facto agents" under the VIE guidance (ASC 810-10-25-43).

Related party tie-breaker



.62 Under current guidance, if a reporting entity does not meet both the power and economics tests on a standalone basis, it would need to consider whether, together with its related parties, the group collectively meets both tests. If the related party group has both characteristics of a primary beneficiary, the "related party tiebreaker" test is performed to identify the variable interest holder within that related party group that is "most closely associated" with the entity. The party most closely associated with the VIE would be the one to consolidate it.

.63 As discussed in paragraph .60, the ASU introduces the indirect interest concept that effectively accelerates the consideration of related party interests by incorporating them into the reporting entity's assessment of whether it is the primary beneficiary on a standalone basis in situations where the power test is met by a single party. However, consistent with current practice, all variable interests must be considered when assessing whether the related party group has the characteristics of a primary beneficiary.

.64 The ASU limits application of the related party tiebreaker test to the following two circumstances:

(1) If no single party in the related party group has unilateral power (i.e., power is shared), then the related party tiebreaker should be applied to identify the related party that consolidates the entity.

(2) If a single party in the related party group has unilateral power, and the related party group is under common control, then the related party tiebreaker should be applied to identify the related party within the common control group that consolidates the entity.

PwC observation:

The FASB retained the notion that a VIE should be consolidated at an intermediate level (i.e., sister company level) in common control situations by requiring application of the related party tiebreaker. This is due to the discretionary or arbitrary manner in which an ultimate parent could shift interests within a related party group to avoid consolidation at the lower level. Under the voting model, consolidation is generally not required at an intermediate level if that reporting entity lacks a controlling financial interest in the investee on a standalone basis.

.65 The FASB made the changes discussed in paragraph .64 to reduce the application of the related party tiebreaker in response to constituent feedback that the tiebreaker test is applied in too many fact patterns and sometimes requires consolidation that results in less decision-useful financial reporting. In addition, requiring the application of the tiebreaker test after a reporting entity had already considered indirect interests held through related parties would in effect subject the reporting entity to two related party tests.

PwC observation:

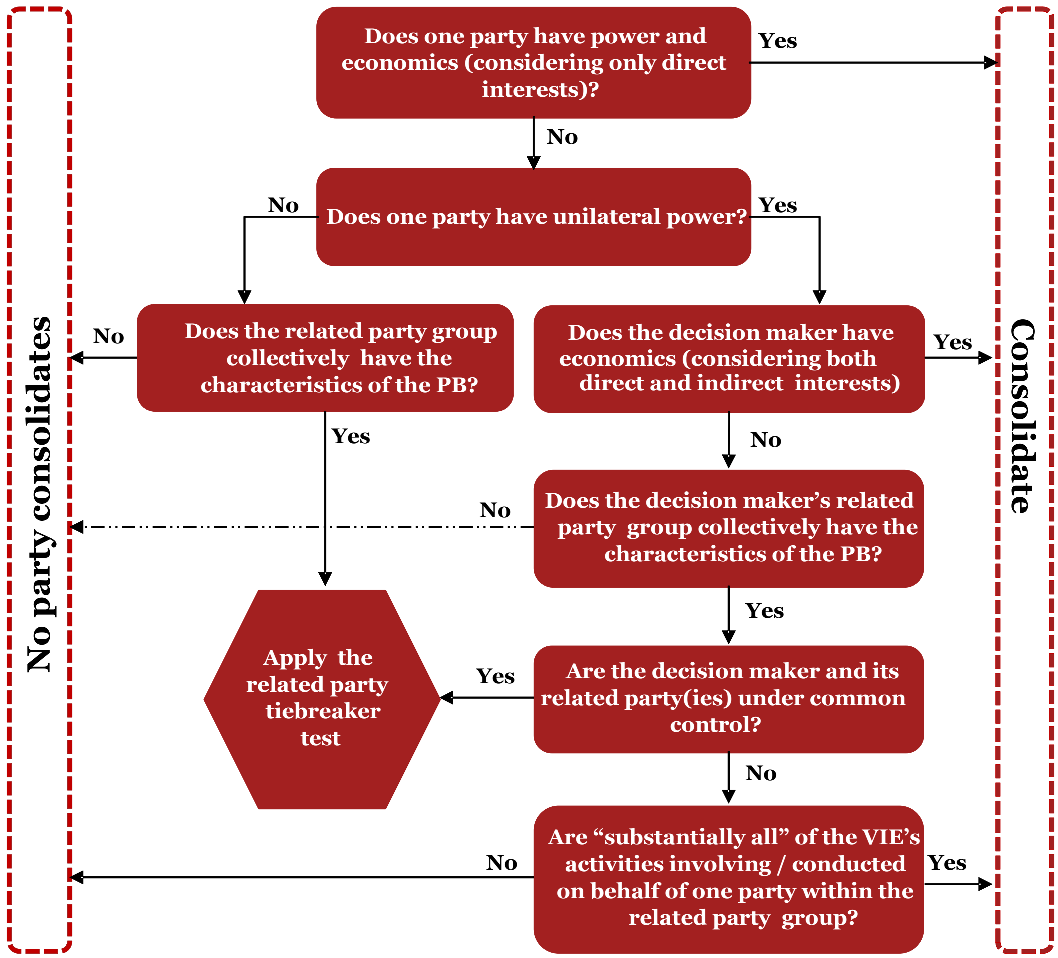
Some may question when, if ever, the related party tiebreaker would apply in common control situations where a single party has power. The ASU requires a decision maker with unilateral power to consider its indirect interests held through related parties when applying the economics test. A decision maker must have a direct variable interest in a related party that has a variable interest in the VIE for that relationship to represent an indirect interest. Therefore, a decision maker would not consider a commonly controlled related party's variable interest(s) in the VIE absent a direct variable interest in the related party when determining if the decision maker is the VIE's standalone primary beneficiary.

If the decision maker does not individually meet both characteristics of a primary beneficiary, the related party group must be evaluated to assess whether it meets the economics test. In that circumstance, all variable interests held by the related party group must be considered. If the related party group meets the primary beneficiary test, the related party tie breaker would be required to determine which party within the commonly controlled related party group must consolidate the VIE. The related party tiebreaker analysis requires judgment and a consideration of various factors, and therefore it is possible to conclude that the affiliate, and not the decision maker, would consolidate.

.66 If a single party within a related party group has unilateral power and the related party group is not under common control, the related party tiebreaker would not apply. However, the ASU requires that if "substantially all" of the VIE's activities involve or are conducted on behalf of any party within the related party group, then that party is required to consolidate the VIE. This requirement is intended to prevent abuse (i.e., "vote parking" arrangements) where the decision maker's level of economics is not consistent with its stated power. This assessment (which is intended to be consistent with the assessment of whether an entity is a VIE because the equity investment at risk has non-substantive voting) is qualitative and should consider all relevant facts and circumstances.

.67 The ASU specifically exempts investors in low income housing tax credit (LIHTC) partnerships from having to assess whether they benefit from "substantially all" of the entity's activities. The FASB was concerned that investors would be required to consolidate these partnerships despite not meeting the power test when they hold substantially all of the limited partner interests. This outcome would undermine the recent ASU[5] enabling investors in qualified affordable housing projects to apply the proportionate amortization method (see Dataline 2014-02, *Accounting for investments in qualified affordable housing projects,* for further information).

.68 The analysis to be applied for related parties can be illustrated as follows:

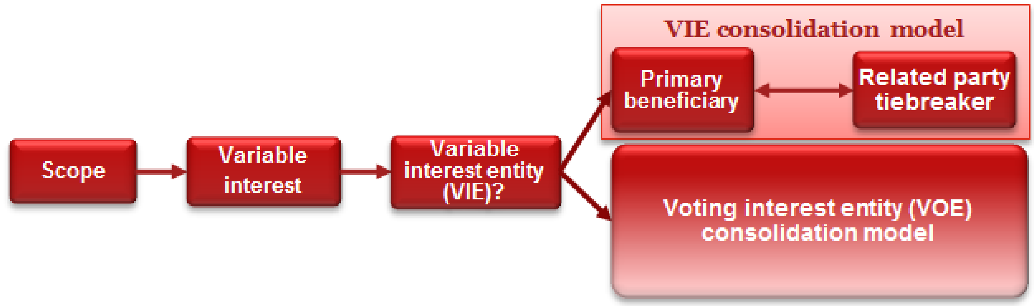


PwC observation:

Situations where the related party tiebreaker has been applied under current guidance should be evaluated carefully when there is a single party that meets the power test. It is possible that the new circumstances in which the tiebreaker is applied and the introduction of the new indirect interest concept could lead to different consolidation outcomes in certain fact patterns.

[5] ASU 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*

Voting interest model



Creation of a single voting interest model for all entities

.69 The ASU creates a single model for all voting interest entities regardless of the entity's legal form of governance structure. This single VOE model will focus on relative voting rights and consider other rights that enable a noncontrolling equity investor to participate in an entity's ordinary course operating and/or financial decisions. Such voting rights may be in the form of kick-out or participating rights. In the absence of such rights, a majority investor would be expected to control an entity unilaterally and consolidate the entity under the voting model.

.70 In creating a single model, the ASU removes the voting model specific to limited partnerships and similar entities (ASC 810-20, formerly EITF 04-5). That guidance is effectively incorporated into the VIE determination in assessing whether the equity investment at risk has decision making rights (see paragraphs .28 – .33). In addition, the rebuttable presumption that a general partner unilaterally controls a limited partnership under the VOE model has been eliminated.

.71 The ASU also clarifies that a single investor's ability to exercise a kick-out right (for example, a limited partner that holds the majority of the kick out rights) may convey unilateral control to the holder in the voting model, assuming another limited partner does not hold a substantive participating right. Accordingly, the investor with the kick-out right may be required to consolidate the entity under the revised voting model. This represents a change in current practice as the holder of a single party kick-out right typically accounts for its interest in a partnership that is a VOE using the equity method of accounting, as opposed to consolidation.

PwC observation:

The changes will, in effect, mean that a general partner will not consolidate a limited partnership under the VOE model due to the existence of substantive kick out or participating rights.

In addition, unlike a single party kick out right, the ability to unilaterally exercise a participating right would not give a limited partner control, absent any other rights. Participating rights do not convey power, but only prevent the party with power from exercising that power (i.e., they provide the holder with the ability to veto decisions made in the ordinary course of business as oppose to directing such decisions).

Proportionate consolidation

.72 Only investors in unincorporated entities that are in the extractive industry (for example, oil and gas exploration and production) and the construction industry may apply proportionate consolidation instead of the equity method of accounting.

Proportionate consolidation requires the investor to reflect its pro rata share of assets, liabilities, revenues, and expenses of the investee on a gross basis. Although the separate consolidation model for limited partnerships and similar entities that are VOEs is being removed by the ASU, the previous exception in that model is being retained. Accordingly, a general partner may continue to apply the proportionate consolidation method rather than consolidating the entity and reflecting a noncontrolling interest.

Disclosures

.73 The ASU does not amend the existing disclosure requirements for VIEs or VOEs. During redeliberations, some Board members acknowledged the concerns of some stakeholders that the current disclosures pertaining to VIEs may at times be excessive and not helpful to financial statement users. However, the reconsideration of the current disclosures for VIEs was outside the scope of this project.

.74 The ASU does, however, require new disclosures for reporting entities that have explicit arrangements to provide financial support to money market funds. In addition, reporting entities would have to provide disclosures if they have provided any financial support during any of the income statement periods included in the financial statements. The following represent examples of sources of support noted in the ASU that would require disclosure in a reporting entity's footnotes:

- Capital contributions to the money market fund
- Standby letters of credit
- Guarantees of principal and interest
- Agreements to purchased troubled securities at amortized cost
- Waiver of fees, including management fees

PwC observation:

The sponsor of a money market fund may waive a portion of its management fee solely to enhance the fund's performance relative to its peer group. We believe the disclosure requirements for sponsors of money market funds apply when the sponsor has provided any form of support, including those described above, regardless of its purpose or intent. These disclosures should not be limited to situations where support provided by the sponsor was necessary to prevent the fund from "breaking the buck." Other requirements under the money market rules and investment company guidance may already result in similar disclosures.

Effective date and transition

.75 The ASU will be effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2015. Nonpublic business entities will need to apply the standard for annual periods beginning after December 15, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted.

.76 Reporting entities will be able to early adopt the changes in any interim reporting period and are required to apply the changes on a modified retrospective or on a full retrospective basis. If a reporting entity adopts the ASU during an interim period on a modified retrospective basis, it would be required to reflect any adjustments as of the beginning of the annual period of adoption. If a reporting entity adopts the ASU on a full retrospective basis, it would be required to reflect any adjustments as of the beginning of the earliest comparative period presented.

PwC observation:

Companies seeking to early adopt the ASU should not underestimate the work needed to update their analyses, and the related changes that may be needed to systems and controls. In addition, associated internal controls may need to be evaluated and tested.

.77 The transition guidance is intended to be broadly consistent with those contained in ASU 2009-17, summarized as follows:

- For entities that will be consolidated for the first time due to the application of the ASU, assets and liabilities should be recognized as of the date of adoption based on what the carrying amounts would have been had this guidance always been applied. If it is not practical to determine the carrying amounts of individual assets and liabilities of the entity, then the fair value as of the date of adoption can be used. In addition, reporting entities can elect the fair value option on an entity by entity basis provided that the fair value option is applied to all eligible assets and liabilities of that entity.

- For entities that will be deconsolidated upon adoption of the ASU, the carrying amount of any retained interests should be determined based on what they would have been had this guidance always been applied. If it is not practical to determine the carrying amount of the retained interest in the entity, then the fair value of the retained interest as of the date of adoption can be used.

- Any difference between the net amount of the assets and liabilities of the entities that are added to, or subtracted from, the reporting entity's balance sheet and the previously held or retained interest, should be recognized as a cumulative-effect adjustment to retained earnings.

PwC observation:

As reporting entities enter into new transactions prior to adoption of the ASU, they should consider the consolidation conclusions under the new guidance.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

Authored by:

John Bishop
Partner
Phone: 1-973-236-4420
Email: john.bishop@us.pwc.com

Chris May
Partner
Phone: 1-973-236-5729
Email: christopher.r.may@us.pwc.com

Lee Vanderpool
Director
Phone: 1-973-236-5129
Email: lee.vanderpool@us.pwc.com

Lucy Lillycrop
Partner
Phone: 1-973-236-4294
Email: lucy.lillycrop@us.pwc.com

Craig Cooke
Director
Phone: 1-973-236-4705
Email: craig.cooke@us.pwc.com

In depth
A look at current financial reporting issues

pwc

Revenue from contracts with customers

The standard is final – A comprehensive look at the new revenue model

US2014-01 (supplement)
September 8, 2014

What's inside:

Real estate industry supplement

At a glance

On May 28, the FASB and IASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices.

In depth US2014-01 is a comprehensive analysis of the new revenue standard. This supplement highlights some of the areas that could create the most significant challenges for U.S. GAAP reporters in the real estate industry as they transition to the new standard.

Overview

The new revenue standard will supersede existing revenue recognition guidance; however, certain types of contracts will be scoped out of the revenue standard. Most significantly for real estate, leasing transactions are not within the scope of the new standard. Accounting for leasing transactions is being addressed by a separate standard-setting project that is currently underway.

The new revenue standard is effective for public entities that are U.S. GAAP reporters for the first interim period within annual reporting periods beginning after December 15, 2016 (nonpublic companies have an additional year to adopt). The standard prohibits early adoption for public entities that are U.S. GAAP reporters, but does allow nonpublic companies to adopt the standard using the public company effective date.

This publication focuses on how the standard will affect certain revenue arrangements for real estate companies applying U.S. GAAP. The examples and related discussions are intended to provide areas of focus to assist entities in evaluating the implications of the new standard. The views expressed in this publication are preliminary and may change as interpretations of the guidance evolve.

This publication will predominantly address sales of real estate, real estate asset management considerations, and property management arrangements. Appendix A to this publication provides examples of common real estate transactions and the implications of the new revenue standard as compared to existing U.S. GAAP. Appendix B to this publication provides a detailed example illustrating the practical application of the new revenue standard for a "vertically integrated" homebuilder.

Scope

The new revenue standard will apply to sales of real estate assets to customers, such as sales by homebuilders, merchant builders, land developers, condominium sellers, and timeshare sellers. Sales of real estate that constitute a business, when those sales are made to customers, will also be in the scope of the new standard. The new standard will also apply to property management fees, construction or development fees, leasing commissions, and other types of fees commonly present in real estate arrangements.

Sales of property, plant, and equipment, operating property, and investment property are generally not considered "revenue from contracts with customers" or an output of an entity's ordinary activities. For the transfer of nonfinancial assets that are not an output of an entity's ordinary activities (e.g., sale of real estate to a non-customer), the FASB amended ASC 360-20, *Real Estate Sales,* and requires companies to apply other standards, as described below.

If the real estate is being sold to a non-customer and constitutes a business, the guidance in ASC 810, *Consolidation*, applies. For sales of nonfinancial assets to non-customers, the FASB created ASC 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*, which requires entities to apply the guidance from the new revenue standard on the following topics: (a) existence of a contract – to determine when the seller has a contract that creates enforceable rights and obligations; (b) control – to determine when to derecognize the asset; and (c) measurement – to determine the amount of gain or loss to recognize when the asset is derecognized (including any constraints on the transaction price when the consideration is variable).

If derecognition treatment is appropriate (e.g., the seller has transferred control of a business under ASC 810-10 or the seller transferred control of an asset under ASC 610-20), these transactions generally result in a non-operating gain or loss rather than revenue.

Homebuilders, land developers, merchant builders, condominium sellers, and timeshare sellers are expected to be the most affected by the new standard. For these entities, when a performance obligation is satisfied subsequent to a sale to a customer, timing of both revenue and costs may differ from current accounting. Examples include amenities (such as pools, clubhouses, and golf courses), infrastructure, and offsite elements completed after delivery of a portion of the property to customers.

The standard may also affect entities in other industries that enter into real estate transactions. Examples include sales of manufacturing facilities, sales of real estate (e.g., other real estate owned or "OREO"), sales by banks, sales of plants in the power and utility industry, and store carve-outs and divestitures in the retail and consumer industry. The type of real estate sales these transactions represent (e.g., sale of a business or an asset to a customer or non-customer) will dictate which accounting guidance is applicable.

PwC observation:

The new standard could significantly change the timing of revenue recognition for many arrangements. As a result, the standard may require management to perform a comprehensive review of existing contracts, business models, company practices, and accounting policies.

The standard also has broad implications for an entity's processes and controls. Management may need to change existing IT systems and internal controls to capture different information than needed in the past. The impact could extend to other functions such as treasury, tax, and human resources. For example, changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and key financial ratios.

Changes to financial reporting without changes to tax requirements may necessitate complex tracking of book/tax differences for tax return and deferred tax provision purposes.

Overview of the revenue model

The boards believe a single, comprehensive revenue recognition model for all contracts with customers will lead to greater consistency in the recognition and presentation of revenue and will improve comparability within industries, across industries, and across capital markets.

The standard contains principles that an entity will apply to determine the amount and timing of revenue recognition. The core principle is that an entity recognizes revenue as it transfers goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services.

The five-step approach to revenue recognition

Step 1: Identify the contract(s) with the customer
In many situations, identifying a contract with a customer is one of the easier aspects of the model to apply. However, for sales of real estate, this step may be critical as the appropriate derecognition model will depend primarily on whether there is a sale of an asset or a business to a customer or a non-customer.

Step 2: Identify the performance obligations in the contract
A performance obligation is a promise (whether explicit or implicit) in a contract with a customer to transfer a distinct good or service (or bundle of goods or services) to the customer. A good or service is distinct if (a) 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 and (b) the good or service is distinct in the context of the contract.

Step 3: Determine the transaction price
The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring goods or services, excluding amounts collected on behalf of third parties. Variable consideration, significant financing components, noncash consideration, and consideration payable to a customer can all affect the transaction price.

Step 4: Allocate the transaction price to the performance obligations
The standard generally requires an entity to allocate the transaction price to the separate performance obligations based on their relative standalone selling prices. Standalone selling price is generally the observable price of a good or service sold separately by the entity; however, there could be a number of instances where the standalone selling price is not observable and must be estimated. Entities may utilize a residual approach to estimate the standalone selling price of a good or service, but only if the selling price is highly variable or uncertain. This will often require real estate entities to make estimates of the standalone selling prices for services they do not sell on a standalone basis, which could require judgment.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied
An entity will recognize revenue when (or as) it satisfies a performance obligation by transferring control of a promised good or service to a customer. Performance obligations can either be satisfied at a point in time or satisfied over time.

Sales of real estate

The new revenue standard will apply to transfers of a nonfinancial asset to a customer (either a business or an asset). Transfers of a nonfinancial asset (that does not constitute a business) that is not an output of an entity's ordinary activities is within the scope of ASC 610-20, which incorporates aspects of the guidance in the new revenue standard. This decision was made in response to concerns raised regarding sales of real estate, but it could have broader implications. Derecognition or timing of income recognition might differ depending on the guidance applied.

The nature of sales of real estate will need to be evaluated to determine if they are sales of assets or businesses, and whether those sales are to customers or non-customers. Significant judgment will be required to determine if the sale of real estate constitutes an asset or a business. Under U.S. GAAP, substantially all sales of rental real estate (with leases in place) may be considered sales of businesses to non-customers.

The appropriate revenue recognition model to apply depends on which sales scenario exists, as illustrated in the table below.

Scenario	Revenue recognition model
Scenario 1: Sales of real estate to customers Sales of real estate (businesses and assets) to customers in the ordinary course of business (e.g., timeshares, condominiums, homebuilding, etc.)	Apply the new revenue standard to the entire transaction.
Scenario 2: Sales of real estate (asset sales) to non-customers Sales of real estate outside of the ordinary course of business (non-customers) that does not constitute a business (e.g., sale of vacant building or empty land lot)	Apply ASC 610-20, which requires entities to apply certain aspects of the new revenue standard to determine: 1. if an enforceable contract exists, 2. if control of the asset has transferred to the buyer, and 3. the amount of gain or loss to recognize when the asset is derecognized, considering any constraint on income due to variable consideration.
Scenario 3: Sales of real estate (businesses) to non-customers Sales of real estate that constitute a business	Refer to the derecognition model in the consolidation guidance (ASC 810), which has been modified to no longer scope out sales of real estate. This guidance also refers to ASC 610-20, which incorporates aspects of the new revenue standard, as described above for "Scenario 2."
Scenario 4: Partial sale of real estate Sales of real estate (businesses and assets) to a joint venture to be accounted for as an equity method investment (e.g., seller retains interest but does not control the joint venture)	The appropriate accounting model to apply to the partial sale will depend on whether the transaction is a partial sale of a business or asset. The derecognition model in the consolidation guidance (ASC 810) or the partial sale model in the nonmonetary transaction guidance (ASC 845) may need to be considered. Determining the appropriate gain recognition and accounting treatment of the retained interest will depend on which model is applied.

Note: Refer to Appendix A for discussion of the accounting considerations relevant to certain real estate sales scenarios outlined in the table above.

The current real estate sales guidance in U.S. GAAP was largely written in the 1970s to address perceived financial reporting abuses in the real estate sector. It is viewed by many in the industry as a rigid, rules-based approach; therefore, some may welcome the changes resulting from the new revenue standard. The current guidance has two primary objectives: (a) the appropriateness of derecognition, which is assessed by evaluating whether a sale has been consummated for accounting purposes (this is not necessarily based solely on whether a legal sale has occurred); and (b) measurement of profit.

Under current U.S. GAAP guidance, sales of real estate are assessed to determine whether "risk and rewards" have transferred, including consideration of any continuing involvement by the seller. These rules are complex, and often a sale is not recognized or a large amount of profit is deferred based on the maximum exposure to loss (rather than the expected exposure). Many view the maximum exposure to loss concepts in the existing guidance to be inconsistent with revenue models applied in other industries.

Today, if a sale of real estate meets the criteria for sale accounting, the transaction is evaluated for "full accrual" profit recognition (which allows for full profit recognition upon sale). Typically, the most significant factor impacting profit recognition is whether there is sufficient initial and continuing investment. A sale may be recorded under the deposit method (no sale recognized), installment method, cost recovery method, or reduced profit method if the investment is not sufficient. Over time, a transaction may migrate (usually with incremental investment from the buyer, such as principal payments on seller financing) from one method to another and ultimately, to the full accrual method. Further, certain types of continuing involvement may require reduction in the amount of profit recognized (under the appropriate method) until the continued involvement is eliminated or expires on a maximum-exposure-to-loss basis (potentially deferring all the profit if the exposure is not capped).

Sales of real estate may be recognized earlier under the new standard as it eliminates these prescriptive requirements. Collectibility, contract enforceability, and transfer of control will be the key factors in determining whether to recognize revenue under the new standard.

While most forms of continuing involvement today may not prevent derecognition under the new standard, these factors can call into question whether control of the asset has transferred. Certain terms in a transaction (such as significant seller financing) may also call into question whether an entity has a contract with a customer that is in the scope of the standard. Common terms that could prevent derecognition of a real estate asset include repurchase rights or obligations. Appendix A to this publication provides examples of common forms of continuing involvement and their implications under current guidance and the new standard.

PwC observation:

In recent years, the Emerging Issues Task Force (EITF) has addressed perceived conflicts between the real estate sale guidance (ASC 360) and consolidation guidance (ASC 810). Specifically, these decisions addressed partial sales of real estate and the potential deconsolidation of in-substance real estate entities when a default on nonrecourse debt exists. In each of these instances, the EITF concluded that the real estate sale guidance should prevail.

In the new revenue recognition standard, the board reversed these historical positions of the EITF to conclude that sales of real estate to non-customers that meet the definition of a business, should be subject to the derecognition rules in ASC 810 (formerly FAS 160), which will likely result in transactions achieving derecognition earlier than under the existing guidance.

Sales of real estate to customers

The scope of the new standard specifically includes sales of real estate, whether a business or an asset, to customers. This may include sales by homebuilders, land developers, merchant builders, condominium sellers, and timeshare sellers.

Under the new standard, a performance obligation can be explicit or arise in other ways. Legal or statutory requirements can create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as an entity's practice of providing customer support, might also create performance obligations.

The new standard will significantly affect the accounting for sales of real estate in situations where certain performance obligations are satisfied after the legal sale of the assets. Such performance obligations could be explicitly defined in the contract (e.g., an "amenity" such as a pool or clubhouse) or implicitly required by the builder in order to get zoning for the subdivision and sale (e.g., roads, infrastructure, schools, firehouse, street lights, etc.).

Homebuilders, land developers, and merchant builders construct assets (that they own during construction) for sale to customers upon completion of construction. Therefore, these arrangements are fundamentally different than those in the construction industry where the entity is constructing an asset on behalf of the owner and the entity does not own or control the asset during construction.

Management will need to assess whether these transactions meet the criteria for performance obligations satisfied over time. The new standard states that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met: (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs; (b) the entity's performance creates or enhances an asset (e.g., work in process) that the customer controls; or (c) 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. If none of these criteria are met, an entity satisfies the performance obligation at a point in time.

It will be important for all entities to assess and make a determination as to which pattern of revenue recognition (point in time versus over time) is applicable.

Sales by homebuilders

Under current guidance, there is frequently only one sale recognition point for real estate transactions even in cases where some costs will be incurred at a later date (e.g., amenities). Current real estate guidance requires a "cost accrual" model relating to these sales transactions under ASC 970-340-25-9 and 25-10 (formerly FAS 67). For example, a homebuilder may sell an individual home before completing roads, amenities, or offsite costs (e.g., schools, firehouses, stop lights) for which it is committed pursuant to the contract with the customer. Today, upon each sale, the homebuilder accrues a liability for the unit's pro-rata portion of future costs and includes this amount in the cost of sale at the time the sale is recorded, even though these costs have not yet been incurred. In some jurisdictions, amenity work may be performed and paid for under a separate contract with a government authority rather than with the customer, in which case this issue might not apply.

However, under the new revenue standard, there may be multiple performance obligations that could result in different timing of revenue recognition for portions of the transaction price for the same unit. Refer to Appendix B of this publication for a detailed example of the impact of the new standard on a sale by a homebuilder.

PwC observation:

The nature of an entity's operations may significantly affect how revenue is recognized. The issue discussed above is relevant for "vertically integrated" homebuilders that are also responsible for land development. A homebuilder that buys finished lots and is solely responsible for the delivery of the home may reach different accounting conclusions.

Sales of timeshares and condominiums

Today, certain types of real estate sales (such as sales of timeshares or condominiums) have specialized accounting and may qualify for "percentage of completion" revenue recognition. This specific literature will be eliminated by the new standard, and these sales might not meet the criteria for revenue recognition over time under the new standard.

For example, the new standard includes an illustration (ASC 606-10-55-173 through 55-182) of a real estate developer that enters into a contract to sell a specified condominium unit once construction is complete, and receives a deposit from the customer at contract inception. The asset (unit) does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The determination of the appropriate revenue recognition is therefore dependent on whether the developer has an enforceable right to payment for its performance to date throughout the contract, which may differ based on jurisdiction. If it is determined that the right to payment is legally enforceable, the developer will recognize revenue over time. If not, the developer will recognize revenue at the point in time at which control of the unit is transferred to the customer.

The new revenue standard could also result in delayed revenue recognition for sales of condominiums and timeshares due to the potential for having multiple performance obligations that are satisfied over time.

Contract costs

Incremental costs of obtaining a contract are costs the entity would not have incurred if the contract had not been obtained (e.g., sales commissions). Under the new standard, an entity is required to recognize an asset for the incremental costs to obtain a contract that management expects to recover. As a practical expedient, an entity is permitted to recognize the incremental cost of obtaining a contract as an expense when incurred if the amortization period would be one year or less.

An entity recognizes an asset for costs to fulfill a contract when specific criteria are met. Management will first need to evaluate whether the costs incurred to fulfill a contract are in the scope of other standards (e.g., inventory, fixed assets, or intangibles). Costs that are in the scope of other standards should be either expensed or capitalized as required by those standards. If fulfillment costs are not in the scope of another standard, an entity recognizes an asset only if the following criteria are met: (a) the costs relate directly to a contract, (b) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and (c) the costs are expected to be recovered.

An asset recognized for the costs to obtain or fulfill a contract will be amortized on a systematic basis as control of the goods or services to which the assets relate is transferred to the customer. An entity recognizes an impairment loss to the extent that the carrying amounts of an asset recognized exceed (a) the amount of consideration the entity expects to receive for the goods or services less (b) the remaining costs that relate directly to providing those goods or services.

Currently homebuilders record sales commissions and other direct contract acquisition costs at the time of closing (that is, at the same time as the related revenue recognition). However, under the new model, this may become more complex. A portion of the contract acquisition costs may need to be allocated to the various performance obligations (if more than one) and recognized when the related revenue on those performance obligations is recognized.

Warranties

Under the new standard, an entity will account for a warranty (e.g., a home warranty) as a separate performance obligation if the customer has the option to purchase the warranty separately. An entity accounts for a warranty as a cost accrual if it is not sold separately. However, if a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, that service is a separate performance obligation.

An entity that promises both a quality assurance and service-based warranty, but cannot reasonably separate the obligations and account for them separately, will account for both warranties together as a separate performance obligation recognized over the warranty period.

The guidance in the new standard on warranties is generally consistent with current guidance under U.S. GAAP. However, it could be challenging in some instances to separate a single warranty that provides both a standard warranty (e.g., for defects in construction) and a service element (e.g., an extended warranty or a maintenance arrangement). Also, determining the estimated standalone selling price for warranty-related services when such services are not sold separately requires judgment and could be challenging.

Service element warranties are less common in the real estate industry, but may exist and need to be evaluated. For example, in timeshare transactions, other contractual arrangements (such as annual assessment fees) could include a service element.

Sales of real estate to non-customers

Certain sales of real estate that are "not an output of an entity's ordinary activities" (e.g., sales to non-customers) will be subject to aspects of the guidance in the new standard as outlined in the table above. This may include: (a) certain sales of real estate by a real estate company primarily engaged in leasing such property or (b) the sale of property, plant, and equipment by a manufacturer or retailer (including "non-traditional" real estate or integral equipment considered to be real estate). Such transactions may also be constructively completed through the sale of equity in an entity that is "in substance" the sale of real estate.

Because ASC 360-20 provides guidance for recognizing profit on *all* real estate sales, regardless of whether real estate is an output of an entity's ordinary activities, the FASB considered the implications of retaining the guidance in ASC 360-20 for contracts that are not within the scope of the new revenue standard. The FASB noted that retaining the existing real estate guidance for real estate sales could result in an entity recognizing the profit or loss on a real estate sale differently depending on whether the transaction is a contract with a customer. However, there is economically little difference between the sale of real estate that is an output of an entity's ordinary activities (e.g., sales to customers) and the sale of real estate that is not (e.g., sales to non-customers). Consequently, the FASB concluded that the difference in accounting should relate only to the presentation of the profit or loss in the income statement. ASC 360-20 was therefore superseded, except for certain guidance related to sale-leaseback transactions.

As noted in the table above, an entity that sells a business to a non-customer will now refer to the derecognition model in the consolidation guidance (ASC 810), which focuses on the consolidation and changes in ownership interest (including disposals) of a subsidiary (a legal entity). This guidance has been modified to remove the scope exception that previously existed for sales of in-substance real estate and refers to the guidance in ASC 610-20to determine: (a) the amount of consideration to be included in the calculation of the gain or loss on sale, and (b) when a sale of real estate (business) should be derecognized. Sales of real estate assets (that do not constitute a business) to non-customers will also follow the guidance in ASC 610-20.

Under ASC 610-20, to measure the appropriate gain or loss on sale, an entity will apply certain elements of the new revenue standard to determine the transaction price, including all of the following: (a) estimating variable consideration; (b) constraining estimates of variable consideration; (c) the existence of a significant financing component; (d) noncash consideration; and (e) consideration payable to a customer.

To determine when to derecognize the real estate, a seller will apply certain elements of the new revenue standard, including identifying the contract and assessing when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators that control has transferred, which include, but are not limited to, the following:

- The seller has a present right to payment for the asset.
- The seller has transferred legal title of the asset.
- The seller has transferred physical possession of the asset.
- The buyer has the significant risks and rewards of ownership of the asset.
- The buyer has accepted the asset.

Assessing the indicators that control has transferred could require judgment, such as determining whether the buyer has the significant risks and rewards of ownership of the asset. Various forms of continuing involvement may indicate that the significant risks and rewards of ownership have not been transferred to the buyer and still remain with the seller.

Appendix A includes examples that further discuss the accounting considerations for sales of real estate to non-customers.

Partial sales of real estate

Sales or a contribution of real estate to a newly formed joint venture in which the seller retains an ownership interest are common transactions in the real estate industry and are considered "partial sales." These transactions are outside of the scope of the new revenue standard. For joint ventures accounted for under the equity method of accounting (e.g., the seller retains an ownership interest but does not control the joint venture), an entity will need to evaluate the transaction to determine the appropriate accounting model to apply to the partial sale, which will depend on whether the transaction represents a partial sale of a business or an asset.

For a partial sale that constitutes a business, the derecognition model in the consolidation guidance (ASC 810) will need to be evaluated to determine whether control of the business has been lost. Within the consolidation guidance, sales or transfers of nonfinancial assets (including partial sales of real estate that constitute businesses to non-customers) require an entity to evaluate the guidance in ASC 610-20 to determine: (a) the amount of consideration to be included in the calculation of the gain or loss on sale and (b) when a sale of real estate (business) should be derecognized. Refer to additional discussion in the section titled "Sales of real estate to non-customers" above.

For a partial sale that constitutes an asset, the guidance for nonmonetary transactions in ASC 845, *Nonmonetary Transactions*, will need to be evaluated to determine if full or partial gain recognition is appropriate.

Determination of the appropriate gain recognition and accounting treatment of the retained interest will depend on which model is applied.

Real estate asset management

Revenue recognition in the real estate asset management industry can be complex as there are many variations of investment structures aimed at achieving returns or investment income for investors. Asset managers will recognize revenue they expect to be entitled to, subject to a constraint. The constraint will limit the amount of consideration that may be recognized to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. As a result, there could be changes in how revenue is recognized in the real estate asset management industry.

The impact of the new standard will vary depending on an entity's existing accounting policies. Areas most affected could include recognition of upfront fees (which may now be deferred in some cases), upfront costs, and performance-based fees. Some of the key issues companies will need to address include identifying who the "customer" is, and how to identify the distinct performance obligations.

Customer considerations

The new standard requires an entity to identify the contract with the customer. As part of this step, an entity must determine which party is its customer. This important step has ramifications throughout the revenue model and might significantly affect how the standard is applied. Asset managers will need to apply judgment in some situations to determine whether the customer is the investor or the fund itself. This issue may evolve as industry constituents begin applying the guidance to typical investment structures.

While not determinative, certain factors may point to the fund or investor being the customer. Management will need to weigh the different factors, and reach a conclusion based on the overall facts and circumstances.

A factor that points to the fund being the customer is a fund's ability to enter into contracts with third parties for additional services such as fund accounting or transfer agent activities. Also, in certain fund structures, there may be numerous investors that the manager does not deal with directly. For example, in many registered investment companies, some investors purchase shares through a third-party distributor that holds the shares in "omnibus account" along with other investors. An omnibus account is often used by third-party distributors to simplify the subscription and redemption process into a fund. There may be situations where the asset manager does not have visibility into the underlying investors that make up the omnibus account.

In other situations, factors may point to the investor as the customer. If the investor is heavily involved in negotiating specific fees, or interacts directly with the manager, this could indicate that the investor is the customer. Also, if there are very few investors in a fund, this could indicate that the investors have the potential to play a more direct role in the arrangement. As noted above, these factors are not determinative, and management will have to consider all facts and circumstances.

Determining which entity is the customer is important when it comes to identifying the performance obligation(s), timing of revenue recognition, and capitalizing contract costs. The FASB acknowledged these alternate perspectives during its public deliberations, but ultimately did not formally take a position given the wide variety of arrangements in the asset management industry. In our view, the conclusion should be based on the facts and circumstances of each arrangement and should not be viewed as an "accounting policy" election.

Performance obligations

Another key assessment that affects the timing of revenue recognition is whether there is more than one performance obligation in a contract. There are often several different fees the asset manager is entitled to, such as management fees and performance fees. The new standard will require a manager to consider whether the services being performed should be viewed as a single performance obligation, or whether some of these services are "distinct" and should therefore be treated as separate performance obligations.

Even though these services and related fees are often included in different contracts, they may represent a single performance obligation. The new standard requires an entity to combine contracts that are entered into at or near the same time and account for them as a single contract if they are: (a) negotiated as a package, (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract, <u>or</u> (c) the services in the contracts represent a single performance obligation. Since these contracts are typically entered into at the same time in the asset management industry, the contracts would be combined and accounted for as a single contract if, for example, the services performed under the contract represent a single performance obligation.

The new standard requires an entity to assess the services promised in a contract with a customer and identify as performance obligations those services that are distinct. A service is distinct if: (a) the customer can benefit from the service either on its own or together with other resources that are readily available to the customer and (b) the service is distinct in the context of the contract. If a service is not distinct, the entity must combine the services until such a point that a bundle of services are viewed as distinct. In some cases, this will result in all services being combined into a single performance obligation.

In general, identifying the separate performance obligations will be heavily dependent on which entity is deemed the customer. For example, if the fund is the customer, a distribution service may be a distinct service that the fund could obtain from another party, and accordingly, a separate performance obligation. On the other hand, if the investor is the customer, the service of distributing the funds to that customer may not be distinct as it is just a necessary prerequisite to allow the asset manager to provide the asset management services to that customer. This is an area of significant judgment and it is possible that views will evolve in advance of the standard becoming effective.

Variable consideration

The transaction price is the consideration the real estate asset manager expects to be entitled to in exchange for satisfying its performance obligations. Management must determine the amount of the transaction price at contract inception and update any estimates of variable consideration at each reporting date. One of the primary performance obligations in the asset management industry is the delivery of asset management services. This performance obligation is satisfied over time, as asset management services are delivered.

If the amount the entity expects to be entitled to is variable, the variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. In making this assessment, an entity should consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to: (a) the amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility), (b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, and (c) the contract has a large number and broad range of possible consideration amounts.

Management fees for real estate funds are usually based on net assets under management, while performance fees are usually based on profits generated from the underlying investments held by funds subject to certain thresholds (e.g., internal rate of return). As such, management fees and performance fees are variable consideration that is subject to the constraint. Also, an entity will need to consider whether there is some minimum amount of variable consideration that needs to be recorded even if the full amount of variable consideration cannot be recorded.

PwC observation:

The boards included the constraint in response to feedback that revenue could be recognized prematurely for variable consideration. We expect that some entities will recognize revenue earlier under the new guidance because they will be able to recognize amounts before all contingencies are resolved.

Management fees

A fixed percentage asset-based management fee is variable consideration that is subject to the constraint in the revenue standard. For management fees, an asset manager will update its estimate of the variable consideration each reporting period. Because the management fee is calculated based on net assets under management, any uncertainty related to the variable consideration will generally be resolved as of the end of each reporting period. The asset manager will allocate the transaction price associated with the management fees to the services provided during the period because the fee relates specifically to those services. In many circumstances, analysis of the pattern of transfer of asset management services will result in recognition of management fees in a manner that is consistent with current practice under U.S. GAAP.

Performance fees

The new standard may impact the timing of recognition of performance fees, as these fees are variable consideration and subject to the constraint. Accordingly, performance fees that have a broad range of possible outcomes and are highly susceptible to market volatility will often not be included in the transaction price until the uncertainty is resolved or almost resolved. Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint. Management will reassess its estimate of the transaction price each reporting period, including any estimated minimum amount of variable consideration.

Real estate asset managers of funds with a finite life (e.g., ten years) often receive performance fees (or carried interest) that are subject to clawback on a cumulative basis based on the performance of the fund over its life. Thus, it is possible the manager will have to return the cash distribution if the fund underperforms in the future. Periodic cash receipt from a fund as a result of its current performance will not necessarily indicate that the entity is able to recognize the amount as revenue.

Accordingly, for funds with a finite life, the entity will need to determine the appropriate time when the performance fees (or a portion thereof) overcome the constraint on variable consideration and can be included in the transaction price. This may be before the end of the fund's life. Later in the fund's life cycle, it may be probable that a significant reversal in the amount of cumulative revenue recognized will not occur for some portion of the fee given the fund's cumulative performance in relation to remaining assets. For example, a fund that holds a limited number of remaining investments could sustain total losses on those investments and still exceed the performance fee hurdle; therefore, revenue should be recognized for the portion of the performance fee that is not constrained.

PwC observation:

Application of the new guidance may result in significant changes for entities that record performance fees under Method 2 (otherwise known as the "hypothetical liquidation method") today, where performance fees are recognized as revenue at the amount that would be due under the contract at any point in time as if the contract was terminated at that date. As a result, there is a possibility that fees earned by exceeding performance targets early in the measurement period could be reversed due to missing performance targets later in the measurement period under today's guidance.

The new guidance requires a higher degree of certainty before recording performance fees than the approach under Method 2. As discussed above, management must conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur prior to recognizing revenue.

Other considerations

Property management contracts

Entities in the real estate industry frequently enter into property management and incentive performance fee revenue arrangements with related parties or third parties. For fixed fee arrangements, revenue will likely be recognized ratably over time as this is likely the best reflection of progress given an equal amount of effort provided over time. However, the fees for these arrangements are not typically fixed.

More frequently, property management fees are based on a fixed percentage of revenue or net operating income of the property each month. Generally, these contracts do not provide for any clawback of prior fees if property performance deteriorates. These contracts are often subject to termination with 30 days advance notice or upon sale of the underlying property. In addition, incentive-based contracts provide for participation by the property manager expressed as a percentage of the change in the value of the property at a point in time or upon sale or refinancing.

Arrangements to provide property management services over a period of time will likely be viewed under the new standard as a single performance obligation. Today, such fees are recognized at the end of each operating period, typically each month. If the management arrangement is considered a series of monthly performance obligations, then there will not be many differences in the accounting applied today and under the new revenue standard.

Incentive fees based on the fair market value of the property upon sale or refinancing of the property (or upon termination of the contract) represent variable consideration. Such amount can only be recognized to the extent that the performance obligation is satisfied and the amount of variable consideration is not constrained. Generally, this will occur only when the measurement period has ended and it is probable that a clawback of the incentive will not occur as a result of subsequent declines in performance or value.

Tenant construction management

Many real estate entities perform construction management services on behalf of their tenants (e.g., oversight and management of construction of tenant improvements). These arrangements are similar to other construction management contracts except on a smaller scale.

Under existing guidance, fees a landlord earns a fee for performing construction management services for the build out of tenant improvements are typically recorded over the construction period. Under the new standard, entities will need to evaluate the criteria to determine if the arrangement qualifies for recognition over time (i.e., over the construction period).

The arrangement may qualify for recognition over time if construction of tenant improvements has "no alternative use" to the entity and the entity is entitled to payment for performance to date, even if the tenant terminates the contract. If it does not qualify, fees for tenant construction performed prior to lease commencement may need to be deferred and recognized when the performance obligation is satisfied, which may be upon commencement of the lease. This is because control of the tenant improvements may not transfer until the tenant obtains control of the leased asset (i.e., lease commencement).

Leasing commission revenue

Many real estate entities provide leasing services on behalf of third parties or related parties (e.g., equity method ventures with other parties). In general, the associated fees are earned at the inception of the lease and upon renewal of the lease. The fees are typically a fixed percentage of contractual future revenues to be received by the property owner from the tenant. Renewal periods are contingent upon the exercise of a renewal by the tenant.

For example, a real estate entity may be a broker in a third-party leasing arrangement where the tenant will be paying an aggregate of $10 million and $6 million in rent for an initial period of ten years and a subsequent option period of five years, respectively. Under the terms of the broker contract, the broker receives a commission of $600,000 (6% of $10 million) upon the tenant taking possession of the leased space for the initial period and, potentially, an additional $360,000 (6% of $6 million) upon the beginning of the renewal period in the event the tenant exercises the renewal.

From the perspective of the real estate entity providing these broker services, there is likely a single performance obligation that is satisfied when the tenant takes possession of the space, at which point the broker has no remaining services to provide. However, the portion of the transaction price associated with the potential renewal period is variable consideration, since the renewal is uncertain at the inception of the lease. An estimate of variable consideration is included in the transaction price and recognized as revenue only if the entity concludes it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the tenant decides whether or not to renew its lease.

For real estate leasing commissions, the exercise of a particular tenant renewal may be affected by a multitude of factors including the terms of the contract, tenant operations (both general and property-specific), and general market conditions. Accordingly, it may be difficult to assert that historical experience is predictive of the outcome of a particular lease (that is, whether the tenant will renew the lease). Entities will need to consider a number of factors in determining whether leasing commissions earned for extension periods should be included in the transaction price, or whether such amounts are constrained. For example, there may be certain indicators that the renewal is likely to be exercised at some point prior to the renewal, such as extensive tenant improvements by the tenant during the lease period or the property representing a flagship location.

Disclosures

The revenue standard includes a number of disclosure requirements intended to enable users of financial statements to understand the amount, timing, and judgments related to revenue recognition and the corresponding cash flows arising from contracts with customers.

The more significant disclosure requirements include:

- The disaggregation of revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors

- An explanation of the significant changes in the contract asset and the contract liability balances during the reporting period

- An analysis of the entity's remaining performance obligations, including the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied), the nature of the goods and services to be provided, the timing of satisfaction, and significant payment terms

- Significant judgments and changes in judgments that affect the determination of the amount and timing of revenue from contracts with customers

- Disclosure of the closing balances of capitalized costs incurred to obtain and fulfill a contract and the amount of amortization recognized during the period

PwC observation:

While there is some relief provided to nonpublic reporting entities from the above disclosure requirements, the extensive disclosure requirements for public reporting entities may be particularly onerous and complex.

Transition

An entity can apply the new revenue standard retrospectively, including using one of more of the following practical expedients:

- For completed contracts, an entity is not required to restate contracts that begin and end within the same annual reporting period.

- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in prior periods.

- For all reporting periods presented before the date of initial application, an entity is not required to disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when it expects to recognize that amount as revenue.

An entity should apply any expedients it elects to use consistently to all contracts within all reporting periods presented. In addition, an entity is required to disclose the expedients it has used and a qualitative assessment of the estimated effect of applying the expedients, to the extent possible.

An entity can alternatively choose to recognize the cumulative effect of initially applying the new standard to existing contracts as an adjustment to the opening balance of retained earnings in the annual reporting period that includes the date of initial application, with some additional disclosures.

Entities that elect the simplified transition method are required to disclose, for reporting periods that include the date of initial application:

- The amount by which each financial statement line item is affected in the current reporting period by the application of the new standard as compared with the guidance in effect before the change

- An explanation of the reasons for significant changes identified between the reported results under the new standard and the guidance in effect before the change

Entities that elect this method must also disclose this fact in their financial statements.

Appendix A – Common real estate sales transactions

This Appendix provides examples of common real estate sales transactions and the consideration of certain forms of continuing involvement. The examples discuss the guidance under the new standard as well as other guidance that will be applicable to certain types of real estate sales scenarios.

Example 1: Sale recognition (absent any forms of continuing involvement)

Seller and Buyer enter into a purchase and sale agreement for an existing office property on September 30, 20X1. Closing occurs with consideration and title transferring from Seller to Buyer on December 15, 20X1.

Existing U.S. GAAP

The sale is recognized at the time of the closing, once title has transferred and all consideration has been exchanged, as this is typically the date the sale has been "consummated" in accordance with ASC 360-20-40-7.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Under the new revenue standard, when and how revenue is recognized is driven by the terms of the contract with the customer. Typically, an approved contract where both parties demonstrate commitment to fulfill their respective obligations will meet the criteria for sale recognition at the time control transfers to Buyer. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

In this example, if there are no forms of continuing involvement that preclude Seller from transferring control to Buyer, it is likely that the sale will be recognized under the new standard when consideration is paid to Seller and title transfers to Buyer on December 15, 20X1.

Example 2: Seller is required to develop the property in the future

Seller sells a parcel of land to Buyer. In connection with the sale, Seller also agrees to develop a single tenant industrial warehouse to be used by Buyer in its business.

Existing U.S. GAAP

Under ASC 360-20-40- 61 through 40-63, profit allocable to (a) the performance after the sale of the land and (b) the sale of land should be recognized when the sale meets the criteria of ASC 360-20-40-5 if the future costs of development can be reasonably estimated at the time of sale. If such costs cannot be reasonably estimated, no profit should be recognized at the time of the sale. The profit is allocated to the sale of the land and the subsequent development or construction on the basis of estimated costs of each activity with the same profit margin attributed to each activity.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will need to determine if the bundle of goods and services represents one performance obligation or two separate performance obligations. Goods and services will be accounted for as separate performance obligations if both of the following criteria are met:

- The promised good or service is capable of being distinct because 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.

- The promised good or service is distinct within the context of the contract because the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

In this example, it is expected that the sale of the parcel of land and development of the warehouse will be considered distinct as the customer can benefit from each on its own and they are separately identifiable; therefore, the contract includes two performance obligations. Seller will allocate the transaction price to the two performance obligations based on their standalone selling prices and recognize revenue as each performance obligation is satisfied.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize of the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

In this example, Seller will likely conclude that the sale of land and the development of the property represent two separate performance obligations, as discussed. While current U.S. GAAP requires a constant profit margin to be recorded on both elements (that is, the sale of land and the development of the property), the new guidance could result in different profit margins on each performance obligation.

Example 3: Seller-provided financing

Scenario #1

Buyer purchases a multi-tenant property from Seller with nonrecourse financing provided by Seller to Buyer representing 98% of the purchase price. The loan includes interest-only payments over the five-year term with a balloon payment in year five.

Existing U.S. GAAP

No sale is recorded. Because the amount of cash paid by Buyer is only 2%, the transaction may be more appropriately viewed as an option to purchase the property. If the amount of cash paid was more significant, but not sufficient to qualify for the full accrual method under ASC 360-20-55-1, the transaction might qualify for sale (i.e., derecognition), but Seller would need to apply either the cost recovery or installment methods (depending on the facts).

Sales of real estate (assets and businesses) to customers (new revenue standard)

The new standard requires a seller to determine whether the buyer is committed to perform its obligations under a contract. In this example, Seller may determine that Buyer has not made a sufficient down payment to qualify for revenue recognition because Buyer could decide to default on its obligation and surrender the real estate to Seller. However, Seller will need to consider all facts and circumstances, not just the extent of the down payment.

If Seller concludes Buyer is not committed to perform its obligations, Seller will continue to re-evaluate this conclusion each reporting period. Unless this criterion is met, revenue will not be recognized until either: (a) Seller has no remaining obligations to transfer goods or services to Buyer, and all, or substantially all, of the consideration promised by Buyer has been received by Seller and is nonrefundable, or (b) the contract has been terminated and amounts received are nonrefundable.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

This first scenario will likely result in a similar outcome to today's accounting with no sale recognized. However, the treatment of the cash received (the down payment) could differ from today's accounting due to the embedded economic put feature inherent in nonrecourse financing (refer to example on "buyer put options" below for more details).

Scenario #2

Assume the same facts as above, except Seller provides Buyer with a loan representing 90% of the purchase price. The loan terms include principal and interest payments over the five-year term with a balloon payment for any remaining outstanding principal at the end of the term.

Existing U.S. GAAP

Seller will recognize a sale; however, the sale will likely not qualify for the full accrual method because the down payment would not meet the minimum initial investment threshold described in ASC 360- 20-55-1 and 55-2 for this property type. Seller will likely apply either the installment method or cost recovery method.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will be able to recognize the sale if it determines that Buyer is committed to perform its obligations under the contract. If not, Seller will re-evaluate this conclusion each reporting period and record the sale when it determines that Buyer is committed to perform under the contract.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

Under the new guidance, Seller will need to determine if Buyer is committed to perform its obligations under the contract. That determination will drive when revenue is recorded. This represents a difference from current accounting where some or all of the gain would be deferred under either the installment method or cost recovery method.

Example 4: Option or obligation to repurchase the property

Seller "call" option

Seller sells a property to Buyer. The sales agreement provides Seller with an unconditional option to repurchase the property at some point in the future.

Existing U.S. GAAP

Under ASC 360-20-40-38, if the buyer provides an option to the seller to repurchase the property, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

Sales of real estate (assets and businesses) to customers (new revenue standard)

The accounting depends on the amount of the repurchase price relative to the original sales price, as follows:

- If the repurchase price is less than original sales price, Seller will account for the transaction under the leasing guidance in ASC 840.

- If the repurchase price is greater than or equal to the original sales price, Seller will account for the transaction as a financing. Seller will not derecognize the property and will record a financial liability for the consideration received from Buyer.

If the agreement creates an unconditional obligation, rather than an option, for the seller to repurchase the asset in the future, the resulting accounting will be the same as above under the new standard.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

The existence of an option for Seller to repurchase the property in the future will likely prevent Buyer from obtaining control of the property, therefore preventing Seller from recognizing the sale.

PwC interpretive response:

It is likely that control has not passed to Buyer in this situation, so the sale is not recognized.

Buyer "put" option

Seller sells a property to Buyer. The sales agreement provides Buyer with the ability to put the property back to Seller at any time within three years of the transaction date.

Existing U.S. GAAP

Under ASC 360-20- 40-38, if the seller may have an obligation to repurchase the property, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will evaluate at contract inception (without a requirement to reassess) whether Buyer has a significant economic incentive to exercise the put:

- If yes, the sale is not recorded and Seller will account for the transaction as a financing or a lease following the guidance in ASC 840.
- If no, the sale is recorded and Seller will recognize an asset and a liability for any expected returns.

In evaluating whether a significant economic incentive exists, the following factors should be considered:

- Relationship of repurchase price to the sales price and expected market value of the property at potential repurchase date
- Length of time until the put option expires

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

The existence of an option for Buyer to require Seller to repurchase the property in the future may not prevent Seller from transferring control of the property if it is determined that Buyer does not have a significant economic incentive to exercise the put option. This will be based on the facts and circumstances of the transaction.

PwC interpretive response:

Determining whether a buyer has a significant economic incentive to exercise a put option will require significant judgment as it will be based on the facts and circumstances of the transaction. This could result in different entities arriving at different conclusions for the same (or similar) transactions.

If a conclusion is reached that the buyer does not have a significant economic incentive to exercise the put option, the concept of recording an asset and liability for any expected returns may present a challenge as sales of real estate are unique in nature.

Example 5: Guarantees (seller provides a return of or return on the buyer’s investment)

Seller sells a multi-tenant retail property to Buyer. Because some of the leases are expected to expire within the next 6 to 18 months, Seller guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for the first four years after the sale.

Existing U.S. GAAP

Under ASC 360-20-40- 41, if the seller guarantees return of the buyer’s investment or guarantees a return on the investment for an **extended** period, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

If the guarantee of a return is for a **limited** period, the deposit method should be used until operations of the property cover all operating expenses, debt service, and contractual payments.

Sales of real estate (assets and businesses) to customers (new revenue standard)

The existence of an obligation to support operations would not preclude the sale transaction and derecognition of the property. Seller will separately account for the guarantee under ASC 460, *Guarantees*, and allocate a portion of the sales proceeds received to the guarantee. The amount allocated to the guarantee will be the fair value of the guarantee and the remaining consideration will be allocated to the sale of the property.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

Under current U.S. GAAP, this form of continuing involvement precludes sale recognition for accounting purposes. That is, the real estate remains on the seller's balance sheet. Compared to today, the new standard will result in a dramatically different outcome where the sale is recognized (assuming control has transferred) and the measurement of the gain/loss on sale will be impacted by the fair value of the guarantee.

Example 6: Seller's participation in future profit (without risk of loss)

Seller sells a property to Buyer for $10 million. As part of the agreement, Buyer agrees to share 15% of any excess proceeds it receives above $10 million from a subsequent sale to another buyer at some point in the future.

Existing U.S. GAAP

Under ASC 360-20-40-64, the contingent future profits should be recognized when they are realized. All of the costs of the sale are recognized at the time of sale (i.e., no costs are deferred to periods when the contingent profits are recognized).

Sales of real estate (assets and businesses) to customers (new revenue standard)

The future profit participation is variable consideration, which could impact the transaction price. Seller will estimate the transaction price using either: (a) the "expected value" (sum of probability-weighted amounts) or (b) the "most likely amount" (single most likely outcome) approach. Seller will update its estimate at each reporting period end until the contingency is settled.

Seller is limited to recording income for the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved, and will need to consider whether there are any minimum amounts that should be recorded.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

If Seller concludes that some minimum amount of the variable consideration is not constrained, the new standard will result in earlier recognition of income than current U.S. GAAP. The assessment of variable consideration will introduce significant judgment and requires updating the estimate each period.

Also, in assessing the variable consideration and whether a significant reversal would occur, Seller needs to consider the amount of cumulative revenue recognized. Since it will have recognized $10 million at the time of sale, the evaluation of the variable amount needs to consider the potential for 15% of the upside as compared to the $10 million already recorded. For example, if the entity believes the future sale will be at least $11 million, then the variable consideration that is being assessed is only $150,000, which may not be considered "significant" compared to $10 million.

Appendix B – Application of the new standard for a "vertically integrated" homebuilder

Background

A homebuilder has a 200-unit project (homogeneous units) and sells the individual homes over a four-year period. The homes are sold with a promise (based on the sales contracts or zoning agreements) to complete certain amenities (e.g., a school, roads, or a pool/clubhouse) by the middle of Year 3. In this example, there is no seller-provided financing or other forms of continuing involvement.

The revenue and cost assumptions are as follows (in 000's except unit numbers):

		Total	Per unit
Total units		200	
Sales price		$20,000	$100

		Total	Per unit	Cost ratio	
Land/homebuilding construction cost		$15,000	$75	88.2%	
Costs for non-home construction elements		$2,000	$10	11.8%	
		$17,000	**$85**	**100%**	

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Contractual revenue:	$4,000	$7,500	$6,500	$2,000	$20,000
Costs					
Land/home construction	$3,000	$5,625	$4,875	$1,500	$15,000
Total costs for non-home construction elements	-	-	2,000	-	2,000
Total costs	$3,000	$5,625	$6,875	$1,500	$17,000

Application of the new standard

Step 1: Identify the contract(s) with the customer
The contracts with the individual homebuyers are the relevant contracts

Step 2: Identify the performance obligations in the contract
In addition to the delivery of the constructed home, there are potentially several performance obligations in this example that may be satisfied at different times. For purposes of simplifying this example, we have assumed that all of the non-home construction elements are completed and delivered simultaneously and therefore can be treated as a single performance obligation separate from the home delivery performance obligation. For this purpose, the standard home warranty is predominantly a "quality assurance" element in many jurisdictions and not treated as separate performance obligations.

Step 3: Determine the transaction price
The transaction price is the sale price for the individual home sales. In this example, there are no other elements that impact the transaction price, such as variable consideration, time value of money (all cash paid at closing), noncash consideration, or consideration paid to a customer.

Step 4: Allocate the transaction price to the performance obligations
The transaction price should be allocated between the identified performance obligations based on their relative standalone selling prices. Possible approaches to estimating standalone selling price include (but are not limited to) expected costs plus a reasonable margin or assessment of market prices for similar goods or services. Generally, the non-home construction elements would not have separate market prices and in this case, possibly neither do the home construction elements since each project is different. For purposes of this example, we allocated based on the relative costs between home and non-home construction performance obligations and assuming a consistent margin between the two. In reality, there is likely a different margin earned on the non-home construction elements, which could result in further complexities.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied
Upon each home settlement (that is, the transfer of control to the buyer), the performance obligation relating to the home delivery is settled. Until the non-home construction performance obligations are completed, none of the related per unit revenue should be recognized. At completion of the non-home construction elements, the portion of the revenue related to units settled to date will be recognized. Thereafter, the non-home construction elements will be recognized upon each home settlement (as control of the non-home construction elements does not transfer prior to home settlement).

Application of the current accounting model

(in 000's except unit numbers)

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Contractual revenue at closing	$4,000	$7,500	$6,500	$2,000	$20,000
Costs					
Land/home construction	$3,000	$5,625	$4,875	$1,500	$15,000
Allocated non-home construction costs	400	750	650	200	2,000
Total costs	**$3,400**	**$6,375**	**$5,525**	**$1,700**	**$17,000**
Gross margin	***$600***	***$1,125***	***$975***	***$300***	***$3,000***

Application of the new standard

(in 000's except unit numbers)

Allocation of transaction price per unit to performance obligations using cost ratio	Revenue	Costs	
Home construction	$ 88.235	$ 75.000	88.2%
Non-home construction elements	11.765	10.000	11.8%
Total	$100.000	$ 85.000	100%

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Performance obligation revenue:					
Home construction at delivery	$3,529	$6,618	$5,735	$1,765	17,647
Non-home construction:					
At delivery of non-home elements for closings to date			1,735		1,735
Subsequent to non-home elements at settlement			383	235	618
Total non-home construction			**2,118**	**235**	**2,353**
Total revenue	***$3,529***	***$6,618***	***$7,853***	***$2,000***	***20,000***
Costs:					
Home construction at delivery	$3,000	$5,625	$4,875	$1,500	$15,000
Non-home construction:					
At delivery of non-home elements for closings to date			$1,475		1,475
Subsequent to non-home elements at settlement			$325*	$200*	525
Total non-home construction			**1,800**	**200**	**2,000**
Total costs	***$3,000***	***$5,625***	***$6,675***	***$1,700***	***$17,000***
Gross margin	***$529***	***$993***	***$1,178***	***$300***	***$3,000***
Difference (new standard vs current accounting model)					$(0)
Revenue	$(471)	$(882)	$1,353	-	$(0)
Costs	(400)	(750)	1,150	-	$(0)
Gross margin	$(71)	$(132)	$203		

*Costs to fulfill the non-home elements performance obligation would likely be capitalized and amortized as control of the non-home elements transfer to the customers.

PwC observation:

Most projects will be substantially more complex than the example provided and may have significant subsequent changes in assumptions/estimates over the life of the project. Further, tracking of income tax temporary differences, already complex for many entities, may become substantially more challenging as a result of the new standard.

About PwC's Real Estate practice

PwC has a global team of multidisciplinary professionals providing real estate services. Our industry specialists span our core assurance, tax, and advisory capabilities. This team of dedicated professionals advises members of the private and public sector, owners, users, and investors in real estate throughout the capital stack. Our commitment to industry is demonstrated by the corporate owners/users, developers, hospitality organizations, investors, and REITs we serve, as well as our active participation in leading real estate organizations, and the quality of research and reporting we provide to executives, investors, owners, and ratings agencies, among others.

PwC helps organizations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 184,000 people who are committed to delivering quality in assurance, tax, and advisory services.

For more information, please contact:

Byron Carlock
US Real Estate Leader
Phone: (214) 754-7580
Email: byron.carlock.jr@us.pwc.com

Rich Fournier
US Real Estate Assurance Leader
Phone: (617) 530-7168
Email: richard.e.fournier@us.pwc.com

Brian Ness
US National Office Real Estate Leader
Phone: (973) 236-4436
Email: brian.ness@us.pwc.com

Tom Wilkin
US Real Estate Life Cycle Leader
Phone: (646) 471-7090
Email: tom.wilkin@us.pwc.com

Jill Niland
US Real Estate Partner, Capital Markets & Accounting Advisory Services
Phone: (678) 419-3454
Email: jill.niland@us.pwc.com

Questions?

PwC clients who have questions about this publication should contact their engagement partner. Engagement teams who have questions should contact the contacts listed in the National Professional Services Group.

Authored by:

Brian Ness
Partner
Phone: 1-973-236-4436
Email: brian.ness@us.pwc.com

Bill Staffieri
Senior Manager
Phone: 1-973-236-5120
Email: william.a.staffieri@us.pwc.com

Pushdown accounting: make the right choice for your company

What you need to know

- New guidance allows acquired companies to elect whether to apply fair value pushdown accounting in their separate financials, on a transaction-by-transaction basis.
- Previous SEC guidance has been eliminated, which required or precluded pushdown accounting depending on the buyer's ownership percentage.
- In deciding whether to apply pushdown accounting, consider the needs of financial statement users and the practical implications to the buyer and acquired company.
- The new option is available immediately for all open financial reporting periods.

Pushdown accounting is now optional–which approach is best for your company and investors?

Typical impact of pushdown accounting on an acquired company's financial statements[1]*:*

Assets	↑	Impact of goodwill and "step up" in value of PP&E, intangibles, and inventory	Revenue	NEUTRAL	Future revenues could decrease if the fair value of acquired deferred revenue is less than book value
Liabilities	NEUTRAL	Liabilities could increase if contingencies are recorded at fair value	Expenses	↑	Impact of increased amortization and depreciation expense
Equity	↑	Reflects value paid by buyer; typically exceeds book value	Net income	↓	Impact of increased expenses
Operating cash flows	NEUTRAL	Impact of pushdown is typically noncash	EBITDA	NEUTRAL	EBITDA could decrease if "step up" of inventory results in increased costs of goods sold

[1]Illustration purposes only; impact could vary depending on the transaction.

"Pushdown" accounting refers to establishing a new basis for reporting assets and liabilities in an acquired company's separate financial statements based on a "push down" of the buyer's basis. This typically results in "stepping up" the basis of assets and liabilities to fair value and recording goodwill in the acquired company's financial statements. Under the new guidance, pushdown accounting is optional for any transaction in which another party obtains control of the reporting company. Now that there is choice, management will need to weigh various factors to decide whether to apply pushdown accounting, including both practical considerations and the needs of investors and creditors.

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An election to apply pushdown accounting is irrevocable – weigh the factors before making a decision

What matters to investors and creditors?

It is important to consider the needs of the users of the acquired company's financial statements–and those needs may vary. Some users may prefer the "stepped-up basis" that results from pushdown accounting. For example, retaining the historical basis can result in the acquired company reporting negative equity if the transaction involves taking on new debt to finance the purchase of treasury stock (a leveraged recapitalization). Management should also keep in mind any regulatory or contractual requirements that focus on balance sheet measures.

Other users may prefer an acquired company retain its historical basis to avoid distorting income statement trends as a result of increased amortization and depreciation expense. Users that focus on cash flow and EBITDA measures, however, may be indifferent to the impact of pushdown accounting as these measures are often not significantly affected.

Other considerations before electing pushdown accounting

From a practical standpoint, buyers that report consolidated results may favor pushdown accounting at the subsidiary level to avoid separately tracking assets, such as goodwill and fixed assets, at two different values (historical basis and "stepped-up basis"). Conversely, the acquired company may prefer to carry over its historical basis due to the increased complexities of pushdown accounting. Companies may also decide to retain the historical basis when that is the basis used for tax reporting purposes (that is, in transactions where there is no tax "step up").

You can change your mind later…but only in one direction

If an acquired company does not elect to apply pushdown accounting upon a change-in-control event, it can do so in a subsequent period as a change in accounting policy. However, once pushdown accounting is elected for a specific transaction, that election is irrevocable. Management should therefore weigh the needs of investors and the practical implications prior to making an election.

In the loop

Executive-level insight into today's top financial reporting and regulatory issues

How PwC can help

To have a deeper discussion of how the pushdown accounting guidance might affect your company, please contact:

Beth Paul
973 236 7270
elizabeth.paul@us.pwc.com

Matthew Sabatini
646 471 7450
matthew.e.sabatini@us.pwc.com

Coming soon

In depth: Pushdown accounting becomes optional
More details and insights on the new guidance, including when the pushdown election is available and how pushdown accounting is applied

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To Our Clients and Friends:

The Securities and Exchange Commission ("SEC") continues to emphasize the primary role and responsibility assumed by management and audit committees in providing meaningful and transparent information to investors. The uncertainties in the current economic and regulatory environment make the preparation of high-quality reports increasingly important and challenging.

To help you prepare for your annual reporting, PwC's Financial Services Industry Group has developed the enclosed publication titled Stay informed Financial Services 2014 SEC comment letter trends. In this latest edition of our annual publication we have analyzed SEC staff comment letters issued to registrants across different sectors within the financial services industry, including: banking and capital markets, insurance, asset management, and real estate. We have highlighted the top areas where registrants received the majority of comments and have also provided relevant examples of recent comment letters along with the applicable accounting or reporting guidance.

Understanding the SEC staff's recent areas of focus is an important aspect to consider as part of the year-end reporting process. The SEC staff continues to emphasize the importance of providing information to investors that is reliable, meaningful and transparent, particularly in areas that involve significant judgment. Continuing key themes emphasized by the SEC staff through recent comment letter trends impact both financial and non-financial statement disclosures, with management's discussion & analysis once again being the most frequent area of comment.

We hope that a better understanding of these trends, along with specific examples of comments, will provide you with helpful insights and will aid in your producing high-quality annual reports for investors and other stakeholders. Please don't hesitate to contact your PwC engagement team or me to discuss the information in this publication or to address any questions you may have.

Best regards,

Bob

Robert Sands
U.S. Financial Services Assurance Leader

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SEC Developments

2014 was a busy year at the SEC. Although there were only a few changes in senior personnel (compared to 2013 when several high profile staff positions were filled and three Commissioners, including a new Chair, were appointed), one notable change was the appointment of Jim Schnurr as the SEC's Chief Accountant. Schnurr joined the SEC staff in October and will play a major role in shaping the SEC's agenda at a time when accounting, auditing and financial reporting are key areas of focus. This focus reflects a common understanding that transparent, accurate and reliable financial reporting forms the foundation of trust which allows our capital markets to function properly and provides the transparency and confidence investors need when making decisions.

Following through on initiatives started in 2013, 2014 has seen a high level of activity in the SEC's enforcement program, with renewed attention on financial fraud, issuer disclosure and gatekeepers. The Enforcement Division's Financial Reporting and Audit Task Force—a small group of experienced attorneys and accountants charged with developing state-of-the art tools to better identify financial fraud and incubating cases to be handled by other groups—is one example of how the SEC has increased its focus. The Task Force monitors high-risk areas, analyzes industry performance trends, reviews restatements, revisions, and class action filings as well as academic research. It is also working on the SEC's Accounting Quality Model—sometimes referred to as Robocop—which is being developed to use data analytics to assess the degree to which a company's financial reporting appears noticeably different from its peers. The Task Force was very busy during 2014 with even more activity expected in 2015.

The SEC staff has continued to focus on internal control over financial reporting, with more attention on how companies evaluate deficiencies relating to immaterial financial statement errors. The SEC staff signaled its intention to increase its focus in this area in late 2013, and this has led to more frequent comments and questions in 2014, with more likely to come in 2015.

Recognizing that full and fair disclosure is a central goal of the U.S. securities laws and is critical to the fulfillment of the SEC's core mission, during 2014 the SEC launched a "Disclosure Effectiveness" initiative. Through this initiative, the SEC is looking for ways to update and modernize its disclosure system and to eliminate duplicative or overlapping requirements, while continuing to provide material information. Trying "to put better disclosure into the hands of investors," the SEC staff is taking a fresh look at the question: what information do investors need to make informed decisions? In addition to looking at the specific disclosures companies provide, the SEC staff is also looking closely at how disclosures are provided, particularly in light of advances in technology and changes in how information is consumed. For instance, the SEC staff might explore a "company file" approach through which investors would access company-specific information on the SEC's website through tabs such as "Business information," "Financial information," "Governance information" and "Executive compensation," instead of searching for that same information by combing through a reverse chronological list of filings. The SEC staff has been clear that reducing disclosure is not the objective of this important project (indeed, they have said that updating the requirements may well result in additional disclosures), but they have indicated that they believe the initiative can reduce costs and burdens on companies.

Even before any rule changes are adopted (or proposed), companies already have the ability to improve the quality and relevance of their disclosures by reducing redundancy, removing out-of-date, unnecessary information, and refining disclosures to focus on those issues which are truly applicable and material. The SEC staff has been encouraging companies to experiment with the presentation of the information in their filings with the objective of improving the transparency, quality and relevance of their disclosures.

John

John A. May
SEC Services Leader

Overview

Overview

To help registrants gain insight into the SEC staff's current areas of interest, PwC analyzed comment letters issued to domestic registrants within the financial services industry. From this analysis, we identified "hot topic" areas, including industry-specific considerations and some other notable trends in comments received across the financial services industry that we believe are relevant and may be of increasing focus in the near term.

The hot topics identified among comments issued to registrants in the financial services industry are somewhat consistent with those in other industries, with management's discussion and analysis disclosures regarding results of operations, liquidity, and capital resources being the most prevalent. Financial services shares a continued focus on loss contingencies and impairments with other industries as well. Other comments specifically impacting the financial services industry relate to valuation and business combinations, among other areas. As in prior years, executive compensation continues to garner a significant number of comments, generally with a focus on the determination, drivers and transparency of executive compensation. In addition, regulatory reporting, primarily as it relates to the insurance sector, was a significant trend, including comments regarding statutory accounting matters.

Our analysis considered the breakdown of the financial services industry into four sectors: banking and capital markets, insurance, asset management, and real estate. All four of the sectors, when analyzed individually, presented substantially similar trends. Significant matters specific to a particular sector are summarized in our "Sector highlights" section.

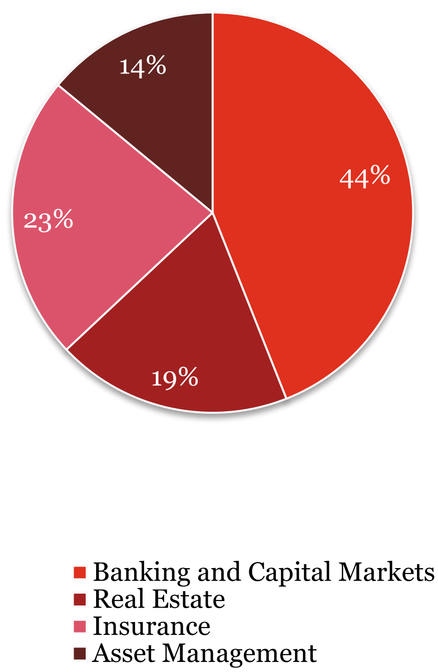
Rank	"Hot topic" financial services reporting areas	%
1	Management's discussion and analysis	28
2	Fair value measurements	11
3	Business combinations	7
4	Regulatory reporting*	4
5	Impairments	3
6	Executive compensation	3
7	Loss contingencies	2
8	Other**	42
Total		100

*See statutory disclosures in the Insurance sector highlights for further detail
**Primarily items covered in sector highlights

Overview

The chart below shows the percentage of total comments by sector included in our analysis of comment letter trends.

Breakdown by sector



Methodology

The analysis of SEC staff comment letter trends was based on comments issued and released by the SEC between November 1, 2013 and October 31, 2014 related to Forms 10-K and 10-Q. For consistency of evaluation, the analysis was based solely on the Standard Industrial Classification (SIC) codes indicated on the SEC EDGAR website for each respective financial services sector, as follows:

- Banking and Capital Markets – 6021, 6022, 6029, 6035, 6036, 6099, 6111, 6141, 6153, 6159, 6162, 6163, 6172, 6189, 6199, 6200, 6211
- Insurance – 6311, 6321, 6324, 6331, 6351, 6361, 6399, 6411
- Asset Management – 6282, 6221, 6799, and Business Development Companies
- Real Estate – 6500, 6510, 6512, 6513, 6519, 6531, 6532, 6552, 6798

Financial Services Comment Letter Trends

Management's discussion and analysis and Risk factors

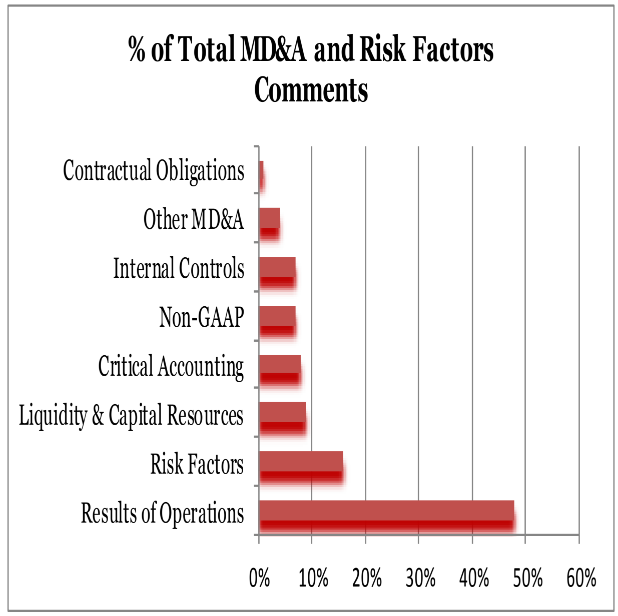
Management's discussion and analysis (MD&A) of financial condition and results of operations is a critical component of registrants' communications with investors and continues to be the top area for comment by the SEC staff in 2014. The key objectives of MD&A are to provide a narrative explanation of the financial statements that enables investors to see the company through the eyes of management, to offer context to the financial statements, and to provide information that allows investors to assess the likelihood that past performance is indicative of future performance. We have found that the majority of SEC staff comments in this area are not aimed at meeting specific technical requirements, but rather at enhancing the quality of disclosures to meet these objectives.

The requirements themselves are set forth in Item 303 of Regulation S-K, which identifies five categories of disclosure in MD&A: liquidity, capital resources, results of operations, off-balance-sheet arrangements, and contractual obligations. Item 503 of Regulation S-K provides the requirements for risk factors. Additional guidance is also contained in Financial Reporting Release (FRR) 36 and FRR 72.

More recently, following the release of its December 2013 Report on Review of Disclosure Requirements in Regulation S-K mandated by the JOBS Act, the SEC has indicated that the Division of Corporation Finance will pursue a project to develop recommendations focused on improving and streamlining disclosure requirements. This project may reduce the costs and burdens on companies and eliminate duplicative disclosures in MD&A, but may also identify opportunities to increase the transparency of information, which may lead to new requirements.

In the meantime, the comment letter process has reinforced the well-established MD&A objectives that disclosures should be: 1) transparent in providing relevant information, 2) tailored to the company's facts and circumstances, 3) consistent with the financial statements and other public communications, and 4) comprehensive in addressing the many business risks that exist in today's economic environment.

The table below summarizes the percentage of comments received by registrants by topical area of MD&A and risk factors. Results of operations and liquidity and capital resources are the areas of MD&A that have received the most attention in SEC staff comment letters. We provide relevant examples of comments issued in each of these areas.



Results of operations

SEC staff comments have reminded registrants that the results of operations section should provide readers with a clear understanding of the significant components of revenues and expenses and events that have resulted in or are likely to cause a material impact on revenues or income from operations.

The SEC staff has frequently issued comments specifying that MD&A should not simply repeat information provided elsewhere in the filing; rather, it should explain the underlying drivers behind changes in the financial position, results of operations and cash flows of registrants. Increasingly, registrants are being challenged to quantify the impacts that such factors have had, especially when an account has been impacted by multiple factors. General observations on the population of SEC staff comments include the following:

- Disclosing known trends - The SEC staff has asked registrants to disclose known trends affecting the business, in particular, disclosure of events that have occurred and how those events were a positive or negative indicator of future performance. Examples include changes in market conditions, entering a new market or changes in asset classes, or an acquisition that is expected to impact operating results. In addition, they encourage the discussion of key operating metrics used by management, coupled with an analysis of the relationship between such metrics and GAAP results

- Drivers behind fluctuations - Many comments relate to improving registrants' disclosures of significant fluctuations between periods. The SEC staff has asked for more detailed descriptions related to the specific factors driving such fluctuations and for registrants to quantify each factor separately, even when they net to an insignificant change overall
- Consistency of information - The SEC staff has been known to review public information for consistency with the information included in a registrant's periodic filings. When management discusses events or trends on earnings calls, social media channels, investor presentations or the company's website, the SEC staff may question why such events are not also addressed in MD&A

Sample comments:

1. We note that your MD&A section is overly brief and does not present all of the information required under Item 303 of Regulation S-K. In future filings, you should provide more analysis of the disclosure you are currently providing. For example, discuss the reasons for the increases or decreases in operating expenses and address the material changes in line items under the "Expenses" section, including general and administrative, and professional fees. Rather than simply repeat information that is contained in the financial statements, you should provide an analysis and narrative disclosure throughout your MD&A section so that investors understand the company's business model and future plans in the context of the financial information provided in this section.
2. You state that the low interest rate environment has impacted earnings and that in addition to continuing spread compression in your interest sensitive product line, there is also potential for interest rate related impacts to amortization and the level of reserves, which could be material. Please provide us proposed disclosure to be included in your future periodic reports (in MD&A) that discloses the expected effects of this known trend or uncertainty on your future financial position, results of operations and cash flows.
3. Please revise your discussion of results of operations to provide your investors with more insight on the causes of increases or decreases in the components of net income. Please include the following:
   - When you identify more than one reason for an increase or decrease in the components of net income, to the extent possible, please quantify the effect of each different reason.
   - When you identify intermediate causes of changes in revenues please provide your readers with insight into the underlying drivers of those changes.
4. We note your disclosure of underwriting and distribution revenues and expenses segregated by distribution channel. In an effort to provide greater transparency into your various revenue sources, please revise your disclosure in future filings to quantify the significant components of your underwriting and distribution revenues (e.g., 12b-1 fees, front-end load sales, fees from asset allocation products, insurance premiums, etc.). Consider providing these disclosures in a tabular format.
5. We note on your website that you issued an overview of the Mortgage Data Program that includes an implementation timeline of the requirements in such program. We were unable to locate disclosures in your Form 10-K and first quarter Form 10-Q on the program and its related requirements. Please tell us and revise future filings to disclose a detailed summary of the program along with the requirements and implementation dates and how it impacts your business. Please ensure your discussion includes detailed information on the program and whether it will impact any of your internal models (i.e., internal price index).

Liquidity and capital resources

A key objective of the liquidity and capital resources discussion is to provide a clear picture of the registrant's ability to generate cash and to meet existing known or reasonably likely future cash requirements. The SEC staff expects the liquidity and capital resource discussion to address material cash requirements, sources and uses of cash, and material trends and uncertainties related to a registrant's ability to use its capital resources to satisfy its obligations. General observations on the population of SEC staff comments include the following:

- Disclosure of events impacting liquidity - The SEC staff has asked registrants to discuss known trends, events, or uncertainties that are reasonably likely to impact future liquidity. Such events could include entry into material commitments, loss of customers or contracts, or plans for significant capital expenditures
- Debt agreements and related covenants - Comments from the SEC staff have requested expanded disclosure of the material terms of debt agreements, including an indication of compliance with financial covenants. In situations where there has been or is projected to be a violation with regard to covenant compliance, registrants should provide a detailed description of the covenants, the target and actual covenant measures for the most recent reporting period, and an indication of the sensitivity of those measurements, if applicable. Other items potentially impacting the availability of credit should also be made clear, including limitations on the ability to draw on existing lines of credit, or other borrowing limitations
- Stranded cash - For companies with foreign operations, the SEC staff has focused on the registrant's ability to repatriate cash to the United States in order to meet significant upcoming obligations, such as debt repayments or mandatory pension contributions. Comments have focused on the relationship between liquidity needs and the income tax assertion about management's intent to permanently reinvest foreign earnings. The SEC staff has also asked companies to quantify the amount of cash held overseas and the amount of incremental deferred tax, if any, that would be recorded if cash were to be repatriated. This is also a common topic in SEC staff comments related to income taxes
- Cash flow analysis - One of the common criticisms in the liquidity analysis is when registrants simply repeat information readily found on the face of the statement of cash flows. Instead, registrants should disclose the underlying factors driving changes in operating assets and liabilities and the related cash flows

Sample comments:

1. In future filings please provide a more informative analysis and discussion of changes in operating cash flows for each period presented. In doing so, please explain the underlying reasons for and implications of material changes between periods to provide investors with an understanding of trends and variability in cash flows. Please ensure your discussion and analysis is not merely a recitation of changes evident from the financial statements. Refer to Item 303(a) of Regulation S-K.
2. Please provide us proposed revised disclosure to be included in future periodic reports that quantifies the parent company's short-term and long-term obligations over the next few years and any plans to deploy excess capital, and that quantifies the sources of liquidity to meet these obligations and plans.
3. Please identify and discuss any known trends, demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in your liquidity increasing or decreasing in any material way. In this regard, we note your disclosure that your long-term indebtedness has steadily increased and has more than doubled in five years. Please refer to Item 303(a)(1) of Regulation S-K.
4. We note you have international operations in multiple foreign countries and local taxes and currency controls may impact your ability or willingness to repatriate funds to the United States. Please clarify the amount of cash and cash equivalents held by foreign subsidiaries. To the extent material, please revise future filings to disclose this amount and also provide a statement indicating whether it is your intention to repatriate these funds and that you would need to accrue and pay taxes if repatriated.

Risk factors

Registrants are required by Item 503(c) of Regulation S-K to provide a description of significant risk factors within Item 1A of the Form 10-K. The discussion should include an explanation of the risks that specifically affect the registrant (a summary of generic risks that would apply to all entities is not sufficient). Registrants are also required to address market risks, including credit and interest risks, in Item 7A of the Form 10-K.

In recent months, cybersecurity has become a top concern for many companies, regulators and law enforcement agencies given the impact it has had on companies and other capital market participants. Cyber-attacks aimed at the capital markets can have a devastating effect not only on a company but also on the economy and individual consumers. The SEC staff has continued to focus on cybersecurity-related issues and in 2011 issued guidance to assist public companies with their disclosures of cybersecurity risks and cyber incidents. The guidance reminds companies to disclose the risk of cyber incidents if it is among the most significant factors that make an investment in the company speculative or risky. Registrants should evaluate their cybersecurity risks and take into account all available relevant information, including prior cyber incidents and the severity and frequency of those incidents in determining whether a risk factor is required.

Sample comments:

1. We note that you disclose that you may be vulnerable to breaches, hacker attacks, unauthorized access and misuse, computer viruses and other cybersecurity risks and events. Please tell us whether you have experienced any breaches, hacker attacks, unauthorized access and misuse, computer viruses and other cybersecurity risks and events in the past and, if so, whether disclosure of that fact would provide the proper context for your risk factor disclosures.
2. We note the Company increased its mortgage banking activities during the year and intends to continue to increase its activities in this area going forward. Please tell us and revise future filings to disclose the specific risks involved with this shift in business focus, including the Company's exposure in the event it is unable to sell the mortgages into the secondary market.
3. Please expand the risk factor to explain that adverse market conditions vary with respect to different products and the overall product mix. For example, you noted in your recent earnings call that several of your products generally perform better in down markets and you have experienced net outflows in periods of strong market conditions.

Fair value measurement

The SEC staff has continued to focus on compliance with the financial statement disclosure requirements included in ASC 820, *Fair Value Measurement*, emphasizing both the quantitative and qualitative requirements set forth in the standard. Qualitative comments have placed an emphasis on how the registrant implements its processes and controls to support fair value measurements, while the quantitative comments have focused on significant unobservable inputs for level 3 measurements and how they were used to determine fair value.

Management's process to understand the assumptions used by third-party pricing sources has been a point of focus by the SEC staff. Comments have been focused on ensuring management maintained responsibility for the estimates provided by the pricing service and used in the company's financial statements. Ultimately, management's ownership and understanding will result in more meaningful and reliable information disclosed in the financial statements.

The SEC staff comments have continued to focus on the following disclosures:

- The weighted average of the significant unobservable inputs to supplement any wide ranges and the basis for determining the weighted average
- The amount for each valuation technique used within a class of assets or liabilities when multiple valuation techniques were used
- The factors considered when determining the appropriate weighting to be applied to each valuation technique when multiple valuation techniques are used to determine fair value
- The procedures and controls in place to support the completeness and accuracy of the prices received from third party vendors
- The basis for any adjustments made to the valuations received from third-party vendors

As it relates to the categorization of assets and liabilities within the fair value hierarchy, the SEC staff has requested additional information from registrants supporting their determination of a particular asset or liability's classification. Questions raised by the SEC staff surrounding leveling have been asked about both assets and liabilities measured using valuations provided by third-party vendors and those valuations measured internally. The SEC staff has challenged companies' classification of certain level 2 assets and liabilities whose valuations may include significant level 3 inputs.

Sample comments:

1. We note your disclosure of the range of significant unobservable inputs used in the fair value measurement of level 3 assets and liabilities as well as qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs. Given the wide range of assumptions for several of the categories, please revise your future filings to also provide a weighted average of the significant unobservable inputs reported, similar to the illustration provided in ASC 820-10-55-103, and state your basis for calculating the weighted average (e.g., weighted average by notional, principal, etc.).
2. Please break out (based on the valuation technique actually used) the dollar figures in the column entitled "Fair Value at December 31, 20XX" among the various valuation techniques set forth in the column entitled "Valuation Technique".
3. We note that you use valuations provided by third-party pricing services as the basis for your fair value measurements for several different types of financial instruments. Please revise your future filings to disclose the procedures you perform to validate the valuations received from such third-party pricing services.
4. We note that the fair values of certain level 3 investment are determined using broker quotes for the subject security and/or similar securities. We also note your disclosures related to the valuation process for fair value measurements categorized within level 3. Please enhance your disclosure in future filings to address the following:
    - Discuss the average number of broker quotes received and whether such quotes are binding or non-binding.
    - Describe the process you undertake to validate the broker quotes received.

Fair value measurement

- Confirm the broker(s) quotes you receive provide you with sufficient detail such that you are able to assess whether the pricing methodology complies with ASC 820.
- Discuss how frequently you adjust the pricing of any particular security you receive from the broker(s).

5. You disclose that in your fair value measurement for collateral dependent loans you discount third-party appraisals based on the historical sales proceeds compared to appraised values. This discount appears to meet the definition of a level 3 input. This input also appears to be significant to the entire measurement and therefore, the entire measurement should be categorized within level 3 of the fair value hierarchy. Refer to ASC 820-10-35- 38A. Please revise your disclosure accordingly or tell us why you do not believe the discount is a level 3 input. Additionally, please disclose the information required by ASC 820-10-50-2.bbb and c.
6. We note that you have classified impaired loans as level 2 in the fair value hierarchy, and have disclosed that the fair value is determined based on quoted prices for similar assets, adjusted for the attributes of the loan, or based on the fair value of the collateral, which is typically estimated based on the quoted market prices if available, appraisals or other internal valuation techniques. Please tell us in more detail how you determined that the techniques used for these impaired loans qualified as level 2 in the fair value hierarchy. For example, describe the types of impaired loans and the market information used in the analysis to support a level 2 classification.
7. It appears from your fair value hierarchy disclosures that the majority of your credit derivatives are level 2. Please address the following regarding your credit derivatives in your synthetic credit portfolio: Tell us the level in which you have classified these instruments in the fair value hierarchy as well as your basis for including the item in that particular level. Tell us if there were any adjustments made for liquidity or any other adjustments made to the fair value of these positions. If so, tell us how you consider whether the adjustment is significant to the overall fair value measurement for purposes of classification in the fair value hierarchy.

Business combinations

Acquisition-related accounting and disclosure requirements can be complex, and can vary based on the nature of the transaction and the nature of the assets acquired and liabilities assumed. As companies continue to seek growth opportunities through acquisitions, the SEC staff continues to comment on various acquisition accounting and disclosure items.

ASC 805, *Business Combinations,* requires extensive disclosures to enable users to evaluate the nature and financial effects of a business combination. Companies should carefully consider all of the disclosure guidance in preparing financial statements, both in the period of the acquisition and in subsequent periods.

For companies in the financial services industry, SEC staff comments have focused on both the accounting and disclosure requirements of ASC 805*,* including:

- Questions about how fair value was determined and the key assumptions used
- The reasons for significant adjustments to the initial determination of fair values and the reasons why such information was not available at an earlier date
- How goodwill was allocated to reporting units and the interplay with the company's operating segments disclosures

Sample comments:

1. Please provide us proposed revised disclosure to be included in future periodic reports that indicates your accounting policy for business combinations. In your disclosure, please specifically indicate: that you apply the acquisition method; how you record assets acquired and liabilities assumed; how you record contingent consideration; how you determine the value of goodwill; and, how you treat acquisition costs.
2. We noted that the Company recorded a measurement period adjustment during the fourth quarter, based on the receipt of new appraisals, to reflect a change in the estimate of the acquisition date fair value of the loans acquired earlier in the year. Please confirm, if true, that the new information obtained in the fourth quarter was directly related to facts and circumstances that existed as of the acquisition date.
3. Please tell us how you calculated the purchase consideration associated with the contingently issuable shares of the common stock. Please also clarify and disclose in future filings how you intend to account for any changes in the fair value of this consideration prior to resolution of the contingency, as well as the revenue targets that must be achieved to trigger the annual issuances of stock. We refer to ASC 805-30-35-1.

Loss contingencies

The SEC staff continues to focus on ensuring that registrants comply with the guidance of ASC 450, *Contingencies*. Some registrants are resistant to providing the required disclosures for fear that they may divulge information that could adversely affect the outcome of litigation. To that end, the SEC staff has indicated that they will accept disclosure of estimated exposure on an aggregated basis, rather than requiring separate disclosure for each individual matter.

GAAP requires companies to record an accrual for a loss contingency when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Even if the criteria for accrual have not been met, disclosure may still be required if the loss is reasonably possible. For loss contingencies that meet the criteria for disclosure, registrants should disclose the nature of the contingency and an estimate of the possible loss or range of loss (or a statement that such estimate cannot be made).

To keep investors apprised of material developments associated with the nature, timing and amount of a loss contingency, such details should generally not be disclosed for the first time in the period in which they are recorded. The SEC staff has frequently evaluated the disclosures in periods prior to the period in which a loss is recorded and commented on the lack of adequate early-warning or foreshadowing disclosures. Such comments often request additional information to understand the triggering event for recording the loss and whether such losses should have been recorded in an earlier period. The SEC staff expects that loss contingency disclosures will be updated regularly, both qualitatively and quantitatively, for developments in the related matters and as more information becomes available.

Sample comments:

1. In future filings, for any contingencies where there is at least a reasonable possibility that a loss or an additional loss may have been incurred, please provide an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.
2. Although you do not expect the outcome of outstanding legal proceedings to have a material adverse impact on your financial position, the outcome of any such matters could be material to your results of operations or cash flows in a given period. Despite your assertion that it is not presently possible to determine your ultimate exposure to these matters, please tell us if you are able to estimate a loss or a range of losses that are at least reasonably possible, and revise your future filings to provide this disclosure as required by ASC 450-20-50-3 and 50-4.
3. Please tell us and revise future filings, to address whether there is an exposure to loss in excess of the amount accrued and what the reasonably possible loss or additional loss may be.

Impairments

The SEC staff continues to issue comments on registrants' considerations of disclosures surrounding critical accounting estimates related to goodwill, indefinite-lived intangible assets and long-lived asset impairments.

Goodwill and indefinite-lived intangible assets

SEC staff comments during the 2014 comment letter cycle reflected themes similar to 2013. Comments have requested additional details about a company's assessment of qualitative factors used to determine whether it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount (referred to as step zero). Additionally, details surrounding a company's quantitative impairment tests and the related assumptions used have also been requested. For reporting units whose fair values are not substantially in excess of their carrying amounts ("at risk" reporting units), the SEC staff has asked registrants to disclose:

- The percentage by which the fair value of the reporting unit exceeded its carrying value as of the date of the most recent quantitative analysis
- The amount of goodwill allocated to the reporting unit
- A description of the methods and key assumptions used in the impairment assessment and how they were determined
- A discussion of the degree of uncertainty associated with key assumptions
- A description of potential events and circumstances that could have a negative effect on the reporting unit's fair value

These types of requests are consistent with guidance outlined in the Division of Corporation Finance Financial Reporting Manual Section 9510.3.

The SEC staff has also continued to challenge whether impairment charges were recognized in the appropriate period. In some instances, the SEC staff has requested that registrants provide the current period and historical impairment analyses, accompanied by a comparison of key assumptions underlying each analysis with supporting evidence for changes in those assumptions. Some registrants also received comments from the SEC staff when no impairment charge was recorded during the annual assessment, but other publicly available data indicated the presence of a negative trend that could impact the impairment assessment.

Long-lived assets

The SEC staff comments related to long-lived assets were consistent with the themes presented for goodwill and other indefinite-lived intangible assets. Specifically, the SEC staff scrutinized the timing of when impairment charges were recorded and the sufficiency of disclosures of valuation methodologies. The SEC staff has also requested that registrants provide additional information about the level of uncertainty and sensitivity of key assumptions related to "at risk" assets or asset groups. In some instances, the SEC staff requested details of the impairment analysis and challenged registrants' conclusions relative to how registrants considered economic challenges, operating losses at a specific segment, the impairment of similar assets as a potential trigger event, or how they defined the lowest level of identifiable cash flows used to identify the asset group.

Sample comments:

1. We note your on-going losses in the insurance segment. We also note that the goodwill allocated to this segment is not impaired because you state that the estimated fair value of the insurance reporting unit exceeded its carrying value and that, therefore, step two of the impairment analysis was not performed. Please provide us the following information regarding your analyses for each period presented in your Form 10-K and include any available updated information through the fiscal quarter ended June 30, 20XX:
   - Provide us your complete impairment analysis for each of the periods mentioned above.
   - Provide us a complete narrative of your analyses, including all material assumptions and any change in those assumptions between periods.
   - Provide us pricing information of your common stock and market capitalization for each of the periods mentioned above.

Impairments

  – Discuss how this information and any other external indicators were considered in your analyses.

2. We note that you elected to perform a qualitative assessment in your evaluation of goodwill impairment and concluded that performance of the two-step test was not required. Please provide us with additional insight into the positive and negative qualitative factors that you considered in concluding that this qualitative analysis was sufficient for each of your reporting units with specific attention to your Insurance reporting unit given the continued net losses generated by the business in recent periods. Please also tell us the date that you last performed Step 1 of the goodwill impairment test for your Wealth Management reporting unit and its fair value as a percentage of carrying value as of that date.

3. We note that based on a review of past filings a significant amount of your indefinite-lived intangible assets relate to management contracts that were obtained in the acquisition. Please tell us and consider revising your disclosure in future filings to address whether the merger-related outflows impact your assessment of whether the values of the management contract intangible assets are impaired and whether the indefinite-life classification is still appropriate. In your response, specifically address whether, and if so, how you determined that there is a high likelihood of continued renewal based on historical experience for these acquired management contracts, which we noted is a key factor in the assignment of indefinite lives to such contracts per your disclosure on page xx.

4. You stated in the 10-K for the year ended December 31, 20XX that your reporting unit indicated the carrying value exceeded fair value by 2% in step 1 of your goodwill analysis. In step 2 the implied fair value was greater than the carrying value by $X million. Please tell us why you believed your assumptions in your goodwill analysis were reasonable. For example, tell us the basis for assuming the 40% control premium disclosed.

5. Please tell us each reporting unit for your goodwill impairment test and the respective goodwill balance at December 31, 20XX. For any reporting unit in which the estimated fair value is not substantially in excess of the carrying amount and therefore is at risk of failing step one of the impairment test, please provide proposed revised disclosure to be included in future filings to include the following:

   – Percentage by which fair value exceeded carrying value as of the date of the most recent test;

   – Amount of goodwill allocated to the reporting unit;

   – Description of how the key assumptions in the impairment analysis were determined;

   – Discussion of the degree of uncertainty associated with the key assumptions. The discussion regarding uncertainty should provide specifics to the extent possible (e.g., the valuation model assumes recovery from a business downturn within a defined period of time); and

   – Description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

Executive compensation

The SEC staff continues to focus on registrants' executive compensation disclosures in an effort to establish more direct and transparent disclosures to shareholders. Item 402 of Regulation S-K contains extensive disclosure requirements related to executive compensation. The applicability of these disclosures varies based on each registrant's particular facts and circumstances. SEC staff comments in this area focused on enhancing the disclosures of specific aspects of an employee's performance and/or the criteria used to evaluate and determine compensation awards. Where benchmark or market data, including competitor information, is used in the evaluation the data, its use should be specifically disclosed.

Sample comments:

1. In future filings, please describe in greater detail how you determine the cash bonus and long-term incentive awards granted to your named executive officers on an individual basis. While we note the subjective nature of your compensation decisions, your future disclosure should provide enough information for an investor to understand why you awarded specific amounts to each named executive officer, as well as the reasons why award amounts may have differed significantly among named executive officers.
2. We note your disclosure illustrated that the total compensation targets "generally fall near the median compensation for peers..." Please clarify how you establish and approve the total compensation targets for your named executive officers.
3. We note that individual compensation levels are determined on a discretionary basis. Please expand your disclosure to describe the factors the Compensation Committee considered awarding the revenue productivity, the subsidiary management bonus and the cash bonus. Expand the discussion of the company based goals and individual performance goals to explain which bonuses these goals were designed to affect. Additionally, discuss the level of achievement of these goals and how these achievements impacted the bonuses awarded.

Pay Ratio Disclosure

The SEC has proposed a new rule, as required under the Dodd-Frank Act, that would require public companies to disclose the median annual total compensation of all employees, excluding the chief executive officer; the annual total compensation of the CEO; and the ratio of the two figures. The proposed rule does not require a specific methodology for determining the median employee, but rather allows for flexibility. The selection of a methodology would be based on a company's circumstances, including the size and structure of the company and the way it compensates employees.

The comment period closed in December 2013 and the SEC is currently moving toward a final rule. Although there is no definitive timetable as to when the final rule will be issued, recent comments by the SEC staff indicate that the final rule may yet be issued in 2014. Under the proposed rule, a company would be required to provide the new pay ratio disclosures for its first fiscal year commencing on or after the effective date of the final rule, which if released in 2014, would mean calendar-year registrants would need to calculate the pay ratio based on 2015 compensation.

Internal Control

We have heard various members of the SEC staff signal that internal control over financial reporting (ICFR) is an area of increasing interest. At the 2013 AICPA National Conference on Current SEC and PCAOB Developments Conference, several presenters noted that as part of the comment letter process, the SEC staff is looking for potential indicators of material weaknesses, such as corrections of an error or disclosures regarding material changes in internal controls. Presenters also commented that the SEC staff may be interested in a registrant's conclusions regarding ICFR in instances where they do not agree with a registrant's conclusion on an accounting matter. This focus on ICFR has continued to be mentioned in the months since the conference, and we expect it to be discussed again at the 2014 conference. We have begun to see an increasing volume of comments in this area, with the SEC staff challenging registrant's conclusions regarding the existence and severity of internal control deficiencies. Registrants should continue to carefully evaluate the ICFR and disclosure controls and procedures (DC&P) implications in responses to the SEC staff and the sufficiency of their disclosures, assessments and certifications.

While the SEC staff is likely to question why a restatement did not result in the reporting of a material weakness, we have also seen comments about the existence of material weaknesses when errors are corrected by means of revision of comparative financial statements.

Companies sometimes assess control deficiencies with a priority focus on the Control Activities component of COSO. It is important to evaluate the implications of control deficiencies on all COSO components. The SEC staff has asked for additional information about the company's consideration of specific components within the COSO framework.

The SEC staff has also questioned registrants when there is no explicit conclusion about the effectiveness of DC&P or when management has concluded that ICFR is ineffective but DC&P is effective. Under Rule 13a-15(b) of the Exchange Act, the registrant's management must evaluate the effectiveness of DC&P as of the end of each fiscal quarter. This evaluation includes assessing the controls and other procedures designed to ensure that information required to be disclosed by the registrant in its filings is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Although separately assessed, it is important to remember that there is substantial overlap between the processes considered DC&P and those considered part of IFCR. Nearly all of ICFR falls within the scope of DC&P, whereas there are aspects of DC&P that extend beyond what is considered part of ICFR. As such, it is rare that a material weakness in ICFR would not also result in DC&P being considered ineffective.

Item 308 of Regulation S-K requires registrants to disclose any change in the company's ICFR that has materially affected, or is reasonably likely to materially affect, the registrant's ICFR each quarter. Changes requiring disclosure include changes in internal control made in the process of remediating previously identified material weaknesses, as a result of the integration of significant acquisitions, or due to the implementation of new information technology systems. The SEC staff often looks to information contained in companies' current reports, on their websites, and in other sources to identify potential changes in ICFR. SEC staff comments in this area have focused on the timeliness and completeness of the disclosures in periodic filings.

If a registrant has identified one or more material weaknesses in its internal control over financial reporting, the SEC staff may ask that the registrant include a risk factor (in accordance with Item 503(c) of Regulation S-K) to explain the potential adverse effects resulting from these circumstances and how it could impact the company's financial reporting, results of operations and market value.

Sample comments:

1. It appears that your control structure failed, in either design or execution, to prevent an error from being detected before resulting in a material restatement. It remains unclear whether there were no controls in place that would have prevented such an error, or if the controls in place failed. Please clarify. Further, because the control failure resulted in a material restatement, it is unclear why you believe the related weakness is not material. Please explain.
2. We continue to question your evaluation of the deficiencies in ICFR and your determination that it was not reasonably possible that a material misstatement of your financial statements would not be prevented or detected on a timely basis as a result of certain control deficiencies.

Internal control

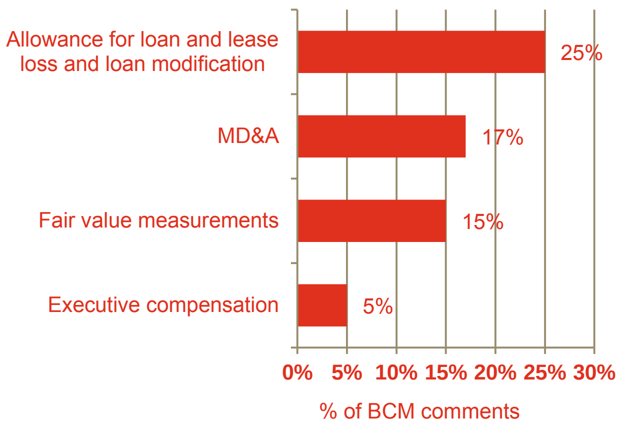
3. Tell us why the severity is limited to the specific, individual process-level errors you describe in your response and how you determined that the reasonably possible potential error for each is limited to the various errors identified. For example, how was it determined that the significant deficiency is limited to only being manifested through an immaterial error in a specific type of revenue transaction.
4. Please describe in greater detail how you considered the numerous deficiencies in evaluating the monitoring and risk assessment components of COSO. Specifically, we continue to question whether one or more deficiencies exist in the risk assessment or monitoring component and whether one or more such unidentified deficiencies represent a material weakness.
5. In light of the ineffectiveness of your internal controls over financial reporting, it is unclear to us how you determined that your disclosure controls and procedures were effective. Please explain.
6. Exchange Act Rule 13a-15(b) or 15d-15(b) requires that management evaluate, with the participation of the principal executive and principal financial officers, the effectiveness of disclosure controls and procedure as of the end of each fiscal quarter. Please revise to disclose that your principal executive and financial officer participated in the evaluation. Item 308(a) of Regulation S-K.
7. We see you assessed your disclosure controls and procedures as of December 31, 20X1 as "not effective" due to the material weakness that resulted in the restatement of your financial statements. Subsequently, you conclude that as of March 31, 20X2, disclosures controls and procedures are effective and state that there have been no changes in internal control over financial reporting in the fiscal quarter ended March 31, 20X2. Please tell us how disclosure controls and procedures are now effective without any changes in internal control over financial reporting. Please also reconcile the statement that there were no changes in internal control over financial reporting in the quarter ended March 31, 20X2 with the disclosure of the remediation efforts to address the material weakness subsequent to year-end in your Form 10-K.
8. In light of the disclosure regarding disclosure controls and procedures in your quarterly reports, please revise this section to provide a risk factor to alert investors to your ineffective controls and procedures. The risk factor should disclose all material risks resulting from these circumstances. In this regard, consider addressing the risk to the Company if it is unable to adequately correct any material weaknesses in its internal controls and procedures. Alternatively, if you have determined that a risk factor is unnecessary, tell us the basis for your conclusion.

Sector highlights

Sector highlights

Banking and capital markets

Most frequent banking and capital market comment letter topics



Allowance for loan and lease losses and loan modifications

The SEC staff continues to focus on the transparency and completeness of disclosures over the allowance for loan and lease losses and modifications. This is an area where significant judgment is required to develop the accounting estimate and continues to be a focus point for investors, regulators and other stakeholders. Comments continue to be focused on changes financial institutions have made to their models and the assumptions used to calculate their allowance. The SEC staff expects disclosures around these changes to be clear and transparent and has requested that registrants quantify the impact of the change.

As the economy continues to stabilize, the focus has shifted slightly to the release of reserves. The SEC staff believes that the investor needs to be able to understand the drivers of changes in the allowance for loan and lease losses ("ALLL") and how they are consistent with the changes to the credit and asset quality indicators. To this end, the SEC staff continues to ask for more robust information, with a focus on the MD&A disclosures regarding economic trends and how they reconcile to the decision to release or increase reserves. Comment letters have also requested additional information about the financial institution's policy of allocating the ALLL to the various pools of assets that are not assessed on an individual basis.

Expressing similar concerns, loan modifications, including troubled debt restructurings ("TDRs"), remains an area of focus for the SEC staff. The staff continues to look for enhanced qualitative and quantitative disclosure around modifications being made and how income accruals are impacted. They have also expressed concern in public statements that they continue to observe a lack of clarity in how banks define payment default and that practices are varied with regard to look back disclosures. In addition, the lack of disclosure around the removal of a TDR designation has been an area of increased comment.

Sample comments:

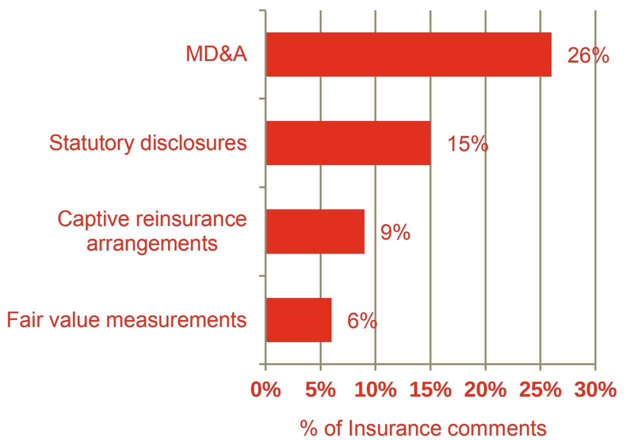
1. Despite the small and decreasing amounts of loan and lease charge-offs and the noticeable improvement in asset quality you have continuously recognized provisions for loan and lease losses over this five year period. Please tell us and revise future filings to provide a more detailed discussion of the changes in your credit quality since your methodology for determining the allowance for loan and lease losses does not appear to capture the apparent improvement in credit quality in your loan portfolio.
2. Please revise the table of non-accruing loans presented in future filings to clearly set forth accruing and non-accruing troubled debt restructurings.
3. Provide a rollforward of the activity in the allowance for loan losses for non-purchase credit impaired loans for each of the periods presented. This will provide the reader with an enhanced understanding of the performance of the non-purchase credit loans given the continued significant growth of these types of loans.
4. You had significant levels of loans classified as delinquent 90 days or more which were accruing/accreting. Please provide us with your analysis that supports the continuing accrual of income on loans that are past due more than 90 days. Please also tell us the fair value of the collateral and the amount of the accretable yield for the non-covered loans that are past due more

than 90 days for which you are continuing to accrue income.

5. Please tell us and revise your future filings to disclose the dollar value and delinquency thresholds for your commercial portfolios (including impaired commercial real estate, construction and land, and large commercial and industrial loans) that are reviewed for impairment on an individual basis.
6. We note that loans individually evaluated for impairment principally include troubled debt restructurings (TDRs). Please address the following for loans that are past due 180 days and individually evaluated for impairment: Tell us whether you believe measuring the incurred losses for loans past due 180 days based on an individual assessment of the most likely outcome, as opposed to a pool basis, is consistent with the guidance in ASC paragraph 310-10-35-21.

Insurance

Most frequent insurance comment letter topics



Statutory disclosures

The SEC staff continues to focus on registrants' statutory and regulatory disclosures as required by ASC 944, *Financial Services-Insurance*, in an effort to establish more direct and transparent disclosures to shareholders. The SEC staff has been consistent with regard to their comments on these disclosures across all types of insurance products. Comments have included requests for information about regulatory requirements of statutory entities and increased disclosure about restrictions on the payment of dividends. The SEC staff also continues to remind registrants that statutory disclosures should not be labelled unaudited.

Sample comments:

1. Disclose the amount of statutory capital and surplus necessary to satisfy regulatory requirements, if significant in relation to actual statutory capital and surplus, as required under ASC 944-505-50-1b. If not significant, please clarify in the disclosure.
2. Disclose the amount of retained earnings or net income that is restricted or free of restrictions for payment of dividends to your stockholders as required by Rule 4-08(e)(1) of Regulation S-X.
3. Regarding your disclosure that statutory amounts for the latest period are unaudited, please represent to us that you will remove this designation in future filings as this information is required by ASC 944-505-50-1a. To the extent you intended to express that the audits of your statutory financial statements were not yet complete at the time you issued your financial statements, we do not believe that the timing of regulatory filings is relevant to disclosures required by GAAP.

Captive Reinsurance Arrangements

Many registrants in the life insurance industry utilize captive reinsurance arrangements to help ease capital strain that can arise under statutory regulations. While the captive reinsurance arrangements are predominately intercompany in nature, the SEC staff has focused on the impact a change in the use of these arrangements may have on the overall business operations of the registrant. Specifically, the SEC staff has asked registrants to disclose the following in MD&A:

- The nature and business purpose of transactions with captives
- Uncertainties associated with the use of captive reinsurance arrangements and the reasonably likely effects on an entity's financial position and results of operations if they discontinued the use of these arrangements
- The extent of reinsurance assumed from third parties
- The amount of assets and other guarantees that secure the captives' obligations

Sample comments:

1. Please tell us the nature and business purpose of transaction with captives. Please explain whether and if so, how you reinsure with these captives

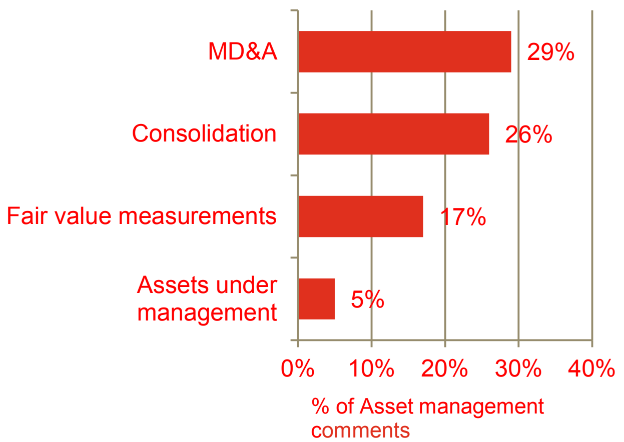
including whether, and if so, to what extent, captives assume reinsurance from third parties to whom you ceded policies.

2. Please tell us the amount of captives obligations and the nature and amount of assets, guarantees, letters of credit of promises that secure the captives' obligations.

3. Please tell us the effects in your GAAP consolidated financial statements of transacting with captives directly and, if applicable, indirectly through third parties.

Asset management

Most frequent asset management comment letter topics



Variable Interest Entities (VIE)

Under ASC 810, *Consolidation*, a reporting entity must consolidate any entity in which it has a controlling financial interest. ASC 810 defines a variable interest as investments or other interests that will absorb portions of a VIE's expected losses or receive portions of the entity's expected residual returns. The identification of a variable interest represents one of the more challenging aspects of the VIE model. A VIE is consolidated by the primary beneficiary, which is the party that has the power to direct the entity's most significant economic activities and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the entity. This party could be an equity investor, some other capital provider, or a party with contractual arrangements. Within the asset management sector, VIE's generally include investment companies advised by asset managers and securitization vehicles involving commercial debt obligations and commercial loan obligations.

The VIE model requires that both the primary beneficiary of a VIE and a reporting entity with a variable interest in a VIE disclose key information on their involvement with a variable interest entity. This is in addition to the disclosure requirement that may be required by other accounting topics. Accordingly it is important that companies develop, monitor and maintain systems, processes and internal controls to ensure compliance with these requirements in a timely and complete manner. ASC 810 provides extensive disclosure requirements to enable users to evaluate the nature and financial effects of VIE's.

The SEC staff comments have requested that registrants enhance their disclosures of their accounting policy and the determination of which entities are consolidated and which ones are not. In addition, the SEC staff has requested additional information about registrant's primary beneficiary assessment, focusing on the significant judgments and assumptions, the qualitative factors considered, and the quantitative analysis used, if any, to determine whether the rights to receive benefits could potentially be significant. The SEC staff has also focused on the existence of any control deficiencies relating to a company's consolidation policy and how management determined the severity of the deficiency.

Sample comments:

1. We note your disclosure that many of your funds are considered variable interest entities (VIEs). Given your involvement with a number of entities and the fact that only certain of them are consolidated, please revise your future filings to provide a more specific understanding of the types of entities with which you are involved, why certain entities are considered VIEs vs. voting interest entities, and the key considerations in determining whether such entities should be consolidated. In this regard, we note your accounting policy disclosure discusses your consolidation policy in somewhat general terms but does not provide the reader with a sense of the specific types of entities with which you are involved and how your consolidation determination may vary by entity based on the consolidation model applied.

2. We note your disclosure that for certain asset management funds, you evaluate the rights of the limited partners to determine whether to consolidate the fund in accordance with ASC 810-20-25. Please revise your future filings to disclose, if correct, that first you determine whether these funds are VIEs in accordance with

ASC 810-10-15-14 and you perform the quantitative assessment to determine whether you are the primary beneficiary. For those funds that you determined do not meet the definition of a VIE, disclose that these funds are considered voting interest entities for which you evaluate the rights of the limited partners to determine whether to consolidate the fund.

3. Please provide us with a comprehensive analysis supporting your determination that you are not required to consolidate your CLOs. In this regard, we note that although you have concluded that you have the power (as collateral manager) to direct the activities of the CLO that most significantly impact the entity's economic performance, you do not believe that you have the obligation to absorb losses or the right to receive benefits that would potentially be significant to the VIE. Your disclosure indicates that you performed a quantitative analysis and determined that under various scenarios your fees would not be significant to the CLOs, but it is not clear whether you determined if they could potentially be significant. Furthermore, it is not clear how you considered any seed investments in these CLOs in your analysis.

4. We note that during the third quarter, you deconsolidated a fund and began recognizing your investment in this investment vehicle under the equity method, as your ownership interest declined below 50%. Please provide us with your analysis as to how you determined that you lost control over this investment vehicle and deconsolidation was appropriate, including specific references to the FASB Codification that supports your accounting.

5. We note that you have concluded that no significant deficiencies or material weaknesses (arising from your consolidation policy) existed as of December 31, 20X2 and December 31, 20X1. Tell us whether you identified the existence of any control deficiencies as of either of those dates in relation to consolidation that did not rise to the level of a significant deficiency or material weakness. If so, explain what they are and discuss how you assessed their severity.

As the FASB's consolidation project nears completion, significant changes have been proposed to the principal versus agent model exposed in 2011, making the potential impacts more broad than initially anticipated. The FASB's initial goal was to provide relief to asset managers from consolidating funds they manage; however, the FASB has made decisions that will impact several aspects of the current consolidation guidance and impact all companies. The tentative decisions reached will impact, among other items (1) how to evaluate control for voting entities; (2) when an entity is a variable interest entity (VIE); (3) how to evaluate economics when determining who consolidates a VIE; and (4) when to apply the related party tiebreaker. As a result of the current decisions, both the VIE model and voting model for consolidation are expected to change. The standard is in its final review stages and is expected to be issued in 2015.

Assets under management

The majority of revenues generated by asset management advisors are based on assets under management ("AUM"). Any fluctuations in AUM will generally have a direct impact on revenues and profitability. The AUM disclosures included as part of the results of operations section of MD&A have been a focus of the SEC staff comments for several years. The SEC staff continues to request enhanced disclosures and transparency surrounding the drivers of changes in AUM and how changes to AUM and asset classes impact the registrant's results of operations. They also frequently ask for additional disaggregation of AUM by various distribution channels or investment strategies and how each class of assets under management impacts the results of operations.

Sample comments:

1. We note you present your assets under management (AUM) by channel, asset class, and client domicile and the average mix of active and passive AUM for the last three fiscal years in the tables provided. We also note your discussion states that investment management fees for products offered in the retail distribution channel are generally calculated as a percentage of the daily average asset balances, and for products offered in the institutional and private wealth management distribution channel, fees also vary in relation to the level of client assets managed. Finally, we note that retail products offered outside of the U.S. do not generate a separate distribution fee, as the quoted management fee rate is inclusive of these products. In an effort to provide more transparent disclosures regarding trends in investment management fees, please revise the tables referred to above to include your average AUM by channel, asset class and client domicile.

Sector highlights

2. Please revise your summary of changes in AUM table in your future filings to disaggregate your market and foreign exchange appreciation (depreciation) amounts. In this regard, we also think it would be more useful to provide disaggregated net flows (i.e., inflows and outflows shown separately) in the table, rather than provide this information in narrative format. Provide us with your proposed disclosures.

3. Please provide a reasonably detailed discussion of your roll forward of fee-earning AUM to help readers understand the impact that such performance/activity had on your results of operations and cash flows. Your discussion should include a comprehensive analysis of each of the significant components in your roll forward for each period presented on a consolidated basis as well as by segment, including market appreciation/(depreciation). Please ensure your discussion addresses material contributions or capital commitments, distributions, redemptions and market appreciation/(depreciation), including the identification and quantification of the material underlying sources that drove those activities.

Business Development Companies (BDCs)

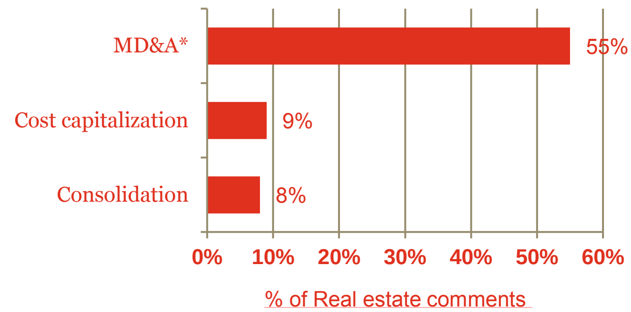
Specific to BDCs, the SEC's Division of Investment Management has issued guidance clarifying the applicability of the rules for presenting separate financial statements and summarized financial information of unconsolidated majority-owned subsidiaries and subsidiaries not consolidated. This guidance has had a significant impact on companies and in some cases, has required BDCs to include the separate audited financial statements of the investee in the Form 10-K or increase disclosures about such investees in the financial statements. The requirement for separate financial statements and/or summarized data with respect to investees is contingent on the significance tests described in Regulation S-X, which determine the financial reporting requirements.

Sample comment:

1. Has the company performed an analysis as to whether the financial statement and disclosure requirements of Rules 3-09 or 4-08(g) of Regulation S-X should be applied? The Staff believes that Rules 3-09 and 4-08(g) of Regulation S-X apply to BDCs and registered investment companies (RICs). Rule 3-09 of Regulation S-X is applicable for a majority owned subsidiary (greater than 50% ownership) which is not consolidated by the Registrant. Rule 4-08(g) of Regulation S-X is applicable for subsidiaries (generally, 25% or more ownership) not consolidated.

Real estate

Most frequent real estate comment letter comments



* Includes "Leasing activities" and "Same property comparison"

Leasing activities

The majority of comments related to MD&A for real estate companies continued to be focused on results of operations and leasing activities. Specifically, the SEC staff has requested enhanced discussion of trends in leasing activities for real estate investment trusts (REITs), including disclosure of average occupancy, average rental rates, comparison of rates of expiring leases vs. current market rents, and costs incurred to obtain new leases.

Sample comment:

1. In future periodic filings please expand your disclosure of your leasing activities for the most recent period, including a discussion of the volume of new or renewed leases, average rents or yields on new and renewed leases, the relationship between new rents and old rents on released space and, where applicable, average tenant improvement costs, leasing commissions and tenant concessions. To the extent you have material lease expirations in the next year, please include trend disclosure regarding the relationship of rents on expiring leases to market rents.

Cost capitalization

Recent comment letters trends show that cost capitalization continues to be an area of focus. The SEC staff has recently asked for disclosure of total soft costs (e.g., interest expense, real estate taxes, payroll, and other general and administrative expenses) capitalized during each period presented. Additionally, the SEC staff has requested further breakout of soft costs capitalized by development, redevelopment, and other capitalized expenditures within MD&A, along with a narrative discussion of fluctuations from year to year. Further, the SEC staff has also requested that registrants disclose in MD&A the anticipated completion date, budgeted costs and costs incurred to date for significant development projects.

The SEC staff has also requested that registrants define when the capitalization period for development begins and ends in their accounting policy footnote and present cash flows used to acquire real estate separate from development costs within the statement of cash flows.

Sample comments:

1. We note that you capitalize soft costs such as interest, payroll and other G&A expenses. In future filings please disclose the amount of these soft costs capitalized that breaks down total capital expenditures between new development, redevelopment and other capital expenditures. Please provide a narrative discussion for fluctuations from year to year.
2. Please tell us, and disclose as part of your significant accounting policies and critical accounting policies in future filings, the capitalization period relating to the other costs associated with your capital projects, including when the capitalization period begins and ends and how that is determined.
3. In future Exchange Act periodic reports, to the extent you engage in development projects or the redevelopment of your properties, and to the extent such development or redevelopment is material, please provide disclosure regarding your anticipated completion date, costs incurred to date, and budgeted costs.

Same property comparison

The SEC staff continues to provide comments on the registrants' explanation of their results of operations, with a focus on same property performance. The SEC staff's comments in this area have focused on providing greater transparency into which properties are included in a registrants' same property portfolio. Specifically, the staff has requested clear disclosure of when development and redevelopment properties are transferred into and out of the same property portfolio and whether acquisitions/dispositions are included. Additionally, the SEC staff has requested enhanced disclosure of the period over period operating performance of the same property portfolio, including the impact of occupancy changes and rental rate changes.

The SEC staff's comments have also focused on registrants providing enhanced disclosure around same property net operating income (NOI). Specifically, the SEC staff has requested that registrants disclose whether management considers same property NOI a key performance measure, define which properties are included in the same property portfolio, and include a clear definition of how same property NOI is computed and a reconciliation to the most directly comparable GAAP measure.

Sample comments:

1. Please tell us if management evaluates the period to period changes in your same store/property performance. If so, please discuss such evaluation and clearly define the same store pool in future Exchange Act reports, as applicable. In addition, within your discussion of the same store performance, please also include disclosure regarding the relative impact of occupancy and base rent and/or management fee changes.
2. In future Exchange Act periodic reports, in order to illustrate for investors your internal earnings growth, please disclose period to period same store net operating income. Additionally, please disclose how you determine the properties that fall within the "same store" pool, including also a discussion of any properties that were excluded from the pool that were owned in all periods compared, and how you determined which revenues and expenses to include in determining NOI. For example, please explain if you include items such as tenant improvement and leasing commissions, ground rent, lease termination fees and marketing costs.

Sector highlights

Consolidation

Consolidation continues to be an area of focus for the SEC staff. Specifically, the SEC staff has focused on investments in which the registrant owns a greater than 50% interest, but accounts for such investment under the equity method of accounting. Registrants should ensure they clearly disclose the provisions of such governing agreement that led the registrant to determine that consolidation was not necessary. For further details on other consolidation issues regarding VIEs, see the VIE section included in the Asset Management sector discussion.

Sample comment:

1. We note that you have a 75% ownership interest in joint venture A. Please provide us with your analysis of how you determined to not consolidate this joint venture. Please cite the applicable guidance in your response.

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About PwC's Financial Services Industry Group

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Robert Sands
U.S. Financial Services Assurance Leader
robert.m.sands@us.pwc.com
(267) 330-2130

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Christopher Gerdau
Partner
christopher.gerdau@us.pwc.com
(973) 236-5010

Ravi Rao
Partner
ravi.s.rao@us.pwc.com
(973) 236-7066

Euclid Zurbaran
Partner
euclid.zurbaran@us.pwc.com
(973) 236-7357

Anthony Arrigo
Senior Manager
anthony.arrigo@us.pwc.com
(973) 236-5029

Paul Kolodziej
Senior Manager
paul.j.kolodziej@us.pwc.com
(973) 236-4164

Todd Kosel
Senior Manager
todd.d.kosel@us.pwc.com
(973) 236-5477

Brian Schramm
Senior Manager
brian.c.schramm@us.pwc.com
(973) 236-7720

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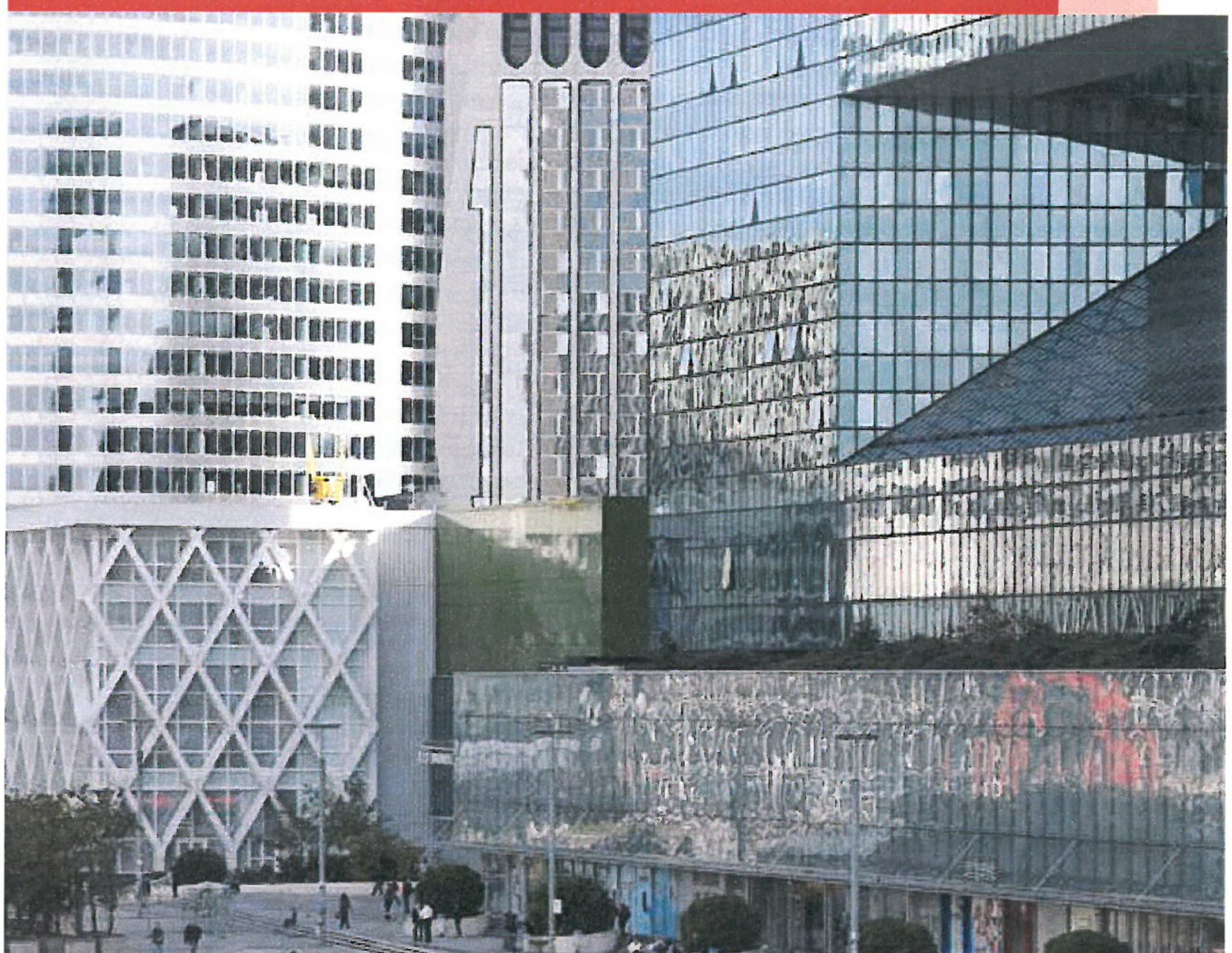

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On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

Consistent with our global vision statement – to build trust and work toward solutions to the world's biggest problems – we continue to bring you thought leadership that is relevant to your industry, while also speaking to your topical needs related to accounting and financial trends and updates.

In this edition of US Real Estate Insights we are especially pleased to provide insightful articles in two areas of increased focus within the real estate investing community – the global search for investment opportunities and the impact of technology and generational preferences on the way commercial real estate is utilized. Following the financial crisis, many investors grew accustomed to identifying distressed investments as opportunities to enhance returns. In "Identifying real property investment opportunities in Spain," David Criado and Matthew Rosenberg discuss how, following a severe economic downturn, a combination of structural reforms and a change in the trends of economic indicators has attracted investors to the risk reward profile of distressed investment opportunities within this Eurozone country. Additionally, in "Where do we grow from here? The impact of millennials on urban real estate," with input from Richard Barkham, CBRE's Global Chief Economist, and Winston Fisher, Partner at Fisher Brothers, Willem VanDooijeweert discusses how landlords and corporations may adjust the way they design their commercial real estate spaces and real estate strategies. These changes are influenced by the generational preferences of Millennials as they become a larger percentage of the workforce.

We also encourage you to read our flagship thought leadership piece, ***Emerging Trends in Real Estate 2015***. As confidence returns to real estate, the industry faces a number of fundamental shifts that will shape its future. To help real estate managers and the investment community better plan, we have looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, will have profound implications for real estate investment and development.

We hope you will find US Real Estate Insights to be informative and helpful to you in your business.

As always, we encourage you to share your thoughts, opinions and suggestions. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.

Byron Carlock, Jr.
National Partner & Real Estate Practice Leader
byron.carlock.jr@us.pwc.com
(214) 754 7580

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Where do we grow from here? The impact of millennials on urban real estate

by Willem VanDooijeweert

A couple of years ago, I walked into the dining room to bring my son dinner, and as I approached the table, I heard the familiar voice of his friend Marcus shouting; "Hi, Mr. V." Ironically, Marcus was present yet nowhere to be found. My son had strategically placed a tablet across the table and was video-chatting with his friend while they both prepared to scarf down a late meal after soccer practice. The idea of a virtual dinner was mind-boggling to me, but also a lesson in efficiency. They discussed everything from school to soccer, polished off homework, shared files and used their smart phones to organize a soccer-video game party where a group of friends would convene later to play online simultaneously.

Two hours later, everything was done!

Earlier generations, such as my own Generation X, were not instantly connected and a great deal of time was lost travelling back and forth to places like malls, libraries, record stores and each other's houses. Weather often cancelled our plans, and information was so far from our fingertips that school reports took weeks, versus hours to complete. Our idea of sharing was a party telephone line using multiple homes accessible from one rotary phone in the kitchen. If we wanted to take a "selfie," the process would span a month including three trips to the store to buy a roll of film, drop it off for development, then pick up prints, which we would review and pay for expensive duplicates to be snail-mailed to select friends or families. Nothing was instant, except the vitamin-fortified breakfast drink, and the idea of getting everything done in an evening was not fathomable.

To keep up with the changing workforce and rapidly-changing technology, many organizations are beginning to scrutinize where and how things get done through a physical and virtual network of connections to understand the evolution of people and place. When signing a fifteen year lease, organizations are constructing an environment not only to meet the needs of the current workforce but also to be suitable for today's teenagers who will start entering the workforce five years from now. Imagine designing office space catering to a new generation of multi-tasking, hyper-connected employees who rarely use E-mail and will likely:

- Share everything from workspace to automobiles;
- Buy groceries without going to the supermarket;
- Hang out without leaving their residences;
- Train behind computers without going to a classroom; and
- Have face-to-face meetings without shaking hands in person.

To real estate professionals educated under the mantra of "location, location, location," the idea of building infrastructure for employees accustomed to visiting places that do not physically exist presents a paradox challenging companies to rethink the definition of place.

The ability of people to connect with colleagues worldwide from almost anywhere has some real estate experts predicting an Arm'chair'meggedon with employees isolated in their residences collaborating on work products without ever going to the office. The corresponding outward migration of staff from the office to remote locations coupled with companies building more efficient infrastructure will then result in a decreased demand for real estate.

As the workforce demographics change, tenants' demand for traditional office space will change; however, landlords need not panic and liquidate their brick and mortar assets for space in the clouds. Building owners clinging to the old school *Field of Dreams* philosophy of "if you build it they will come," could likely suffer declining returns on their investments. Assets positioned to take advantage of the changing demographics and megatrends, however, may be better positioned to reap the benefits of companies who demand a new type of space. Just as today's teenagers do not go to a record store to buy music, they will not aspire to visit an obsolete office building or building full of offices. The big question for an evolving economy of workers who believe work is a thing and not a place "Where will they go?"

Today's millennials (born between 1980 and 2000) are intelligent, global-minded, environmentally-sensitive, highly-social multitaskers, who have hundreds and sometimes thousands of online friends and followers. These network-minded individuals will work most efficiently in buildings and spaces designed to foster connections and knowledge transfer. As organizations embrace mobility, staff will visit the office for specific needs, challenging end users to consider not only designing multipurpose space encouraging employee engagement, but also with finding locations to which people will want to come.

Modern corporate real estate professionals charged with the mission of finding homes for employees who demand more from their infrastructure can no longer determine space requirements based on simple metrics such as square foot per person. Instead, they use sophisticated occupancy tracking tools to provide data for analytical tools used to determine space utilization rates and who is coming into the office. To maximize employee engagement and reduce turnover, firms may rethink the traditional approach of hiring architects to develop designs based on agreed upon company standards or "space mix." Rather, real estate departments, human resources and information technology functions in tangent with the businesses that they serve may partner with architectural firms to develop intricate programs to determine the ideal "place mix." CBRE Group, a leading global real estate advisory firm, in its article *3 Workspace Trends to Watch for in 2013 (and Beyond)* anticipates that companies will need to consider adding a "Chief of Work Officer" into the C-suite coordinating those three departments with an eye of attracting and retaining top talent.

"Place mix" consists of the places an employee occupies while working across two major dimensions:

1. **Virtual place**: the virtual places employees visit using their technological devices to complete activities such as work, communication, socialization, networking, training and research
2. **Physical place**: the physical spaces employees inhabit such as client sites, home offices, coffee shops, airplanes/airports, green spaces, hotels, or company owned real estate

Creating the ideal "Place Mix" requires examining multiple data sources and working with the business lines to develop employee behavioral profiles, which provide the foundation for programming, design and site selection. These behavioral profiles continue to support the ongoing trend of urbanization, offering savvy landlords the opportunity to provide an experience meeting the needs of the future workforce. To understand why, it may be easier to journey into the heads of the new millennials and consider how the city center experience and creative office space designs will satisfy their needs across the following key attributes:

1. Experience craving
2. Hyperconnectivity
3. Global minded

Though millennials represent an increasing share of the future workforce, and thus the focus of this article, it is important to note that many major cities have rebounded even after the dot.com crash. Well before the millennials first entered the workforce, corporations were already moving globally, pushing the envelope on technologies and building the network infrastructure, which supported the growth of the online commerce and communication. It is not uncommon to see long-tenured professionals using laptops, mobile devices and tablets, leveraging a host of applications and software tools designed to help them be more efficient and productive. The gap between millennials and Generation X is not as wide as people think.

Readers are also cautioned that the attributes ascribed to millennials herein, come from a perspective of professionals with experience in financial services, technology sector, post-education and media industries. These industries have experienced dramatic change in how they work ranging from content delivery to leveraging global outsourced solutions. The attributes outlined above, however, are reflective of a generation of young people who are and will be entering all forms of industry, and helping to change the landscape of how goods and services will be delivered in the future. Any industry from manufacturing to healthcare can benefit from understanding how their emerging work force acts and thinks.

Experience craving

Millennials place a high priority on workplace culture and desire a work environment that emphasizes teamwork and a sense of community.[1] Accordingly, the building, the office space and its amenities should synergistically blend into the community to provide a unique experience that gives employees a reason to come into the office and more importantly, enjoy the work. For instance, in PwC's Philadelphia office, full scale wall-graphics and artwork were carefully selected by the architects and the local office design committee to provide a distinctive "Philadelphia" feel and sense of connection to the city and its rich heritage. Designed and built to national standards, the environment provides a mix of collaborative, free address and focus spaces allowing the employees to leverage the different types of settings needed to complete work.

1 PwC's NextGen: A global generational study 2013 Summary and compendium of findings, p 8.

Since millennials are accustomed to sharing, various seat types are reserved through web-based and mobile applications allowing for easy access where and when required. To further enhance the experience, each space is designed to "work harder," or serve multiple purposes. For example, offices are designed as team rooms and are equipped with wireless display monitors, which automatically connect to laptops and mobile devices. The combination of flexible furniture and technology enables staff to utilize the rooms as focus areas, video rooms, overflow seating for seasonal or peak periods, interview rooms, and conference rooms. By providing a flexible environment where a host of activities can be completed in various settings using multiple devices over state-of-the-art wireless platform, the office space attempts to deliver energetic space that maximizes the work experience of the employees.

However, even versatile space brimming with "cool" factor is not enough to draw young professionals. The office location, commuter access, building quality and amenities need to augment the space to create a dynamic environment that millennials crave. Landlords will continually need to rethink the strategies for their buildings and market the overall unique experience of each one to tenants. When asking Winston Fisher (a partner primarily responsible for finance, acquisitions and new development at the Fisher Brothers) about how his role as a landlord has changed over the past few years, he replied, ***"We are no longer just a rent collector. We are now a full service provider from the infrastructure of our buildings to the services we provide our tenants. Each building requires a different mindset."***

Urban landlords can offer space to businesses that enhances the experience of their employees at three levels. Within the building, tenants can leverage special use spaces such as sundry shops, cafeterias, conference rooms, lobby space and retail. At street level, tenants can access a vast array of amenities such as mass transit stops, retail, and restaurants offering everything from fine cuisine to late-night delivery during busy periods. At the city level, employees enjoy access to arts, housing, theater, green spaces, museums and everything urban life has to offer. Echoing the importance of these three levels coming together to create an urban center experience, Fisher claims, "Everything is designed around collaboration. We're green, we're efficient ... from a tenant, landlord and city perspective."

Hyperconnectivity

During one of my son's freshman soccer games, the team's left back made a spectacular tackle that prevented the opposition from scoring a goal. When the cheering subsided and the ball was still in play, his mother yelled that he was awesome, and he calmly responded, "Thanks, now can I have my phone back?"

Most anyone with a teenager at home can tell you, taking a phone away is a travesty of epic proportions. Today's youth are continually connected and their mobile devices, which ping more than the roof of a car in a hail storm, serve as arteries into the heart of their social networks. Similarly, where employees work must foster connectivity in order to engage employees and reduce turnover.

The term "office building" symbolizes a compartmentalized view of space; rather than the more holistic depiction of "network buildings." Since employees are no longer tied to desktop computers linked to local networks and can complete focus work almost anywhere, office space should be designed to foster distinctive connections. Collaborative offices offer multiple spaces allowing for both formal and informal interaction. In addition to conference rooms for formal meetings, the environment must offer spaces where millennials can spontaneously connect to socialize, learn and ideate. Free address spaces such as internet cafes and teaming areas, supplemented by video technology, wall talkers and other devices designed to facilitate interactions are critical for companies whose services depend on creativity of its employees and knowledge transfer.

To increase collaboration, CBRE transitioned its Downtown Los Angeles high-rise office into the new global corporate headquarters, which is the winner of this year's CoreNet *Global Innovator's Award*—a fluid, technologically-advanced, inclusive workplace, and the first office in the world to be WELL Pilot Certified.

Realizing that CBRE's existing space was 51% underutilized, the company was primed to change the game. Addressing the goal of increasing productivity and collaboration, CBRE re-envisioned a completely new and innovative workplace concept for its new global headquarters. Through several months of exploration, research, benchmarking tours, and focus groups, the emerging design objective was to create an innovative, 100% free-address environment connecting two floors in an urban high rise. The result was 48,000 square feet of office space with no assigned offices or work stations, and sixteen different types of spaces to accommodate both individual and collaborative work, as well as informal spaces that encourage interaction between departments. A year after moving in, an employee survey showed that 92 percent of employees report a positive effect on their health and well-being and 83 percent say they feel more productive.

Connectivity does not end at the office. To recruit and retain the best talent, companies should consider locations that develop connections beyond the office walls like cities, which rarely sleep and provide a highly diverse environment to network. Cities with robust infrastructure where people can easily move by foot, bicycle or mass transit systems provide a physical network mirroring the internet, allowing young professionals to move about quickly and connect at locations from favorite happy hour spots to athletic clubs. Universities and other continuing education providers are readily accessible, making urban locations ideal for millennials, who are able to pursue their professional designations and various degrees while building their careers. Further, the high concentrations of industries such as entertainment, banking and financial services in cities such as New York help the millennials meet industry peers, build client relationships, join professional organizations and advance their careers.

Global minded

One of the advantages the millennials have enjoyed through hyperconnectivity is a lifetime of access to global information sources. Growing up with the internet of everything, millennials do not have an outside-looking-in perspective, rather with a computer or portable device they can at any time link to and become a strand on the world wide web. This strand does not simply provide a one way link to a virtual network, but to a lively community of billions of people who share common interests or shared experience. In many cases, such as the gaming community or image/video sharing sites, language is not a barrier allowing people to connect in new ways where the experience becomes the shared mode of communication. Further, at the end of every strand is a unique individual, who not only has access to this content, but the ability to upload and download different types of audio and visual information. Anyone who has ever sent a Snap Chat or viewed an online video can understand that paradigm shift is happening where businesses are controlling less and less of the content on line and the people are empowered to drive change. The media and retail industry has felt this shift hard, and those that have weathered the storm have figured out a way to balance both the physical and virtual connection to provide the best possible experience for their consumers.

Charles Darwin is known for advocating that maximum diversity supports maximum life. The rise of the Internet will likely support growth in urban centers by providing culturally diverse hubs teeming with life where people can physically connect. Richard Barkham, CBRE's Global Chief Economist, notes this parallel and sees, "The world economy is in a period where both physical and virtual infrastructure meet to minimize cost and maximize creativity. Understanding those trends will be crucial for businesses to construct solutions for their people." As the web draws in users, commerce, finance, entertainment, education and tourism have attracted people to major cities for thousands of years and there is no reason to believe that growth will slow down any time soon. Historically, large multinational corporations have a presence in all the major markets and are constantly looking for top notch talent to help expand their businesses. As more millennials work for global firms, they will be exposed to new cuisines, cultures, languages, arts and customs, augmenting their internet networks with personal connections and building social skills. These intangible skills are necessary as their work experience grows and they travel abroad to share best practices and develop integrated global business platforms.

When asked what attracts people to work in a city environment like New York, Fisher responded, "New York has a concentration of different cultures, which breeds collaboration. Different cultures plus collaboration lead to cutting edge innovation, which is what New York is all about. I like to call it 'cross pollination.' People need to gather and collaborate. This is what breeds success." The millennials have grown up on a foundation of sharing and trust, allowing businesses to operate without storefronts, share distribution channels and reach customers in non-trade restricted countries all over the world. As the markets expand and channels widen, the urban centers will continue to see demand from itinerant workers coming in and out of the cities to make connections and expand their businesses.

So where do we grow from here?

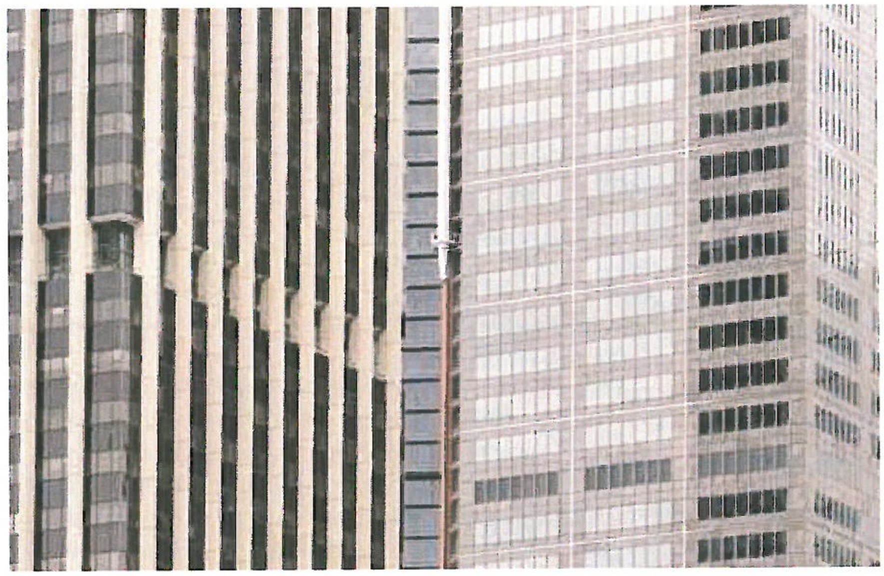
As we adapt to a mobile, high-tech workforce, employees will want a mix of infrastructure allowing them to optimize their "place mix." Corporations will likely cut their "physical place" or traditional real estate as much as fifty percent and focus on building office space, which creates an environment of shared spaces serving various purposes allowing employees to work in multiple settings and complete different activities. In turn for shedding physical space, employees will need technologies such as laptops and mobile devices affording them more access, learning, and collaboration in virtual space. Office space should be designed to match space utilization and the behavioral profiles of businesses rather than against outdated benchmarks like square foot per person or staff to workspace ratios. Finally, these offices should foster connections, knowledge transfer, socialization and diversity to create an experience where people will benefit from coming into work.

Though demands for physical space may diminish, the decline will likely be hardest felt in outdated buildings with limited amenities or differentiators providing unique experiences for tenants. As companies reduce their physical footprint, some may opt to pay more for higher quality or repositioned office buildings that create a unique experience the millennials crave. New developments may also benefit as companies move from lower quality buildings with outdated infrastructure to green buildings with more efficient floorplates. In addition to the traditional urban model, many cities are expanding their infrastructure and amenities by revitalizing areas where the arts, parks, retail and residential growth may help offer the lively experience that young professionals crave. As a result, landlords understanding these trends and positioning their buildings to capitalize changing workforce demands may be better positioned to reap the benefits; whereas, those that fail to do so may find it increasingly difficult to attract tenants at premium rates.

Willem VanDooijeweert is the Real Estate Operations Leader
He can be reached at
willem.vandooijeweert@us.pwc.com

Identifying real property investment opportunities in Spain

by David Criado and Matthew Rosenberg



As value in core domestic markets has become harder to identify, the need and desire of investors to look beyond their home markets to search for investment opportunities has grown. This change in the investing landscape appears to have led many in the real estate investment community to re-evaluate their international investment profile. Of particular focus are those regions which are believed to be nearing the bottom or coming out of their financial crisis. This is because, in many cases, financial crisis' experienced by different economic environments across the globe have led to depressed asset prices. In this regard, since the pace of economic and real estate recoveries has been uneven, some investors are drawn to the potential risk adjusted returns that are presented in certain of these international markets. Many institutional investors have been drawn to Spain, where a real estate bubble has been deflating since 2008.

Background

During the period from 1996 to 2007, the Spanish real estate market endured a significant increase in the price of real estate. According to Global Property Guide, national average home prices increased by 197% in nominal terms, one of Europe's highest home price increases during that period.[1] The growth in home prices has been credited to numerous factors including high demand and the availability of credit.

Increased domestic demand can be credited to high Spanish homeownership rates and changes in the international environment after the introduction of the Euro. According to an International Monetary Fund (IMF) whitepaper, domestic policies, dating back to the 1960s and 1970s, stimulated demand for real estate, such as favorable fiscal treatment of homeownership through tax legislation as well as legal uncertainties and difficulties that owners encountered to evict problem tenants. This is evidenced through a homeownership rate of approximately 80% in Spain.[2] As a result, one could say that homeownership is part of

1 "Spain's Housing Market is Recovering." *Global Property Guide*. N.p., 20 July 2014. Web. 8 Sept 2014.

2 "Technical Note on Housing Prices, Household Debt, and Financial Stability." *Spain: Financial Sector Assessment Program—Technical Note— Housing Prices, Household Debt, and Financial Stability* (2006): n. pag. www.imf.org. International Monetary Fund, May 2006. Web. 8 Sept. 2014.

the Spanish psyche. Moreover, during this period, demand for real estate was driven by the creation of approximately five million jobs during the ten year span, record levels of immigration, and foreign real estate investment since the introduction of the Euro, which resulted in easier cross-country flow of capital.[3]

Further, the availability and cost of credit made homeownership a more attainable goal for many Spaniards. During the period leading up to the bubble, credit institutions were providing mortgages with higher historical loan-to-value (LTV) ratios, at lower interest rates, and for longer terms than had previously been encountered. Typical residential mortgage loans on primary residences were issued at LTVs of 80-100% and at Euribor + 40-85bps, while Euribor rates floated between 200 and 300 bps from 2003 to 2006. Moreover, lending terms extended for as long as 40 years.[1,3] This made investing in homeownership more attainable and attractive for Spaniards. However, the vast majority of these mortgages were at variable rates[2], which meant that a slight change in the Euribor could have a dramatic effect on a borrower's ability to continue to pay debt service.

Inevitably, the financial crisis in the US spread to Europe and Spain's housing market began to crash, along with its economy. From 2008 through 2013, the real estate market suffered price declines of over 35%.[1] Financial institutions suffered terrible losses, the availability of credit froze, real estate construction stopped, unemployment soared above 25%, and GDP fell dramatically. After years without seeing improvements in the economy, in 2011, the government and regulators began to take remedial actions.

Market reforms

The Spanish market adjustments were agreed on between the European Stability Mechanism (ESM), Kingdom of Spain, The Bank of Spain, and Fondo De Reestructuracion Ordenada Bancaria (FROB) and monitored by the European Union, the European Central Bank (ECB) and the International Monetary Fund. Unlike the bailouts of Greece and Ireland, Spain itself was granted a credit facility to recapitalize Spain's banking sector in order to reactivate the financial system and economy. In exchange for the credit facility, the Financial Assistance Facility Agreement required that the financial institutions develop credible restructuring plans that improve the sector's viability, improve burden sharing, and limit distortions of competition in a manner that promotes financial stability, including reducing the amount of participating entities and regional banks' exposure to non-performing and under-performing real estate related assets. The ESM provided a credit facility of up to $100 billion Euros to FROB, which acted as guarantor of the facility and was responsible for dispensing the funds to the respective institutions. Those actions, together with social benefit cuts, public employee salary reductions, tax increases, and social austerity policies, began to bring confidence back to the public.

In August 2012, the Spanish Government established SAREB, or commonly known as the "bad bank," which is beneficially owned by the State, private institutional investors and Spanish banks. SAREB began acquiring bad assets from banks, including non-performing loan portfolios and properties, at a discount, in exchange for bonds secured by the Government of Spain. For example, according to a report released by SAREB in May 2014, SAREB's original portfolio of distressed real estate assets was worth approximately 51 billion Euros, which demonstrated the size and significance of the assets acquired by SAREB.[4] SAREB's strategy is to hold the assets and dispose of them to the public in an organized manner, operating similar to asset management firms. One of the goals of SAREB was to improve the availability of credit in the system by removing these bad assets from banks' balance sheets and stabilizing prices by controlling the supply of real estate assets entering the market.

Further, in 2012, the Spanish government approved structural changes to the Spanish Real Estate

3 Embassy Madrid. *Spain's Booming Housing Market And The Uncertain Future*. Rep. Embassy Madrid, 18 Mar. 2005. Web. 8 Sept. 2014.

4 SAREB, The Key To Cleaning Up Spanish Banks' Balance Sheet. "SAREB." *Press Kit May 2014* (2014): n. pag. *www.sareb.es*. SAREB, May 2014. Web. 9 Sept. 2014.

Investment Trust, (SOCIMI – the Spanish REIT regime). These changes made the investment vehicle more attractive, mainly by reducing the taxation rate from 19% to 0%. This Spanish REIT structure brought a competitive investment vehicle with similar characteristics to REIT structures along Europe and the US and provided a way to increase the amount of capital flowing to the real estate sector. Since the changes, more than 20 Spanish REITs have registered with Spanish tax authorities.

These reforms led to an improving economic environment, as discussed further below.

Current environment

The outlook for the Spanish economy is the best it has been since 2008. Analysts expect that GDP will be positive during 2014. The Wall Street Journal notes that during Q3 2014 the unemployment rate fell to approximately 23.7% after peaking at over 27%. Year to date GDP through Q3 2014 is 1.6%, the highest it has been since before 2008, and Spain's borrowing costs are back to pre-crisis levels. Additionally, housing price declines have started to stabilize, as investors step into the market and the availability of credit improves.

The banking industry has also shown evidence of improvement. Although the real estate industry has not yet seen a substantial increase in available financing, with the consolidation of many smaller and weaker financial institutions, which either entered bankruptcy or merged with larger and more stable institutions, coupled with the reforms discussed above, stronger banks are emerging. According to Bloomberg, after a stress test by the ECB in Q3 2014, Spanish Banks were shown to need no additional capital infusions[5], evidencing the health of the Spanish banking system.

While the outlook is positive and the economic environment appears to be more stable than it has been during the previous six years, current demographics still cause concerns. Unemployment is still at 23.7%, which will continue to impact the consumers' ability to purchase homes. Moreover, the unemployment rate among the Spanish youth is significantly higher than the overall unemployment rate. Economists expect the high youth unemployment rate to slow the absorption of excess supply in the housing market, which resulted from years of over construction during the boom. There are also questions about whether the economic performance of other European countries will affect the recovery in Spain.

Despite conflicting economic indicators, investors have been deploying capital into Spanish real estate assets over the last couple of years. CBRE Spain reported that approximately $5 billion worth of real estate transactions took place during 2013 and investors expect a higher volume of transactions during 2014.[6] According to an October 2014 Cushman and Wakefield report, almost 14 billion euros in transactions have closed during the nine months ended September 2014.[7]

Transactions to date

The Spanish real estate market has been attracting distressed investors since the beginning of 2013. According to DealBook, in July 2013, Blackstone bought 1,860 apartments for 125.5 million euros, followed by Goldman Sachs purchasing a block of public housing in Madrid.[6] This was followed by SAREB selling a 51% stake in a portfolio of close to 1,000 homes around Spain in August 2013, valued at approximately 100 million euros, to H.I.G. Capital.[8] Subsequently, in July 2014, Blackstone bought a portfolio of 40,000 mortgage loans for 3.6 billion euros, outbidding other opportunistic investors including Oaktree Capital Management LP and Apollo Global Management.[9]

5 Munoz, Macarena. "Spanish Banks Shown Needing No Capital After ECB Exercise." *Bloomberg.com*. Bloomberg, 26 Oct. 2014. Web. 02 Nov. 2014.

6 Anderson, Jenny. "Global Investors Looking for Real Estate Bargains Flock to Spain." *DealBook.NYTimes.com*. New York Times, 29 May 2014. Web. 09 Sept. 2014.

7 A Cushman & Wakefield Corporate Finance Publication. "European Real Estate Loan Sales Market." *C&W Corporate Finance Publications* (2014): n. pag. *World Property Journal.com*. Cushman and Wakefield, 1 Oct. 2014. Web. 11 Nov. 2014.

8 White, Sarah. "Spain's Bad Bank Close to Big Land Sale as Disposals Pick up." *Reuters*. Thomson Reuters, 04 Oct. 2013. Web. 02 Nov. 2014.

9 Neumann, Jeannette. "Squatters Welcome Blackstone's Spanish Property Play." *The Wall Street Journal*. Dow Jones & Company, 23 Sept. 2014. Web. 02 Nov. 2014.

More recently, major investment firms such as Apollo Global Management and TPG Capital have been bidding on a contract to market and sell around 50 billion euros worth of property assets held by SAREB, with other bidders including Centerbridge Partners LP and Haya Real Estate SA, owned by Cerberus Capital Management LP.[10]

Moreover, according to the Wall Street Journal, "Spain has seen the most IPOs in Europe in the recent REIT boom, with five listing this year and more to come."[11] Merlin Properties SOCIMI SA raised 1.25 billion euros and expects to have invested 92% of it by the end of the year. Hispania Activos Inmobiliarios also went public during 2014, with investors including Funds managed by George Soros, John Paulson, Moore Capital Management, and Cohen & Steers.[12] While investors appear to be attracted to the risk reward characteristics of the investment opportunities in Spain, despite indications the Spanish economy is improving, there remains a lot of uncertainty that will impact the ultimate success of investments in Spain.

Summary

Since the recent housing crisis in Spain, regulators and the government have enforced structural changes in the economic environment to support the recovery and maturation process of the real estate markets. Following the creation of SAREB, investors from around the world have increasingly pursued deals to gain exposure to Spanish real estate, which has helped support a price floor. Despite uncertainties in Spain's economy, including high unemployment, as real estate prices have stabilized, investors have continued to pursue deals in Spain. Overseas investors, interested in distressed assets coming to market, have provided liquidity and changed the landscape of the real estate sector in Spain. The presence of new debt and equity in the market is a sign that investors are cautiously optimistic that the recovery in Spain may continue forward.

10 Neumann, Jeannette. "Spain's 'Bad Bank' Assets Selloff Goes to Next Round." *The Wall Street Journal.* Dow Jones & Company, 5 Sept. 2014. Web. 02 Nov. 2014.

11 Pirolo, Alessia. "European REITS Are on a Tear." *The Wall Street Journal.* Dow Jones & Company, 9 Sept. 2014. Web. 02 Nov. 2014.

12 Rodriguez, Jose. "Spanish property fund attracts Soros, Paulson ahead of share listing." *Reuters.* Thomson Reuters, 03 Mar. 2014. Web. 19 Nov. 2014.

David Criado is a Partner in PwC's Real Estate Practice in Spain
He can be reached at
david.calzada@es.pwc.com

Matthew Rosenberg is a Senior Associate in PwC's New York Real Estate Practice
He can be reached at
matthew.d.rosenberg@us.pwc.com

Emerging Trends in Real Estate 2015: Sustaining momentum but taking nothing for granted

by Andrew Warren

The following is a summary of the results of the 2015 edition of the Emerging Trends in Real Estate. The findings and opinions reflect those of over 1,400 market participants interviewed and/or surveyed and do not necessarily reflect the views of PwC.

Introduction

Real estate market participants continued to express optimism about 2015 in the current edition of Emerging Trends in Real Estate. Interviewees feel that the fundamental improvement experienced in 2014 may continue during 2015 and that this environment should have an impact on the overall real estate market; influencing both investments and operating decisions in the coming year. Survey respondents overwhelmingly view 2015 as a "profitable" year with 74 percent seeing the prospects for profitability being good or better than the previous year. This is up from the 68 percent of respondents who thought that profitability in 2014 would be good or better. The top 10 trends identified in this year's report, cover a range of themes including: demographics, competition and risk awareness.

Despite a general sense of optimism surrounding the 2015 real estate market, interviewees are taking nothing for granted. Market participants appear to be well aware of a number of risks that could be problematic for the market in 2015. These risks encompass additional geopolitical events and concern about current real estate pricing reaching "bubble" levels not seen since the previous 2007 peak in the market. Accounting for and mitigating these risks may also influence market decisions in 2015.

Trend themes

Demographics are seen as a key driver of a number of 2015's trends. Interviewees see the impact on real estate markets of the maturation of the different demographic groups and the sheer size of these age cohorts as having a significant impact on the economy in general and real estate in particular.

The changing age game – According to the US Census Bureau, the baby boomer and millennial generations are the two largest population cohorts in the US and have been influencing the real estate market for years. So what do interviewee's see that may be different in 2015? Interviewees see that the market may be driven by the fact that a significant number of these two age groups are reaching ages where they will likely be making significant life style choices; for example, where to live, home purchases, job status and the like. The real estate market is contemplating the potential impact on housing and commercial real estate markets.

By 2020, census data suggests that there could be nearly 80 million people who are either millennials age 30 or greater and baby boomers between the ages of 55 to 64. There are a number of questions surrounding the life decisions these groups may make in the next five years, all questions that could influence how different physical locations and real estate sectors will perform in the next five years:

- Will they form households?
- Where will they choose to live?
- Will they remain in the labor force?

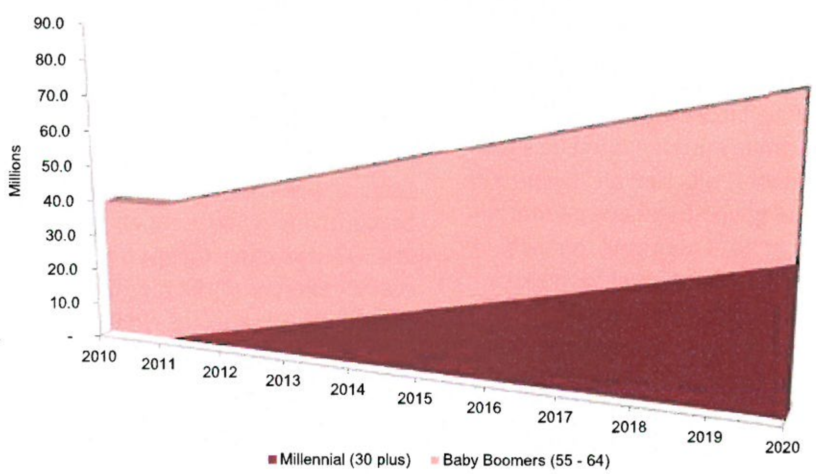
As one interviewee commented, "the biggest risk used to be whether the tenant in a building would renew at the end of their lease term, now you have to be confident that your property will be viable at the end of the term."

Labor markets trending toward tipping point – Relating to the aging of the population is the future size of the US labor force. Interviewees mentioned labor shortages in a number of areas including construction and building maintenance as being problems in 2014, but also raised the issue of labor shortages occurring across the country in the coming years. The concern is not just about shortages of workers, but will those workers have the skills needed to perform the available jobs.

By 2017, the number of baby boomers turning 65 will begin to outpace the number of Generation Z turning 16 (the Bureau of Labor Statistics defines the labor force as non-institutional population ages 16 – 64). The result would be a stabilized decrease in the size of the labor force of approximately 50,000 a year by 2020.

An impending labor shortage likely won't be uniform across the US. Interviewees continue to show interest in those markets that look better positioned to attract a qualified working age population. These markets offer attractive lifestyle amenities, a lower cost of doing business, a lower cost of living or a combination of all three. The concept of jobs chasing people could have a significant impact on individual real estate markets in the near future.

Figure 1 – Population that will be making lifestyle decisions in the next five years



Source: US Census Bureau

Competition

The positive expectations for 2015 are not going unnoticed and interviewees expect increasing competition to drive a number of trends in the future. Competition for investments is expected to rise as the US real estate market remains an attractive destination for both domestic and international capital. In addition, the potential for new sources of capital to enter the market could only serve to increase the competition for attractive investments. Finally, the increases in the development and adoption of technology is seen as having an impact on virtually all sectors of the real estate market.

Love/hate relationship with technology – Interviewees continue to express amazement at the integration of technology into a growing number of aspects in the economy and the influence technology is having on all real estate sectors. The impact of technology includes the continued adoption that is changing how office space is being utilized, continued growth of e-commerce, and the multiple enhancements that technology is making possible to growth in the sharing economy.

It isn't just the adoption of technology that market participants see changing the market, but also the pace of the adoption. New technology is being adopted at an ever faster pace. The combination of integrated devices and a populous that is accepting of technological change is helping to speed how fast technology is changing the industry.

Darwinian market keeps squeeze on companies – Technology and competition aren't only impacting investment decisions, but internal company operations as well. The attractiveness of the real estate market is leading participants to continue to look for ways to get bigger and more efficient. Interviewees are expecting to see continued consolidation in the market from service providers to fund managers. The market's desire to get more efficient and operate at lower costs is a driving force behind this trend as well as service providers looking to expand product offerings or expand geographic footprints.

Risk

The 2015 outlook for the real estate market is good, but that doesn't mean the market is ignoring inherent risks.

Event risk is here to stay – Interviewees feel that the biggest risk to the US economy and subsequently the real estate market would be some type of global "black swan" event. The number of geopolitical events that surfaced in 2014 continue to make the US real estate market look like a favorable location to invest if one of your primary investment objectives is return "of" capital. This is expected to keep competition for market defined trophy assets intense for the foreseeable future.

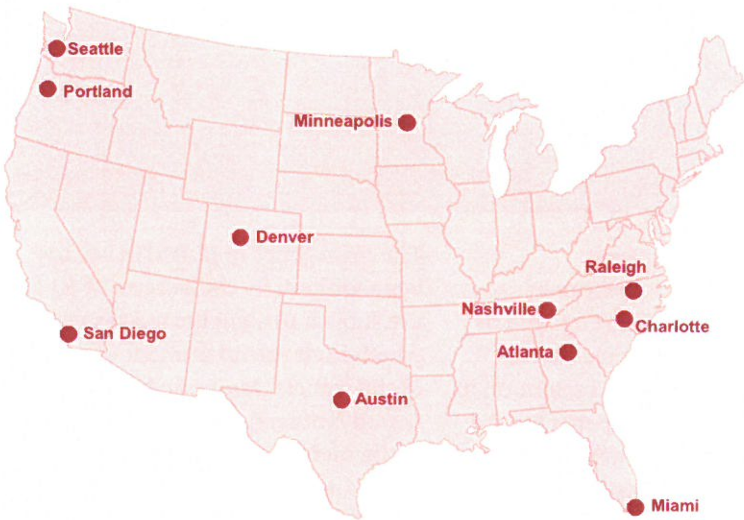
Keeping an eye on the bubble, emerging concerns – While the majority of interviewees don't feel like the overall commercial real estate market is in "bubble" territory, the consensus seems to be that the situation bears watching. Certain product types and markets have seen underlying values bounce back to pre-downturn levels, but values and capital flows to much of the country remain well below previous peak levels.

Market outlook

2015 survey respondents and interviewees expect improvement in most markets for the coming year. Most markets are viewed as benefitting from improved economic growth along with steadily improving fundamentals. The big six markets (New York, Boston, Washington DC, Chicago, Los Angeles and San Francisco) are generally projected to be good performers. The top market trend however, highlights market participants' desire to find opportunities in markets that will benefit from other identified trends.

18-hour city comes of age – Interviewees see 18-hour cities as being strong investment choices in 2015. These cities offer a number of the advantages of the big six markets; urban lifestyle choices, well-educated workforces, diverse employment choices, but they tend to offer these amenities at a more attractive price point.

Figure 2 – Top 18-hour cities



Source: Emerging Trends in Real Estate 2015

These markets are proving to be attractive to millennials entering the workforce so they have the potential to attract skilled labor to their urban core. As the millennials get older they may also find these markets more attractive due to the lower cost of living that offers a better chance of owning a home. 18-hour cities that survey respondents put in the top 10 markets for 2015 are: Austin, Denver, Charlotte, Seattle and Raleigh.

The attractiveness of these markets to potential labor along with what is typically a lower cost of doing business could make these markets attractive to businesses looking to relocate or expand their operations. While these markets are ranked by this year's survey as attractive, they are not without risk. A number of them are not considered supply constrained markets so the potential for oversupply does exist. Despite this risk, the outlook is that they will continue to offer good investment potential over the next several years.

Conclusion

The general consensus of interviewees and survey respondents is that the outlook for commercial real estate in 2015 is positive as market fundamentals continue to improve. The general outlook for a number of markets and property types has improved and the opportunity for investments in more locations and utilizing different strategies should increase. Despite the overall positive outlook, market participants continue to be monitoring a number of demographic, competitive and risk trends to choose where the best opportunities will be in the coming year.

Andrew Warren is a Director in PwC's Real Estate Practice
He can be reached at
andrew.warren@us.pwc.com

The resurgence of the mortgage REIT

by Lynn Chin, Dan Sullivan, Chris Merchant and Seth Drucker

Over the past several years, mortgage real estate investment trusts (M-REITs) have re-emerged as popular investment vehicles in the marketplace and attracted attention in the media. The major impetus for the resurgence of M-REITs has been a low interest rate environment. M-REITs can offer investors attractive yields by investing in higher yielding assets and implementing the right leverage.

Changes in the rules related to classification of investment companies have resulted in a greater number of market participants utilizing an M-REIT structure. M-REITs are generally not characterized as an Investment Company. This non-Investment Company characterization is primarily due to the involvement in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" (15 U.S.C. § 80a-3(c)(5)(C)). This exemption allows M-REITs more flexibility with the use of leverage and the ability to operate with less rigorous regulatory oversight while meeting the strict provisions set out in the Internal Revenue Code ("IRC") to maintain REIT status.

The resurgence of M-REITs has not been without its challenges. M-REITs are subject to complicated tax rules which limit the investment activities of the vehicle. Maintaining the tax-advantaged status of the M-REIT while managing its operational risks is an ongoing challenge. M-REIT managers must successfully employ a strategy that requires deep understanding of the complex tax, regulatory and US GAAP rules and the interactions between them to create a streamlined operation that ensures ongoing compliance with these rules. The penalties of non-compliance are severe and can significantly impact an M-REIT's tax status and its appeal to investors.

Why are M-REITs attractive to investors?

M-REITs effectively operate as a pass-through entity where the M-REIT manager ("operator") distributes its income to investors which is then taxed as a dividend, thereby eliminating any corporate taxes. M-REITs use committed capital and employ a leverage strategy on their assets, commonly through repo funding to purchase longer-term assets. This strategy in a low interest rate environment can increase revenues and dividend yield to investors.

M-REITs are being used as a funding source for a wider range of assets. M-REITs have generally invested in agency and private label residential mortgage backed securities (MBS), but are now expanding their portfolios into other asset classes such as excess mortgage servicing rights (excess MSRs) and residential whole loans. Utilizing a private letter ruling from the IRS, market participants are interpreting the margin between the loan servicing fee and the cost to service each loan (subject to certain thresholds) as a qualifying asset.[1]

Unlike earlier structures, newer M-REITs are taking advantage of the US housing recovery in loans and securities. M-REITs are accumulating portfolios of loans and, in some cases, monetizing portions of those loans through securitization.

How do the tax rules drive M-REIT activity?

In order to maintain its status and avoid double taxation, M-REITs must follow the IRC's gross income and asset tests and other regulatory requirements. If M-REITs engage in certain impermissible activities, the income generated may be subject to a 100% prohibited transactions tax. For example, a re-securitization transaction that is treated as a tax sale could be deemed dealer activity and considered a prohibited transaction subject to 100% tax. As such, M-REIT operators must ensure that they align their activities with the appropriate tax structures entities to promote tax efficiency.

Most M-REITs utilize efficient tax structures and a robust infrastructure to support these operations. Specialists can assist in evaluating standards and the ongoing tax compliance and reporting calculations incidental to operating any M-REIT. These include certain tax hedge identification requirements, the aforementioned quarterly asset and annual income tests, certain elections with implications to shareholder distributions and M-REIT taxable income.

Operational complexities of new M-REITs strategies

M-REITs investing outside of the agency MBS space commonly have higher data needs. As M-REITs enter into new strategies, including originating and securitizing mortgages, the technology and data required to store and process that data increases significantly. The potential operational hurdles can be quite burdensome and may lead to a re-evaluation of the impact on their existing tax, accounting and operational frameworks.

M-REITs require incremental infrastructure for capturing, monitoring and using data to meet valuation, tax, regulatory and financial reporting needs. The origination and securitization of mortgages for an M-REIT strategy are two primary examples where M-REIT operators are leveraging technology and infrastructure support in order to operate data-intensive businesses while considering all the complexities inherent within the M-REIT.

US GAAP accounting considerations

While REITs are tax driven vehicles, there are numerous US GAAP financial reporting complexities that M-REITs face. As M-REITs expand their activities, their financial statement presentation may incorporate issues historically encountered by originators and securitizers, as opposed to just investors.

In particular, M-REITs are likely to face challenges related to:

- Determining which legal entities will be consolidated into its financial statements based on the M-REIT's legal structure and investment profile;
- The recognition or de-recognition of assets or liabilities from its balance sheet;
- The usage of derivatives for hedging purposes and the associated accounting and valuation for those derivatives;
- The financing strategy and the amount of leverage that a M-REIT employs;

1 PLR 201234006

- Complex accounting issues regarding accounting for investments and certain liabilities, such as embedded derivative analysis, interest income approaches and other-than temporary impairment ("OTTI") evaluation; and
- Extensive disclosure regarding their assets and liabilities, including valuation and accounting policies.

Many M-REITs choose to simplify some accounting complexities by making an irrevocable election, upon acquisition or origination of financial assets or liabilities, to classify and measure instruments at fair value. As a result, all changes in fair value of that instrument will be recorded in net income. This election can cause volatility in earnings, but assists in avoiding the complexity within other areas of US GAAP, such performing embedded derivative analysis.

Summary

In addition to creating a compelling investment strategy, M-REITs are seeking to increase value through focusing on expanding their eligible asset investment profile, implementing appropriate tax strategies for the broader investment profile, and creating an efficient infrastructure to support operations. Rapid improvements in technology are enabling more efficient processing, wider business activities, and more sophisticated analysis. A full understanding of the rules and appropriate planning should be taken for any market participant seeking to enter to the M-REIT marketplace.

The PwC Financial Instruments, Structured Products, and Real Estate (FSR) group helps clients achieve success in the capital markets. FSR's deep product knowledge and industry insight can assist companies wishing to become a leader in the M-REIT marketplace by offering tax, accounting and finance solutions to navigate the changing M-REIT landscape.

Lynn Chin is a Partner in PwC's FSR Practice
She can be reached at
lynn.chin@us.pwc.com

Dan Sullivan is a Principal in PwC's FSR Practice
He can be reached at
daniel.k.sullivan@us.pwc.com

Chris Merchant is a Principal in PwC's FSR Practice
He can be reached at
chris.merchant@us.pwc.com

Seth Drucker is a Director in PwC's FSR Practice
He can be reached at
seth.drucker@us.pwc.com

Searching for higher-yielding CRE investments

by Susan Smith

The following is extracted from the Fourth Quarter 2014 issue of the PwC Real Estate Investor Survey, released on December 15, 2014. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.

As buyers of core assets in major cities face rising prices and declining overall capitalization (cap) rates, a growing number of them are looking for plays outside of core assets and primary markets in search of opportunities to take on greater risk in exchange for higher yield. The aspiration to seek out higher-yielding investments and take on greater risk at this point in the commercial real estate (CRE) cycle reflects investors' confidence in the future performance of both the CRE industry and the US economy. In *Emerging Trends in Real Estate® 2015*, recently published by PwC and ULI, value-added, development, and opportunistic investments are considered to have the best prospects for returns in 2015 – ahead of core-plus and core investments, according *Emerging Trends* respondents.

While certain investors are moving further out on the risk spectrum, it is not yet a uniform strategy, particularly for some conservative institutional players, like pension funds, which continue to prefer the elements of "core" investing – Class-A properties, gateway markets, steady income streams with staggered lease expirations – given the need for adequate returns and conserving the capital entrusted to them as fiduciaries. As it becomes much harder to find core deals that make sense and face the continual challenge of putting accumulating capital to work meeting long-term liabilities, some are "going where they have never gone before," heading for niche property types and secondary markets.

Niche property types, like self storage, medical office, and student housing, continue to grow in popularity among both domestic and international buyers. While many players in these niche sectors were first drawn to them at the peak of the previous cycle as pricing for traditional assets got ahead of market fundamentals, they have stayed because of positive demographic trends and favorable risk-adjusted returns.

The search for higher yield in secondary markets is evident when looking at recent sales data. For the 12 months ended June 2014, investing in secondary markets was up nearly 25.0% and back to nearly 72.0% of the previous peak level, as per Real Capital Analytics. With global capital looking to move outside of its typical comfort zone, which has been core major markets and assets, and more investors willing to go where they see the best opportunities, both niche property sectors and secondary markets could report strong investment activity in 2015.

Tenant improvement (TI) allowances

TI allowances vary for each major property sector, as well as across geographies. Based on our Survey, TIs are rarely provided to tenants in regional malls and power centers, where retail tenants typically receive space as a "vanilla box" and are responsible for their own build-out. In industrial and office properties, TIs are commonplace and vary based on whether the leased area is shell space (raw, new space) or existing, second-generation space.

For the 19 city-specific office markets in the Survey, TI allowances for shell space range up to $125.00 per square foot and average $50.04 per square foot. For second-generation office space, TI allowances range up to $100.00 per square foot and average $29.07 per square foot. For renewals, TIs range up to $100.00 per square foot and average $17.32 per square foot.

For the Survey's warehouse markets, TI allowances for shell space range up to $75.00 per square foot and average $4.21 per square foot. For second-generation space, TI allowances range up to $5.00 per square foot and average $1.29 per square foot. For renewals, TIs range up to $3.00 per square foot and average $0.77 per square foot. For the national warehouse market, up to 20.0% of the leased area is finished office space with an average amount of 8.6%.

Overall cap rates

Fervent competition for a limited pool of quality offerings, still-low interest rates, and an abundance of debt and equity pursuing commercial real estate continue to compress yields for the best properties and the best locations across each major property sector.

This quarter, the aggregate average overall cap rate dips for the Survey's 34 markets (excluding development land) for the eighteenth straight quarter and at 6.52% stands as the lowest aggregate average since 1997.

Cap rate declines are diverse and spread across property sectors and locations with the national regional mall and medical office buildings markets each reporting sizeable quarterly drops along with a few city-specific office markets, like Houston. In contrast, the average overall cap rate holds steady for the national strip shopping center and national CBD office markets, which up until now have mainly been reporting declines.

Overall cap rate compression also continues for the national warehouse market, as well as the Pacific and East North Central region warehouse markets.

CRE sector overviews

Office

The national office market sits solidly in the recovery phase of the real estate cycle as fundamentals improve for both CBD and suburban subsectors. Nationally, additions to supply are expected to trail demand, and the US vacancy rate is forecast to slowly improve as the sector moves into expansion in 2016.

Survey participants describe the buying environment in the national CBD office market as "competitive" and "crowded" as investors vie to capitalize on the office sector's ongoing recovery highlighted by growing absorption levels and limited additions to supply. Over the next 12 months, our Survey results show investors expecting property values in the national CBD office market to increase as much as 15.0% with an average expected value increase of 4.9%.

For the national suburban office market, surveyed investors remain upbeat about its future performance. "Many markets are recovering and providing upside so it's a good time to own suburban office," states one surveyed investor. Suburban office properties for sale on the West Coast, such as in Los Angeles, San Diego, and San Jose, continue to draw significant attention from buyers. Futhermore, Southern and Southwest cities, like Dallas, Phoenix, and Denver, are seeing numerous suburban office assets trade.

Retail

As national retail fundamentals continue to slowly improve, the sector is expected to remain in the recession phase of the real estate cycle before transitioning into recovery by year-end

2015. However, a number of individual markets, like Austin, Houston, and San Antonio, are currently in expansion, buoyed by solid demographic and economic trends.

Despite rising consumer confidence and growing retail sales figures, the still-changing retail landscape continues to suppress demand for physical store space among many retailers. From an investment standpoint, the slow and inconsistent recovery in the retail sector continues to favor high-quality regional mall assets, well-located grocery-anchored shopping centers, and well-leased power centers.

Within the retail sector, most surveyed investors foresee positive trends for the US neighborhood and community shopping center sector. While such expectations open up opportunities for both buyers and sellers, most respondents in *Emerging Trends in Real Estate* give this property category a much higher buy than sell recommendation.

Industrial

Steady demand for industrial space is driving new supply in this sector with new additions to supply in 2014 expected to reach the highest level seen since 2008. Fortunately, tenant demand is expected to outpace supply, keeping the national industrial sector solidly in the recovery phase of the real estate cycle through 2017.

Warehouse industrial ranks as the top pick among investors with regard to investment prospects in the year ahead, as per *Emerging Trends in Real Estate*. Specifically, it scored a 3.72 on a scale of 1 (abysmal) to 5 (excellent), just above CBD office buildings with a score of 3.57 and limited-service hotels with a score of 3.52.

For the flex/R&D segment, certain investors suspect that 2015 could be a good year as rising occupancy levels in suburban office locations spillover into flex/R&D properties, resulting in higher tenant demand, rental rates, and property values. Looking ahead, future rent growth is expected as several surveyed investors are using rent spikes in their cash flow analyses.

Apartment

The national multifamily market remains in the expansion phase of the real estate cycle through the end of 2014, but will likely shift into the contraction phase in 2015 as new apartment supply outpaces demand in many metros, limiting rent growth opportunities during the initial lease-up periods. Major metros currently at the peak of the expansion phase include Charlotte, Chicago, Dallas, Denver, Houston, and Seattle. In 2015 through 2017, the apartment sectors within many cities will move into the contraction phase of the cycle as they work to absorb new construction.

Despite the characterization by certain investors of a "too pricey" and "crowded" apartment market, this asset class placed second again this year for overall investment prospects in *Emerging Trends in Real Estate*, scoring a 3.48 on a scale of 1 (abysmal) to 5 (excellent), compared to a score of 3.61 for the industrial/distribution market.

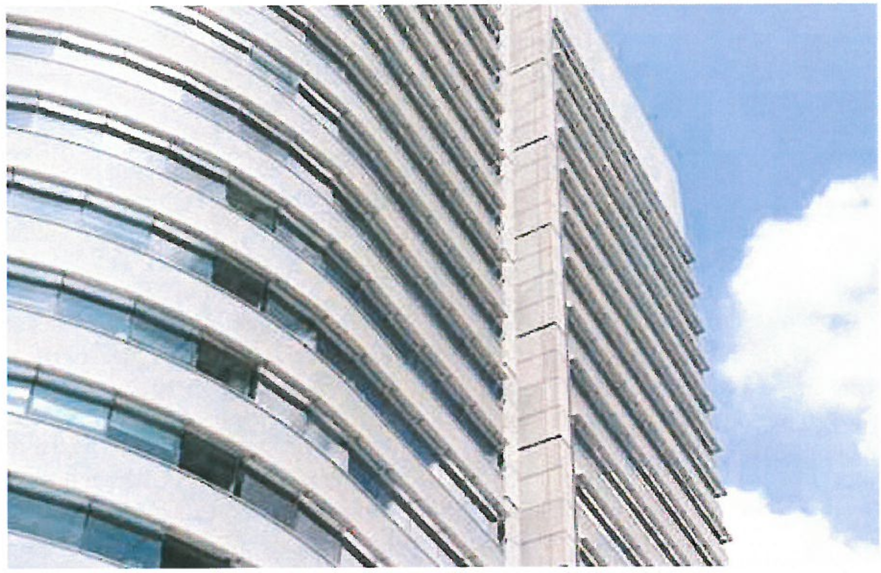
Along with vigorous sales velocity, this market's average overall cap rate dropped to its lowest point in the Survey since its debut in mid-1990. As shown in Table 29, the average overall cap rate drops 15 basis points this quarter to 5.36%. "Cap rates have compressed in both value-added and core deals," remarks a surveyed investor. In the next six months as the supply and demand dynamics shift due to increases in new development, surveyed investors foresee overall cap rates holding steady in this market.

More information on the PwC Real Estate Investor Survey™ can be found at www.pwc.com/us/realestatesurvey or by calling 1-800-654-3387.

Susan Smith is a Director in PwC's Real Estate Practice
She can be reached at
susan.m.smith@us.pwc.com

SEC comment letter trends for real estate companies

by Paul Kolodziej



The Securities and Exchange Commission ("SEC") continues to emphasize the importance of providing meaningful and transparent information to investors and recently highlighted this during the 2014 AICPA National Conference on Current SEC and PCAOB Developments. Understanding the SEC Staff's recent areas of focus is an important aspect to consider as part of the upcoming year-end reporting process. To help registrants gain insight into the SEC staff's current areas of focus, PwC analyzed comment letters issued to real estate companies during the last year to identify trends. The trends identified are somewhat consistent with those in other industries, including management's discussion and analysis and results of operations disclosures being the most prevalent.

The four areas that received the most comments for real estate companies were leasing activities, same property comparison, cost capitalization, and consolidation. Below is further detail on the SEC comment letters received over each of these areas.

Leasing activities

The most frequent area of comment by the SEC was over management's discussion and analysis, with leasing activities being a primary focus. Specifically, the SEC staff has requested enhanced discussion of trends in leasing activities for real estate investment trusts (REITs), including disclosure of average occupancy, average rental rates, comparison of rates of expiring leases vs. current market rents, and costs incurred to obtain new leases.

Same property comparison

The SEC staff continues to provide comments on the registrants' explanation of their results of operations, with a focus on same property performance. The SEC staff's comments in this area have focused on providing greater transparency into which properties are included in a registrants' same property portfolio. Specifically, the staff has requested clear disclosure of when development and redevelopment properties are transferred into and out of the same property portfolio and whether acquisitions/dispositions are included. Additionally, the SEC staff has requested enhanced disclosure of the period over period operating performance of the same property portfolio, including the impact of occupancy changes and rental rate changes.

The SEC staff's comments have also focused on registrants providing enhanced disclosure around same property net operating income (NOI). Specifically, the SEC staff has requested that registrants disclose whether management considers same property NOI a key performance measure, define which properties are included in the same property portfolio, include a clear definition of how same property NOI is computed and a reconciliation to the most directly comparable GAAP measure.

Cost capitalization

Recent comment letter trends show that cost capitalization continues to be an area of focus. The SEC staff has asked for disclosure of total soft costs (e.g., interest expense, real estate taxes, payroll, and other general and administrative expenses) capitalized during each period presented. Additionally, the SEC staff has requested further breakout of soft costs capitalized by development, redevelopment, and other capitalized expenditures within MD&A, along with a narrative discussion of fluctuations from year to year. Further, the SEC staff has also requested that registrants disclose in MD&A the anticipated completion date, budgeted costs and costs incurred to date for significant development projects.

The SEC staff has also requested that registrants define when the capitalization period for development begins and ends in their accounting policy footnote and present cash flows used to acquire real estate separate from development costs within the statement of cash flows.

Consolidation

Consolidation continues to be an area of focus for the SEC staff. The SEC staff comments have requested that registrants enhance their disclosures of their accounting policy and the determination of which entities are consolidated and which ones are not. Specifically, the SEC staff has focused on investments in which the registrant owns a greater than 50% interest, but accounts for such investment under the equity method of accounting. Registrants should ensure they clearly disclose the provisions of such governing agreement that led the registrant to determine that consolidation was not necessary.

In addition, the SEC staff has requested additional information about registrant's primary beneficiary assessment, focusing on the significant judgments and assumptions, the qualitative factors considered, and the quantitative analysis used, if any, to determine whether the rights to receive benefits could potentially be significant. The SEC staff has also focused on the existence of any control deficiencies relating to a company's consolidation policy and how management determined the severity of the deficiency.

Conclusion

The uncertainties in the current economic and regulatory environment make the preparation of high-quality reports increasingly important and challenging. The SEC Staff continues to emphasize the importance of providing information to investors that is reliable, meaningful and transparent, particularly in areas that involve significant judgement. With a better understanding of the SEC staff's latest areas of focus, companies will be able to better produce high-quality annual reports for investors and other stakeholders.

For further details on SEC Comment Letter Trends for Real Estate Companies see the Stay informed, 2014 SEC comment letter trends, Financial Services publication at the link below.

http://www.pwc.com/us/en/cfodirect/publications/sec-comment-letter-trends/financial-services.jhtml

For further details on the 2014 AICPA National Conference on Current SEC and PCAOB Developments see the In depth linked below.

http://www.pwc.com/en_US/us/cfodirect/assets/pdf/in-depth/us2014-09-aicpa-conference.pdf

Paul Kolodziej is a Senior Manager in PwC's National Professional Services – SEC Services Group
He can be reached at
paul.j.kolodziej@us.pwc.com

Real estate state and local taxation: Industry update

by Sean R. Kanousis, Colin M. Coogan and Adam F. Robbins

New York State Tax Reform

On March 31, 2014, New York State enacted legislation that overhauled the state's corporate tax regime as well as makes other significant tax changes. This new legislation is effective for tax years beginning on or after January 1, 2015. In particular, this new legislation replaces the state's existing combined reporting provisions which required the existence of substantial intercorporate transactions between related corporations with a waters-edge unitary combined reporting system.[1]

This new legislation will require two or more corporations engaged in a unitary business to file a combined report when at least one of the following requirements is met: (1) the taxpayer owns or controls either directly or indirectly more than 50 percent of the voting power of the capital stock of another corporation; (2) one or more corporations own or control more than 50 percent of the voting power of the capital stock of the taxpayer either directly or indirectly; or (3) more than 50 percent of the voting power of the capital stock of the taxpayer and such other corporations is owned or controlled directly or indirectly by the same interests.[2] Further, an alien corporation is now required to be included in a combined report if it satisfies these general combined filing requirements unless it is not classified as a "domestic corporation" pursuant to IRC section 7701 and it has no effectively connected income with the United States as determined under IRC section 882.[3]

The definition of a captive real estate investment trust ("REIT") has remained unchanged in the updated New York State Tax Law.[4] Non-captive REITs are now statutorily exempt from combined reporting under the new combined filing regime.[5] On the other hand, captive REITs are

1 NY Tax Law § 211(4)(a).

2 NY Tax Law § 210-C(2)(a).

3 NY Tax Law § 210-C(2)(b)(iii); NY Tax Law § 210-C(2)(c)(iv).

4 NY Tax Law § 2(9).

5 NY Tax Law § 210-C(2)(c)(ii).

6 NY Tax Law § 210-C(2)(a); NY Tax Law § 210-C(2)(c)(ii).

still subject to combined reporting requirements.[6] The new combined filing regime simply requires captive REITs to be included in a combined report with any corporation when the aforementioned updated combined filing standards are met.[7] Accordingly captive REITs should take care to understand the impact of the tax reform on their New York state filings. Captive REIT's that previously filed separately because they did not engage in a substantial intercorporate transaction with a related corporation should analyze their relationships with any taxable REIT subsidiaries or other related corporations to determine whether a combined report is now required.

Whenever a captive REIT is included in a combined report, the updated New York State Tax Code disallows the deduction for any dividends paid to any members of their affiliated group.[8] Business income, including income resulting from the disallowance of the deduction for dividends paid, will be taxed at the general business taxpayer rate of 7.1 percent in 2015 and then 6.5 percent in all subsequent tax years.[9] In addition, unlike non-captive REITs, the capital attributable to the captive REIT will still be included in the capital tax base for the combined group, thus resulting in the captive REIT effectively being subject to the capital tax if the tax calculated using the capital base for the combined group is greater than tax calculated using either the business income base or the fixed dollar minimum base.[10] It must be noted that the effects of this will be mitigated by the fact that the capital tax rate will fall each year during the six-year phased out period beginning on January 1, 2016.[11]

Tennessee Disregarded Entity Clarification

In June 2014, the Tennessee Department of Revenue issued Notice 14-12 reversing its prior stance on the taxation of federally disregarded single member limited liability companies ("SMLLCs") that are wholly owned by REITs.[12] In Tennessee, an entity that is disregarded for federal tax purposes can still be treated as a regarded entity with a separate filing obligation.[13] A SMLLC is only disregarded for Tennessee franchise and excise tax purposes if: (1) it is a disregarded entity for federal tax purposes; and (2) its sole owner is treated as a corporation for federal tax purposes.[14] Despite this rule, the Tennessee Department of Revenue previously had consistently taken the position that a SMLLC owned by a REIT could never be disregarded for Tennessee tax purposes regardless of whether the REIT was treated as a corporation for federal tax purposes.[15] This resulted in SMLLCs wholly owned by REITs being treated as separate taxpayers for Tennessee franchise and excise (income) tax purposes and potentially subjecting them to an income tax liability.[16]

While Tennessee considered the SMLLC of a REIT a separate taxpayer for Tennessee franchise and excise purposes, it was previously unclear whether the SMLLC could benefit from the deduction for dividends paid entitled to its REIT member pursuant to section 857 of the Internal Revenue Code ("dividends paid deduction").[17] Ruling 13-22 states that the federal taxable income of an entity treated as a disregarded entity for federal tax purposes but regarded as a separate taxpayer in Tennessee would be determined on a pro forma basis as if the disregarded entity had filed as a regarded corporation for federal income tax purposes.[18] Tennessee has held that since disregarded entities do not qualify as REITs for federal income tax purposes, such entities must calculate federal taxable income on a pro forma basis without utilizing the dividends paid deduction.[19] This calculation can result in federally disregarded entities having taxable

7	NY Tax Law § 210-C(2)(b)(i).
8	NY Tax Law § 210-C(4)(f)(i).
9	NY Tax Law § 210(1)(a).
10	NY Tax Las § 210-C(1)(ii).
11	NY Tax Law § 210(1)(b).
12, 20	Tennessee Notice 14-12 (June 2014).
13	Tenn. Code Ann. § 67-4-2106(c).
14, 16	Id.
15, 18	Tennessee Revenue Ruling 13-22 (Dec. 2013).
17	IRC § 857(a).
19	IRC § 856(a).

income in Tennessee even though that income is not taxed at the federal level thanks to that income having been recognized at the REIT level and then offset by the dividends paid deduction.

Notice 14-12 reversed Tennessee's stance as it relates to a federally disregarded SMLLCs whose single member is a REIT.[20] Now a SMLLC that is wholly owned by a REIT has no separate Tennessee filing requirement and instead the REIT will file a Tennessee franchise and excise tax return. While a SMLLC filing on a separate company basis may have previously reported an excise tax liability, a REIT should be able to benefit from the dividends paid deduction when calculating its excise tax so long as the REIT is itself not a "captive REIT" for Tennessee purposes.

However, notice 14-12 only extends Tennessee disregarded entity status to SMLLCs owned by REITs.[21] Revenue Ruling 13-22 explicitly states that other non-SMLLC DREs owned by REITs such as qualified REIT subsidiaries and federally disregarded limited partnerships will still be treated as regarded entities and thus separate taxpayers for Tennessee franchise and excise tax purposes.[22] Notice 14-12 has not changed this stance as only the filing position of a federally disregarded SMLLC was addressed in this notice.[23] Given the recent guidance provided by the state, care should be taken to analyze the impact on the Tennessee tax filing requirements of REIT structures owning real property in the state.

Pennsylvania Local Business Privilege Tax

Localities in Pennsylvania (other than Philadelphia) are delegated the authority to impose a tax on the "privilege of doing business" in their respective jurisdictions under the Local Tax Enabling Act ("LTEA").[24] While the LTEA lists a broad base of activities and transactions that can be subjected to this privilege tax, taxation of a number of activities including "leases or lease transactions" is specifically prohibited.[25] Despite this prohibition, the Township of Lower Merion, among other localities, had imposed business privilege taxes "at the rate of 1.5 mills" (0.15 percent) on the gross receipts of lessors who lease real property within the township.[26]

Three taxpayers filed suit in the Court of Common Pleas of Montgomery County arguing that the local business privilege tax imposed by the Township of Lower Merion could not be applied to gross receipts received from lease transactions because the LTEA specifically prohibited it.[27] On September 24, 2013, the Court of Common Pleas ruled against the taxpayers stating that the prohibition on imposing a business privilege tax on "leases or lease transactions" found in the LTEA does not prohibit imposing a business privilege tax to the gross receipts from lease transactions.[28]

The taxpayers appealed the decision of the Court of Common Pleas to the Commonwealth Court of Pennsylvania.[29] The taxpayers cited the LTEA's exemption for lease transactions when arguing that their rental receipts should be exempt from the business privilege tax.[30] On the other hand, the Township of Lower Merion argued that renting real estate constitutes a "business, trade, occupation or profession in the Township" per the Township's Municipal code and thus is subject to the local business privilege tax.[31] On September 19, 2014, the Commonwealth Court reversed the lower court's decision holding that the LTEA prohibits subjecting lease transactions to the local business privilege taxes authorized by that statute.[32] The Court stated that the exemption against taxing lease transactions prohibits both direct and indirect taxes from being imposed on such lease transactions.[33]

21, 28-33 Id.

22 Tennessee Revenue Ruling 13-22 (Dec. 2013).

23 Tenn. Code Ann. § 67-4-2106(c).

24 Pa. Stat. Ann. § 6924.301.1(a.1).

25 Pa. Stat. Ann. § 6924.301.1(f).

26 Township of Lower Merion, Pennsylvania, Municipal Code § 138-42.

27 *Fish v. Twp. of Lower Merion*, No. 1940 C.D. 2013, (Pa. Commw. Ct. 2014).

This decision prevents the future taxation of gross receipts of lessors who lease real property within local jurisdictions in Pennsylvania (other than Philadelphia). This ruling also allows taxpayer to claim refunds for taxes paid on rental real estate receipts for any returns still within the statute of limitations. It must be noted that the Township of Lower Merion could still appeal this decision to the Pennsylvania Supreme Court.

California Proposition 13 Update

In 1978, voters in California adopted Proposition 13 in order to limit property reassessment and taxation. Following this constitutional amendment, yearly reassessment of any property going forward could not exceed 2 percent unless a "change in ownership" occurs. When a change in ownership occurs with regards to a property, the state can fully reassess that property. Generally a transfer of the ownership interest in a legal entity does not constitute a change in ownership with regards to the real property owned by that legal entity.[34] However, a change in ownership in the underlying real property of an entity does occur when any one person or entity obtains control of more than 50 percent of the ownership interest in that entity.[35]

In 2006, 100 percent of the ownership interest of Ocean Avenue LLC ("Ocean") was transferred.[36] Ocean owned a hotel located in California. Michael Dell indirectly acquired approximately 48 percent of the ownership interest of Ocean meanwhile his wife acquired 49 percent of Ocean through a separate property trust.[37] The Los Angeles County Assessor deemed a change in ownership to have occurred and reassessed the hotel despite no one person having acquired a greater than 50 percent interest. Upon appeal by Ocean, the Los Angeles County Assessment Appeals Board upheld the reassessment citing several arguments the most notable of which was that reassessment was appropriate because all of the beneficial ownership rights in the hotel had been transferred.[38] Ocean subsequently filed a refund claim arguing that the hotel could not be reassessed because there was no change in ownership in the ownership interest of Ocean for Proposition 13 purposes.[39] The trial court entered judgment in favor of Ocean.[40]

On appeal, the California Court of Appeals upheld the lower court's ruling on June 24, 2014.[41] The Court rejected the Los Angeles Assessor's argument that substance should take precedence over form.[42] The Court found that the plain statutory language defining a change in ownership was unambiguous and when applied to these facts no change in ownership had occurred with regards to the hotel.[43] Thus, the Los Angeles Assessor was barred from reassessing the hotel. This ruling affirms that prior tax positions taken based on the plain statutory language defining a change in ownership are valid. Further, this ruling indicates that county assessors will follow this interpretation of what constitutes a change in ownership going forward.

California Documentary Transfer Tax Update

In California, documentary transfer taxes have generally been imposed at the local level only when a direct interest in realty is sold.[44] The majority of localities had not previously attempted to impose a documentary transfer tax following a change in ownership for Proposition 13 purposes. Accordingly, the sale or transfer of an entity who indirectly holds real property in the state has not historically been subjected to the documentary transfer tax. However, the Los Angeles County Assessor has been asserting that a documentary transfer tax liability is created under existing law whenever a change in ownership occurs since 2010.[45,46] In

34 Cal Rev. & Tax Code § 64(a).

35 Cal. Rev. & Tax Code § 64(c)(1).

36 *Ocean Avenue LLC v. County of Los Angeles*, B246499.

37-43, 47-48 Id.

44 Cal. Rev. & Tax Code § 11911(a).

45 Los Angeles County Code § 4.60.020.

46 *926 North Ardmore Avenue, LLC v. County of Los Angles*, 178 Cal.Rptr.3d 78 (2014).

one such instance, the Los Angeles County Assessor attempted to collect a documentary transfer tax from 926 North Ardmore LLC ("Ardmore") with regards to a series of transfers of the ownership interests in its sole owner that resulted in an undisputed change in ownership for Proposition 13 purposes.[47] Ardmore paid the documentary transfer tax bill but then filed a claim with the county for a refund of the taxes paid.[48]

After the county rejected this refund claim, Ardmore filed a complaint seeking a tax refund asserting that the Los Angeles County Assessor had an illegal policy of imposing a documentary transfer tax on the transfers of interest in legal entities that directly or indirectly hold real property in the county.[49] The trial court ruled in favor of the county holding that the Los Angeles County Assessor has the authority to impose a documentary transfer tax on the transfer of an interest in a legal entity when it constitutes a change in ownership for Proposition 13 purposes.[50]

On September 22, 2014, the Court of Appeals upheld the lower court's decision stating that whenever a change in ownership occurs for Proposition 13 purposes, it constitutes "realty sold" for California documentary transfer tax purposes thus equating the two terms.[51] While the Court admits that section 11911 of the California Revenue and Tax Code refers to the sale of the real property as the trigger for the documentary transfer tax, it held that the legislative history supports a reading of section 11911 to apply the tax whenever there is a transfer of indirect ownership of real property.[52] As a result of the holding in *926 North Ardmore Avenue, LLC v. County of Los Angles*, all local jurisdictions in California are now authorized to levy a documentary transfer tax whenever there is a change in ownership for Proposition 13 purposes pursuant to their existing documentary transfer tax ordinances. Further, since this holding interprets existing law, the local counties are not precluded from attempting to collect documentary transfer taxes on previous transactions that resulted in a change in ownership for Proposition 13 purposes. However, it must be noted that Ardmore is currently appealing this decision to the California Supreme Court. Further, the California Taxpayers Association has filed a request for depublication, which if granted, would strip the case of any precedential value.

Sean R. Kanousis is a Principal in PwC's SALT – Asset Management Practice
He can be reached at
sean.richman.kanousis@us.pwc.com

Colin M. Coogan is a Manager in PwC's SALT – Asset Management Practice
He can be reached at
colin.m.coogan@us.pwc.com

Adam F. Robbins is a Senior Associate in PwC's SALT – Asset Management Practice
He can be reached at
adam.f.robbins@us.pwc.com

49-50 Id.

51 Id.; Cal. Rev. & Tax Code § 11911(a).

52 *926 North Ardmore Avenue, LLC v. County of Los Angles*, 178 Cal.Rptr.3d 78 (2014).

PwC Real Estate Contacts

Byron Carlock
US Real Estate Leader
(214) 754 7580
byron.carlock.jr@us.pwc.com

Tim Conlon
US Real Estate Clients and Markets Leader
(646) 471 7700
timothy.c.conlon@us.pwc.com

Richard Fournier
US Real Estate Assurance Leader
(617) 530 7168
richard.e.fournier@us.pwc.com

Mitch Roschelle
US Real Estate Business Advisory Leader
(646) 471 8070
mitchell.m.roschelle@us.pwc.com

David Voss
US Real Estate Tax Leader
(646) 471 7462
david.m.voss@us.pwc.com

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SFO Alert (September 25, 2014)

NAREIT's Accounting & Financial Standards Hot Topics

SFO Alert

September 25, 2014

PCAOB SEEKS INPUT ON AUDITING ESTIMATES AND FAIR VALUE MEASUREMENTS STAFF CONSULTATION PAPER

On August 19, the Public Company Accounting Oversight Board (PCAOB) issued Staff Consultation Paper *Auditing Estimates and Fair Value Measurements* (Staff Consultation Paper) for public comment. The Staff Consultation Paper solicits stakeholder input on whether the PCAOB should revise existing audit guidance on accounting estimates and fair value measurements. The Staff Consultation Paper cites management's use of specialists and third party pricing services as areas where additional audit requirements could be added. The Staff Consultation Paper could impact NAREIT member companies based on the initial measurement of typical transactions at fair value (*e.g.*, acquisitions of real estate) and subsequent measurement (*e.g.*, fair value measurement of debt and equity securities). If you are interested in participating on a NAREIT Task Force that will evaluate the Staff Consultation Paper and consider whether NAREIT should develop a response, please contact Christopher Drula by October 3. Comments are due to the PCAOB by November 3.

The areas of accounting estimates and fair value measurements are consistently cited in PCAOB inspection reports as significant audit deficiencies. The Staff Consultation Paper seeks input on the following:

- The potential need for changes to the PCAOB's existing auditing standards to better address changes in the financial reporting frameworks related to accounting estimates and fair value measurements;

- Current audit practices that have evolved to address issues relating to auditing accounting estimates and fair value measurements (*e.g.*, the use of centralized pricing desks or groups by accounting firms, and the use of third parties);

- A possible approach to changing existing standards, and the requirements of a potential new standard; and,

- Relevant economic data about potential economic impacts of standard setting in this area, including data to inform the PCAOB's economic analysis associated with standard setting in this area.

The potential new auditing standard that is discussed in the Staff Consultation Paper could be designed to:

- Align with the PCAOB's risk assessments standards;

- Generally retain the approaches to substantive testing in existing auditing guidance, but include requirements that apply to both accounting estimates and fair value measurements;

- Establish more specific audit requirements relating to the use of third parties in developing accounting estimates and fair value measurements; and,

- Create a more comprehensive standard relating to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application.

CONTACT

Please contact Christopher Drula, VP, financial standards, at cdrula@nareit.com.

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SFO Alert (February 13, 2015)

February 13, 2015

SEC AREAS OF FOCUS IN REVIEWING 2014 10-K FILINGS

Through informal conversations with the Staff of the Division of Corporation Finance of the Securities and Exchange Commission (the Staff), NAREIT has identified potential areas of financial reporting that the Staff may focus on in their review of 2014 real estate company (including REITs) 10-K filings. The areas identified in this alert do not impose new disclosure requirements and they are not intended to limit the areas of potential Staff comments. Please remember Staff comments will depend on the facts and circumstances of a particular company.

General Items

Disclosure Effectiveness

The SEC's Disclosure Effectiveness Project is a division-wide initiative that is intended to review the disclosure requirements included in Regulation S-X and Regulation S-K. The SEC is considering ways to modernize disclosures to facilitate timely, material disclosure by registrants and continue to provide decision-useful information to investors. The Staff reminds registrants to consider this initiative as they prepare 10-K disclosures. Key aspects of the disclosure effectiveness initiative include actions that registrants can take today with respect to preparing 2014 Form 10-Ks. They include:

- Reduce repetition;
- Use hyperlinks;

- Use charts if this can convey information more effectively;
- Tailor disclosures to the reporting entity and specific facts and circumstances;
- Eliminate outdated disclosure or disclosure for items that are no longer considered material; and,
- Do not automatically add disclosure when the Staff requests supplemental information.

Staff requests for supplemental information do not automatically need to be disclosed in the document. The Staff encourages registrants to gather the information requested, and then have a dialog with the Staff before revising disclosure.

Non-GAAP Financial Measures

The Staff reminds registrants that non-GAAP financial measures that are included both inside and outside of Form 10-K are subject to Staff review. This would include the earnings release, the transcript of the earnings conference calls, supplemental information that is furnished as exhibits in Form 8-K, company websites and company press releases.

If the non-GAAP financial measure is considered a key performance indicator (KPI), it should be included in the Form 10-K, accompanied by appropriate disclosures required by Item 10(e) of Regulation S-K. If the non-GAAP financial measure is not considered a KPI, but the registrant still has reason to disclose it outside of its filings, it should be presented and reconciled to the most closely related GAAP measure in accordance with Regulation G.

Regardless of whether a non-GAAP financial measure is included within or outside of a filing, it should be clearly labeled. For example, when registrants use NAREIT Funds From Operations (FFO) and Adjusted Funds From Operations (AFFO) as KPIs, they should clearly label such measures, which can be done by reconciling AFFO through NAREIT FFO.

Rule 3-14 Financial Statements

The Staff continues to answer questions regarding the updated interpretative guidance with respect to the application of Rule 3-14 published in the Division of Corporation Finance Reporting Manual and this will continue to be a focus area in 2014. Given the unique sets of circumstances surrounding acquisitions, the Staff encourages registrants to either call the Staff or submit a written question to the Corporation Finance Office of the Chief Accountant in order to determine whether Rule 3-14 Financial Statements are required. If registrants decide to call the Staff directly, they may be asked to submit a formal question that includes all of the facts and circumstances in the fact pattern.

Recent Initial Public Offerings (IPOs)

Registrants that have recently completed REIT conversions and REITs that have recently completed IPOs are reminded that disclosures about property operating data, including disclosures about geographic information, square feet and/or other capacity measures in units, occupancy, rental rate and lease expirations for material property portfolios may continue to be useful information for investors in annual reports.

Registrants operating assets recently appearing in the public securities market (*e.g.*, single family housing) should consider what types of unique operating information would be useful to investors.

Dividends per Share

In previous years, the Staff has provided registrants with comments on whether or not dividends per share information should be included on the face of the annual income statement in accordance with ASC 260, despite the requirement to present dividends per share on the face of the interim income statements under Rule 10-01(b)(2) of Regulation S-X and the annual requirement to disclose dividends per share on the shareholders' equity statement under Rule 3-04 of Regulation S-X. Recognizing these conflicting pieces of literature, the Staff will no longer be commenting in this area.

Areas of Focus related to Equity REITs

MD&A

- Enhance analysis of factors underlying operating results (*e.g.*, reasons behind changes in occupancy or rental rates);
- Robust disclosure of management's known trends and uncertainties;
- Disclosure addressing the relative impact on period-to-period changes of same store portfolio and non-same store portfolio and, within same store portfolio, the relative impact of changes in occupancy and rental rates; and,
- When "same store" metrics are reported, disclosure of how the same store pool is defined (*i.e.*, the basis of including or excluding "stores").

Leasing Activity and Results

- Disclosure summarizing reporting period leasing activity for both new leases and lease renewals, including costs such as tenant improvements and leasing commissions, and quantitative disclosure of rental rate changes (*e.g.*, changes in rent spreads); and,
- When a significant amount of leasable space will expire over the next twelve months, disclosure of material known trends and uncertainties in current market rates on expiring space as compared to rents under current leases.

Areas of Focus related to Mortgage REITs

Fair Value Accounting

Registrants that report assets and/or liabilities at fair value are reminded to review the fair value hierarchy included in ASC 820 *Fair Value Measurements and Disclosures*. The classification of an asset or liability as Level 1, 2, or 3 drives the amount of required disclosures and could also impact loan covenants and/or risk management policies. For example, some loan covenants may limit the amount of financial assets classified as Level 3 within the fair value hierarchy.

Areas of Focus related to Spin-offs

While not directly related to the review of 2014 10-Ks, the Staff indicated a few areas of focus related to spin-offs.

The Staff reminds registrants to file the proper financial statements when executing a spin-off transaction. The following financial statements are typically required:

- Audited opening balance sheet;
- Carve-out financial statements for assets that have a rental history (not necessarily a legal structure prior to the spin-off) or audited schedule of investments for assets without a rental history;
- Rule 3-05 and/or Rule 3-14 financial statements as appropriate (the significance test should be calculated on the carve-out financial statement level, which is typically lower than the pre-spun-off basis);
- Significant tenant financial statements, especially in sale-leaseback transactions (if the spinor/future tenant was a public company, an explicit reference to periodic reports of that company may be sufficient);
- Pro forma financial statements: 1) Ensure that there is disclosure of the assets' basis (typically carryover basis); 2) Discuss the estimation process for significant income statement items; a) Registrants have the option to provide an unaudited financial forecast instead of a pro forma income statement in accordance with Rule 11-03 of Regulation S-X. The financial forecast should comply with the American Institute of Certified Public Accountants (AICPA) Standards for Forecasts and Projections.
- Schedule III disclosure: 1) Rule 12-28 of Regulation S-X requires supplemental information about real estate investments and accumulated depreciation; 2) Registrants may request relief from some of the specific disclosure, for example: a) A registrant may be unable to provide historical information on the initial cost of the real estate or the costs that were subsequently capitalized; or b) There may be a large number of insignificant assets – in this case, aggregation may be appropriate and acceptable.

Given the technical nature of spin-off transactions, registrants are encourages to pre-clear the accounting treatment with the Corporation Finance Office of the Chief Accountant.

CONTACT

Please contact Christopher Drula, VP of Financial Standards, at cdrula@nareit.com or George Yungmann, SVP of Financial Standards, at gyungmann@nareit.com.

Shareholder Activism & REIT M&A Meeting

Thursday, April 2nd
11am – 12:15pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
David Slotkin, Partner, Morrison & Foerster LLP

Panelists:
Lauren Prevost, Partner, Morris, Manning & Martin LLP
Donald Hammett, Partner, Dentons
Jordan Ritter, SVP & General Counsel, Essex Property Trust, Inc.
Anthony Rothermel, Partner, King & Spalding

CommonWealth and Corvex Management and Related Fund Management

Chronology of Events Surrounding Unsolicited Offer and Potential Proxy Contest

Date	Event Description
February 25, 2013	CommonWealth REIT ("**CommonWealth**") announces that it intends to issue 30,000,000 common shares in a public offering, the proceeds of which will be used to repurchase up to $450 million of certain outstanding unsecured senior notes through a tender offer.
February 26, 2013	Corvex Management LP and Keith Meister (collectively, "**Corvex**") and Related Fund Management, LLC (together with certain affiliated funds, "**Related**") first report beneficial ownership as a group of 8,175,001 shares of CommonWealth's common stock, or approximately 9.75% of CommonWealth's outstanding common stock.
February 26, 2013	Corvex and Related issue a press release in the form of a letter to CommonWealth's Board of Trustees (the "**Board**") (1) demanding that CommonWealth cease its proposed equity offering and debt repurchase, (2) threatening to remove the entire Board by written consent and replace them with new independent trustees and (3) offering to engage in discussions to acquire all of CommonWealth's outstanding shares at a significant premium.
February 26, 2013	Corvex and Related issue a press release in the form of a letter to the Board offering to acquire CommonWealth for $25.00 per share in cash. The bid represents a 58% premium to CommonWealth's February 25 closing price. Corvex and Related also threaten to pursue litigation to enjoin the equity offering or provide for its rescission in the event that it is completed.
February 26, 2013	Luxor Capital Group, LP ("**Luxor**"), a shareholder of CommonWealth, issues a press release in the form of a letter to the Board expressing support for Corvex and Related. Luxor owns 6,700,000 shares of CommonWealth's common stock, or approximately 8.0% of CommonWealth's outstanding common stock.
February 27, 2013	CommonWealth issues a press release acknowledging its receipt of the two letters from Corvex and Related and announcing that, after full review, its Board has determined the best interests of the company will be served by continuing to pursue the equity offering.
February 27, 2013	CommonWealth discloses that the decision to proceed with the public offering is based on the belief that the Corvex and Related proposal (1) could result in numerous changes of control and subsequent defaults under certain debt agreements and (2) may provoke dissident litigation and other activities that could have material adverse effects on the price of CommonWealth's shares.
February 27, 2013	Corvex and Related issue a press release in the form of a letter to the Board increasing their initial offer to acquire CommonWealth from $25.00 to $27.00 per share, conditioned on the immediate cancellation of the equity offering.
February 27, 2013	Corvex and Related file a complaint in the Circuit Court for Baltimore City, Maryland alleging breach of fiduciary duties.

Date	Event Description
February 27, 2013	CommonWealth executes a purchase agreement for the equity offering which prices the public offering of 30,000,000 common shares at $19.00 per share. The underwriters have a 30-day option to purchase up to an additional 4,500,000 common shares. In addition, CommonWealth commences its tender offer.
February 28, 2013	The Delaware County Employees Retirement Fund files a complaint in the U.S. District Court for the District of Massachusetts alleging breach of fiduciary duties.
March 1, 2013	CommonWealth files a prospectus supplement containing the terms of the equity offering.
March 1, 2013	CommonWealth adopts Amended and Restated Bylaws, which clarify the requirements to remove trustees and make procedural adjustments for any shareholder action by written consent.
March 4, 2013	CommonWealth issues a press release announcing that the motions by (1) Corvex and Related and (2) the Delaware County Employees Retirement Fund to enjoin the closing of the equity offering were denied by the U.S. District Court for the District of Massachusetts.
March 5, 2013	CommonWealth issues a press release announcing that its equity offering of common shares has closed. CommonWealth received net proceeds of approximately $627.6 million.
March 11, 2013	CommonWealth enters into a registration agreement with Government Properties Income Trust ("**GOV**") and issues a press release announcing that it has begun a registered public offering of 9,950,000 common shares of GOV. As of March 8, CommonWealth beneficially owned approximately 17% of GOV's issued and outstanding common shares and will no longer own shares of GOV after the offering.
March 13, 2013	Corvex and Related file a preliminary consent solicitation statement to remove all five members of the Board by written consent, and also issue a press release announcing the same.
March 15, 2013	CommonWealth completes their offering to sell all 9,950,000 common shares of GOV for $25.20 per share, raising gross proceeds of $259.7 million.
March 15, 2013	Corvex and Related amend their complaint pending in the Maryland state court to declare void the recent bylaw amendments made by the Board on March 1, and also issue a press release announcing the same.
March 18, 2013	CommonWealth files a preliminary consent revocation statement and also issues a press release announcing the same. In addition, CommonWealth is disputing the validity of the Corvex/Related consent solicitation under Maryland law. According to CommonWealth, Corvex and Related have not satisfied the company's Amended and Restated Bylaw requirement that shareholders requesting to remove trustees by written consent hold at least 3% of the company's shares continuously for at least 3 years. Corvex and Related have only owned shares of CommonWealth since January 16, 2013.
March 25, 2013	CommonWealth enters into a registration agreement with Select Income REIT ("**SIR**") and issues a press release announcing that it may sell up to 22,000,000 common shares of SIR. As of March, CommonWealth beneficially owned

Date	Event Description
	approximately 56% of SIR's issued and outstanding common shares.
March 25, 2013	Corvex and Related send a letter to CommonWealth's Board criticizing the company's decision to sell its equity interest in SIR.
March 25, 2013	CommonWealth issues a press release announcing that it has repurchased a total of $670,295,000 aggregate principal amount of senior notes.
March 28, 2013	Corvex and Related issue a press release announcing that after meeting with CommonWealth representatives on March 26, Corvex and Related are reaffirming their proposal to acquire CommonWealth but are lowering their per share price to $24.50 (from $27.00 per share on February 27) due to the impact of the dilutive equity offering completed earlier in March. The offer is subject to further downward adjustment if CommonWealth moves forward with a sale of its controlling stake in SIR.
March 28, 2013	Corvex and Related report that they now own an aggregate amount of 10,850,500 shares, or approximately 9.2% of CommonWealth's outstanding common stock.
April 10, 2013	Corvex and Related file a definitive consent statement to remove all members of the Board by written consent.
April 13, 2013	Corvex and Related file Supplement No. 1 to the definitive consent statement filed on April 10, noting that (1) on April 12 Corvex and Related delivered to CommonWealth formal shareholder demands to fix a consent record date; (2) Corvex and Related believe that the Board has up to 20 days to fix a record date; (3) if the Board fails to fix the record date by April 22 then it is the view of Corvex and Related that it will be on April 22; and (4) Corvex and Related believe that any longer delay, as purportedly allowed under certain amendments to the Bylaws announced by CommonWealth on March, is invalid as a matter of law.
April 15, 2013	CommonWealth issues a press release stating that at its recent Board meeting on April 12, the Board elected to classify its Board into three classes pursuant to Section 3-803 of the Maryland Unsolicited Takeovers Act. It is CommonWealth's belief that after this election, members of the Board may be removed only "for cause." In connection with the election, the Board also adopted Amended and Restated Bylaws to provide for the same. Accordingly, it is CommonWealth's view that the recent consent solicitation filed by Corvex and Related seeking to remove all members of the Board without cause is invalid.
April 15, 2013	Corvex and Related issue a press release responding to CommonWealth's April 15 statement, calling it "misleading and inaccurate," urging shareholders to move forward with the consent solicitation and indicating that they are proceeding with a record date of April 22.
April 18, 2013	Corvex and Related issue a press release in the form of a letter to CommonWealth shareholders and an investor presentation.
April 18, 2013	CommonWealth formally responds to the record date request by Corvex and Related and issues a press release regarding the same. In the letter, CommonWealth states that although Corvex and Related are aware that the company's Bylaws provide for a 30 day period for the Board to fix a record date after receiving a valid request from shareholders, Corvex and Related "are

Date	Event Description
	attempting to pretend that the record date has been set 10 days after they made a request" by announcing the date as April 22. CommonWealth also believes that the Corvex letter is not a valid request because it is not made by shareholders who have owned at least 3% of CommonWealth's shares for at least 3 years as required by the company's Bylaws, and furthermore, that the Corvex letter does not state any cause for removal.
April 18, 2013	CommonWealth issues a press release urging shareholders to take no action with regard to the purported consent solicitation by Corvex and Related, based on the company's belief that (1) no valid record date has been set and (2) the consent solicitation is invalid.
April 22, 2013	CommonWealth makes an investor presentation available online and issues a press release regarding the same.
April 23, 2013	Corvex and Related respond to issues raised by Commonwealth with regard to (1) whether their consent solicitation is permitted under CommonWealth's Bylaws, (2) whether CommonWealth is eligible to ask for a record date despite not having held 3% of the company's stock continuously for 3 years, (3) whether CommonWealth's recent action of "opting in" to Section 3-803 of the Maryland corporate statute eliminates shareholder rights to remove Board members without cause and (4) whether Corvex and Related have a valid record date. It is the view of Corvex and Related that CommonWealth has been improperly passing bylaw amendments beginning in March to eliminate certain rights granted to shareholders in the company's charter.
April 30, 2013	Perry Corp., who currently owns 5.5% of CommonWealth's outstanding common shares, issues a letter to the Board voicing support for Corvex and Related and similarly criticizing CommonWealth's recent actions.
May 8, 2013	CommonWealth issues a press release announcing that the Circuit Court for Baltimore City has upheld CommonWealth's arbitration bylaw and accordingly, all remaining issues between CommonWealth and Corvex and Related will be determined through arbitration.
May 9, 2013	Corvex and Related issue a press release commenting on the recent Baltimore court ruling and also announcing that they are continuing with their consent solicitation.
May 14, 2013	Following CommonWealth's annual shareholders meeting, held on May 14, director Joseph L. Morea resigned after having received only 21% of shareholder votes for his re-election.
May 15, 2013	CommonWealth issues a press release announcing the results of its annual shareholders meeting held on May 14. In the press release, CommonWealth's Board discloses its view that the insufficient vote for Mr. Morea "appeared not to be directed at any personal failings of Mr. Morea, but rather to be the result of the positions taken by the Board to oppose the hostile takeover efforts" by Corvex and Related. As a result, the Board has requested that Mr. Morea accept re-appointment to the vacancy created by his resignation. Mr. Morea accepts his re-appointment and is reinstated to the Board.
May 15, 2013	Corvex and Related issue a press release criticizing the recent decision by CommonWealth's Board to re-appoint Mr. Morea after he failed to receive the requisite majority of shareholder votes for re-election.

Date	**Event Description**
June 14, 2013	Corvex and Related issue a press release stating that ISS has recommended that CommonWealth shareholders vote to remove the entire Board.
June 17, 2013	CommonWealth issues an open letter to its shareholders requesting they take no action with regard to the Corvex/Related consent solicitation because no court or arbitration panel has made any findings as to the validity of the company's Bylaws, amended in March 1, requiring that shareholders seeking to remove trustees by written consent hold at least 3% of the company's shares continuously for at least 3 years, and on whether the Board may be removed without cause.
June 18, 2013	Corvex and Related issue a press release stating that Glass Lewis has recommended that CommonWealth shareholders vote to remove the entire Board.
June 19, 2013	Corvex and Related issue a press release committing to offer to buy 51% of Commonwealth's $630 million outstanding debt under its revolving credit agreement and term loan at par value if the entire Board is removed, in order to alleviate any shareholder concern as to the possibility of debt acceleration. In the press release, Corvex and Related state that (1) removing the entire Board will not constitute an event of default that automatically accelerates the payment of the debt outstanding under both facilities and (2) in order for an acceleration to occur, the holders of more than 50% of the outstanding obligations would have to affirmatively elect to accelerate repayment.
June 20, 2013	Corvex and Related file Supplement No. 2 to their consent statement (1) noting that it is their view that the Consent Record Date is April 22, 2013; (2) providing updates on the arbitration directed by the Circuit Court for Baltimore City and stating that a hearing regarding the validity of CommonWealth's Bylaws and whether the Board may be removed without cause has been scheduled for July 26, 2013; and (3) reiterating their commitment to purchase 51% of the outstanding debt under the company's revolving credit agreement and term loan if the entire Board is removed.
June 21, 2013	Corvex and Related issue a press release (1) announcing that holders of over 70% of the outstanding shares of CommonWealth have approved removal of the entire Board; (2) demanding that CommonWealth officers immediately call a special meeting of shareholders to elect a new Board, as mandated by the company's charter; and (3) reaffirming their commitment to buy 51% of the company's debt under its revolver and term loan at par, if necessary.
June 24, 2013	CommonWealth issues a press release stating that it is CommonWealth's continued belief that the consent solicitation recently pursued by Corvex and Related has no legal effect because the arbitration panel that is considering the actions by Corvex and Related has not yet issued a ruling.
July 8, 2013	CommonWealth discloses that it has not made a decision whether or not to sell its controlling stake in SIR at this time, and has agreed not to sell SIR shares prior to August 27, 2013 without the consent of the underwriter.
July 9, 2013	CommonWealth provides an update as to its interest in SIR, stating that (1) CommonWealth did not sell any of its 22,000,000 SIR common shares in the SIR public offering of 10,500,000 shares effected on July 2; (2) CommonWealth did not receive any proceeds from the SIR offering; (3) prior to the offering, CommonWealth owned approximately 56% of SIR's outstanding common

Date	Event Description
	shares and SIR was one of its consolidated subsidiaries, and following completion of the offering, CommonWealth now owns approximately 44.2% of SIR's outstanding common shares and SIR has ceased to be a consolidated subsidiary.
August 7, 2013	The arbitration panel issues an interim order concluding that even though some holding period and minimum threshold ownership level can be set in the CommonWealth Bylaws as a condition to shareholders obtaining a record date for consent solicitation, these requirements "cannot in operation separately or together substantially [impair] the right of shareholders to proceed with a consent solicitation by making the obtaining of a record date unreasonably difficult to achieve." The panel holds that CommonWealth's Bylaws, which sets as a minimum requirement holding 3% of the company stock for a 3 year period (the "3+3 bylaws"), is invalid as a matter of law because it exceeds this standard. As a result, the prior version of the Bylaws providing for a $2,000 stock ownership threshold and a 1 year holding period for consent solicitations (the "2+1 bylaws"), which Corvex/Related have also challenged as invalid, is reinstated until a full evidentiary hearing scheduled for October 7 addresses its validity and all other unresolved issues. In addition, the panel notes that it is its preliminary view that CommonWealth's opt-in to Section 3-803 of the Maryland General Corporation Law does not eliminate or otherwise modify the right of the shareholders to remove Board members without cause, but that this is subject to change based on the arguments and evidence presented at the October 7 evidentiary hearing.
September 19, 2013	The arbitration panel issues an order dismissing with prejudice the derivative claim by Corvex and Related against CommonWealth's Board relating to breaches of fiduciary duty.
September 23, 2013	CommonWealth issues a press release announcing its intention to implement certain governance changes, including (1) restructuring the management agreement with Reit Management & Research LLC; (2) increasing the size of the Board and the ratio of independent trustees to total trustees; (3) recommending the elimination of its staggered Board at the 2014 annual meeting; and (4) accelerating the expiration of CommonWealth's poison pill, which currently expires on October 17, 2014, to a date after resolution of the pending disputes with Corvex/Related. CommonWealth also announces that the Board has amended the Bylaws so that the 30-day period during which qualified shareholders may present Board nominations and other business for consideration at the 2014 annual meeting will commence on December 11, 2013, and end on January 10, 2014 (rather than commencing on September 28, 2013, and ending on October 28, 2013, as previously required).
November 18, 2013	The arbitration panel issues an interim arbitration award, ruling, among other things, that the Corvex/Related consent solicitation was not properly conducted and cannot be validated, but that, in the interest of achieving an equitable result, the arbitration panel will allow Corvex and Related to conduct a new consent solicitation in accordance with the procedures set forth in the interim arbitration award.
November 24, 2013	CommonWealth's Board amends the Bylaws so that the period during which qualified shareholders may present Board nominations and other business for consideration at the 2014 annual meeting will commence on February 21, 2014,

Date	Event Description
	and end on March 24, 2014 (rather than commencing on December 11, 2013, and ending on January 10, 2014).
November 25, 2013	CommonWealth issues a press release announcing that its 2014 annual meeting will be held on June 13, 2014.
November 25, 2013	Corvex and Related notify the arbitration panel, CommonWealth and the Board of their intention to pursue a new consent solicitation to remove the entire Board. Consistent with the interim arbitration award, Corvex and Related state that they will submit a request for a record date no later than February 16, 2014.
December 3, 2013	Corvex and Related file a new preliminary solicitation statement to remove all five members of the Board by written consent, and also issue a press release announcing the same. In the preliminary solicitation statement, Corvex and Related remind shareholders that a special meeting to elect new trustees to the Board will only occur if their proposal to remove the entire Board is supported by holders of 2/3 of the outstanding shares of CommonWealth on the record date for the consent solicitation.
December 12, 2013	CommonWealth files a consent revocation statement to allow shareholders to revoke their consents to the Corvex/Related preliminary solicitation statement, and also issues a press release announcing the same. In the consent revocation statement, CommonWealth reminds shareholders that the special meeting to elect new trustees to the Board will only occur if the Corvex/Related proposal to remove the entire Board is successful. In the press release, CommonWealth also announces its intention to implement certain governance changes, including: (1) adding an additional independent trustee to the Board; (2) appointing a lead independent trustee to the Board; (3) declassifying the Board; (4) terminating the company's poison pill; and (4) restructuring the business management fee payable to RMR, the company's manager, to be further aligned with the interests of shareholders.
December 18, 2013	Corvex and Related file an investor presentation listing the reasons why CommonWealth shareholders should vote to remove all members of the Board by written consent.
December 23, 2013	CommonWealth issues a press release announcing certain governance changes, including (1) the amendment of the company's Bylaws to provide for a $2,000 stock ownership requirement and a one-year holding period for Board nominations and shareholder proposals; (2) a plan to submit to a shareholder vote at the 2014 annual meeting an amendment to adopt a plurality voting standard for contested Board elections; (3) the company opting-out of the provisions of the Maryland Unsolicited Takeovers Act, which require a classified or staggered Board; (4) a plan to submit to a shareholder vote at the 2014 annual meeting a proposal to de-stagger the Board, which will be phased-in over a three-year period starting in 2014; and (5) the elimination of the "dead-hand" provisions of the company's poison pill, which prevents dismantling of the pill by a successor Board. The Board also restates its intent to accelerate the expiration of the company's poison pill, which currently expires on October 17, to a date soon after the resolution of the Corvex/Related disputes.
December 26, 2013	CommonWealth files a revised consent revocation statement to allow shareholders to revoke their consents to the Corvex/Related preliminary

Date	Event Description
	solicitation statement.
January 6, 2014	CommonWealth issues a press release announcing the appointment of two new independent trustees to the Board. The Board now consists of seven members, five of whom are independent trustees.
January 21, 2014	CommonWealth files a revised preliminary consent revocation statement to allow shareholders to revoke their consents to the Corvex/Related solicitation statement.
January 23, 2014	Corvex and Related file a revised preliminary solicitation statement to remove all seven members of the Board by written consent.
January 27, 2014	CommonWealth issues a press release announcing that Ronald Artinian, one of its newly appointed independent trustees, has been nominated as "Trustee of the Year" by Fund Industry Intelligence.
January 27, 2014	Corvex and Related file a definitive solicitation statement to remove all seven members of the Board by written consent, and also issue a press release announcing the same.
January 29, 2014	CommonWealth files a definitive consent revocation statement to allow shareholders to revoke their consents to the Corvex/Related solicitation statement, and also issues a press release announcing the same.
January 30, 2014	Corvex and Related file a revised investor presentation listing the reasons why CommonWealth shareholders should vote to remove all members of the Board by written consent, and also issue a press release announcing the same.
February 6, 2014	Corvex and Related file a case study presentation on what they refer to as the company's "Red Tape" Bylaws and "worst-in-class" corporate governance.
February 10, 2014	CommonWealth issues a press release announcing a conditional record date of February 18, 2014 for the consent solicitation, conditioned on Corvex and Related submitting a record date request by February 16, 2014.
February 11, 2014	Corvex and Related issue a press release announcing that Sam Zell and David Helfand, veteran REIT executives, are joining the slate of independent nominees for election to the Board if the pending consent solicitation is successful. CommonWealth issues a press release in response to the announcement.
February 13, 2014	Corvex and Related file Supplement No. 1 to their solicitation statement, noting among other things, that on February 11, 2014, Corvex and Related entered into an agreement (the "**EGI Agreement**") with EGI-CW, an affiliate of Mr. Zell's private investment firm Equity Group Investments ("**EGI**"). Under the EGI Agreement, Corvex and Related each grant to EGI-CW an option to purchase (i) up to 1,190,476 Commonwealth shares at a price per share of $21.00 and (ii) up to 833,333 Commonwealth shares at a price per share of $24.00, within a specified exercise period.
February 13, 2014	Corvex and Related file a revised investor presentation listing the reasons why CommonWealth shareholders should vote to remove all members of the Board by written consent.

Date	Event Description
February 14, 2014	Corvex and Related deliver a formal request for a record date for the consent solicitation. In accordance with the arbitration panel's interim award, the consent solicitation will be completed no later than March 20, 2014.
February 18, 2014	CommonWealth files an investor presentation listing the reasons why CommonWealth shareholders should reject the attempt by Corvex and Related to take control of CommonWealth, and also confirms a record date of February 18, 2014.
February 18, 2014	Corvex and Related deliver an investor presentation to ISS.
February 19, 2014	Corvex and Related send a letter to CommonWealth shareholders announcing that Mr. Zell has agreed to serve as Chairman of the new Board and Mr. Helfand has agreed to serve as CommonWealth's CEO, if appointed by the new Board.
February 21, 2014	CommonWealth issues a press release announcing that (1) beginning February 21, 2014, through Monday, March 24, 2014, shareholders who have owned a minimum of $2,000 worth of common shares for at least one year may make Board nominations and shareholder proposals for consideration at CommonWealth's annual shareholders meeting on June 13, 2014; (2) among the matters to be considered at the 2014 annual meeting will be Board proposals to amend the company's Declaration of Trust to provide for (i) annual election of all members of the Board and (ii) a plurality voting standard in contested Board elections; and (3) in addition to the two independent trustees who were recently added to the Board, the Board is committed to adding at least one more additional independent trustee and to designating a lead independent trustee by the time of the 2014 annual meeting.
February 28, 2014	ISS recommends that CommonWealth shareholders vote in favor of Corvex and Related to remove the entire Board. CommonWealth issues a press release in response to the ISS report, stating: "We strongly believe that ISS reached the wrong conclusion."
March 4, 2014	Corvex and Related send a letter to CommonWealth shareholders announcing that ISS recommends for the second time that CommonWealth shareholders vote in favor of Corvex and Related to remove the entire Board.
March 6, 2014	Glass Lewis recommends for the second time that CommonWealth shareholders vote in favor of Corvex and Related to remove the entire Board. Corvex and Related issue a press release announcing the same.
March 7, 2014	Moody's Investors Service ("Moody") issues a press release announcing that it is placing CommonWealth's investment grade ratings "on review for downgrade." CommonWealth issues a press release commenting on the news, disclosing that "Moody's Investors Service placed the ratings of CommonWealth REIT on review for downgrade reflecting the potential for significant shifts in financial and strategic policies as a result of the activist shareholders' efforts to displace the current Board of Directors and management…. If the activist shareholders are successful, Moody's will focus on potential for increased leverage, secured debt and/or core asset sales, as well as execution risk associated with transitioning the operations of a large, nationally diverse real estate portfolio to a new management team and infrastructure."

Date	Event Description
March 9, 2014	CommonWealth files an Articles Supplementary describing the adoption by the Board of resolutions that prohibit the Board from electing in the future to classify the Board pursuant to Section 3-803 of the MUTA, unless the classification or the repeal of the prohibition is approved by a majority of the holders of the company's outstanding common stock.
March 13, 2014	CommonWealth issues a press release commenting on Mr. Zell's alleged conflict of interest in connection with the consent solicitation. Mr. Zell is the lead investor in Par Petroleum Corporation ("PARR"), which recently acquired one of the largest tenants of SIR, a subsidiary of CommonWealth.
March 17, 2014	CommonWealth issues a press release disclosing additional information concerning Mr. Zell's alleged conflict of interest in connection with the consent solicitation.
March 19, 2014	CommonWealth issues a press release announcing it has received documentation from Corvex and Related that they claim are written consents from holders of approximately 81% of the Company's outstanding shares, thereby reaching the 66.7% threshold required to remove the entire Board without cause. As directed by the November 18, 2013, arbitration decision, CommonWealth will inspect the consents and declare the results of the solicitation within five business days from receipt.
March 25, 2014	CommonWealth issues a press release confirming that the Corvex/Related written consents have reached the 66.7% threshold, and all Board trustees have been removed. As required by the November 18, 2013, arbitration decision, CommonWealth will call a special meeting of shareholders for purposes of electing new trustees to the Board.
April 1, 2014	CommonWealth files a preliminary information statement for the special meeting of shareholders to elect up to seven new trustees to the Board.
April 2, 2014	Corvex and Related send a letter to CommonWealth shareholders providing additional information regarding its seven nominees to the Board for election at the special meeting of shareholders.
April 11, 2014	CommonWealth files a definitive information statement for the special meeting of shareholders to be held on May 23, 2014.
April 30, 2014	Corvex and Related confirm that except for its nominees, no additional trustee nominations were made by other shareholders prior to the deadline for special meeting nominations on April 21, 2014.
May 12, 2014	Corvex and Related issue a press release stating that ISS and Glass Lewis have recommended that CommonWealth shareholders vote for all seven of the Corvex/Related nominees at the upcoming special meeting of shareholders.
May 23, 2014	At CommonWealth's special meeting of shareholders, all seven of the Corvex/Related nominees are elected to the Board. James S. Corl and Edward A. Glickman are elected to Group I with a term of office expiring at the 2014 annual meeting of shareholders to be held on June 30, 2014 (the "2014 Annual Meeting"); Peter Linneman, James L. Lozier, Jr. and Kenneth Shea are elected to Group II with a term of office expiring at the 2015 annual meeting of shareholders; and Sam Zell and David Helfand are elected to Group III with a term of office expiring at the 2016 annual meeting of shareholders.

Date	Event Description
June 11, 2014	CommonWealth files a preliminary proxy statement for the 2014 Annual Meeting. At the 2014 Annual Meeting, shareholders will be asked to vote on, among other things, a proposal to amend the company's Declaration of Trust to declassify the Board and provide for the annual election of trustees. To effectuate the declassification of the Board, each of the seven Corvex/Related newly elected trustees has given resignations effective immediately prior to the vote on the re-election and election, as the case may be, of a total of eleven trustees to the Board. In addition to the seven Corvex/Related trustees standing for re-election to the Board, the Board has nominated four trustees for election to the Board, with all trustees serving one-year terms expiring in 2015.
June 12, 2014	CommonWealth confirms that, as previously disclosed, the removal of the Board without cause constituted an event of default under the company's term loan and revolving credit facility agreements. As a result, CommonWealth obtained waivers of these events of default, effective June 6, 2014, and also amended its loan agreements.
June 23, 2014	CommonWealth files a definitive proxy statement for the 2014 Annual Meeting.
July 10, 2014	CommonWealth files a supplement to the definitive proxy statement for the 2014 Annual Meeting, which was convened on June 30, 2014 but promptly adjourned to July 31, 2014, to revise certain subsections of the proxy relating to amendments to the company's Declaration of Trust.
July 15, 2014	In connection with the EGI Agreement and the exercise of EGI-CW's options granted thereunder, Corvex and Related deliver more than 4 million shares of CommonWealth's common stock to EGI-CW, an affiliate of Mr. Zell's private investment firm EGI. As previously disclosed, Mr. Zell was appointed Chairman of the new Board on May 23, 2014.
July 31, 2014	CommonWealth holds its reconvened session of the 2014 Annual Meeting. At the 2014 Annual Meeting, the company's shareholders (1) elect 11 trustees for one-year terms; (2) approve, among other things, proposed amendments to the company's Declaration of Trust (the "**Charter Amendments**"); and (3) approve the reimbursement to Corvex and Related of up to $33.5 million for expenses incurred in connection with their consent solicitations, half of such payment being contingent upon the company's share performance in years 2015 and 2016. Immediately following the approval, the Company files an Amended and Restated Charter with the Maryland State Department of Assessments and Taxation, which implements the Charter Amendments and also changes the company's name to Equity CommonWealth ("**EQC**"). The company also adopts Second Amended and Restated Bylaws which includes amendments to, among other things, (1) provide for a plurality voting standard in contested trustee elections, rather than requiring the approval of a majority of outstanding shares; (2) increase the maximum permitted number of trustees to 13; and (3) provide that a trustee elected to fill a vacancy will hold office until the next annual meeting of shareholders (because the Charter Amendments declassified the Board), rather than holding office for the unexpired term of the former trustee.
August 8, 2014	Corvex and Related terminate their previous agreement dated January 29, 2013, pursuant to which the parties had agreed to take certain actions with respect to EQC's securities (the "**Termination Agreement**"). Effective upon the execution of the Termination Agreement, each of Corvex and Related ceased to beneficially own the other's shares of EQC and consequently, each

Date	Event Description
	of Corvex and Related ceased to be the beneficial owner of more than 5% of EQC's outstanding common stock.
August 13, 2014	EQC files for removal from listing and registration on the New York Stock Exchange pursuant to 17 CFR 240.12d2-2(a)(4).
September 8, 2014	EQC files an investor presentation.
November 17, 2014	EQC files for removal from listing and registration on the New York Stock Exchange pursuant to 17 CFR 240.12d2-2(a)(1).

PROJECT [NAME]
CLOSING CHECKLIST

May 2015						
Su	M	Tu	W	Th	F	Sa
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

June 2015						
Su	M	Tu	W	Th	F	Sa
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30				

SC	[____________], counsel to Seller
I-Banker	[____________], financial advisor to Seller
Parent	[____________], a Delaware corporation
Purchaser	[__________] Acquisition Corporation, a Delaware corporation and a wholly-owned subsidiary of Parent
SEC	Securities and Exchange Commission
Seller	[____________], a Delaware corporation
PC	[____________________], counsel to Parent and Purchaser
Depositary	Computershare Trust Company, N.A.

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
PRELIMINARY MATTERS					
1		Confidential Disclosure Agreement with Parent	Parent, Seller	Complete	
2		Initial Seller Board of Directors review and authorization to proceed with sale process	Seller	Complete	
3		Engagement letter with I-Banker	Seller	Complete	
4		Non-binding Letter of Intent from Parent	Parent	Complete	
5		Exclusivity Agreement	Parent, Seller	Complete	
PRE-SIGNING					
A.	*Corporate Matters*				
1		Formation of Purchaser • Certificate of Incorporation • Action by Sole Incorporator of Purchaser • Bylaws • Board Consent • Stock certificate issued to Parent	Parent, PC	Complete	

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
2		Seller Board of Directors meeting approving: • the Offer • the merger • merger agreement • Section 16 exemption • Delaware Business Combination Statute (including Share Tender and Voting Agreement) [Note – most REITs are Maryland corporations] • Determination that members of compensation committee satisfy the non-exclusive safe harbor under Rule 14d-10(d)(2) • Approve Authorized Officers • Regulatory and stock exchange filings • Amend existing shareholder rights plan • Amend Company Option Plans • Accelerate options, restricted stock and restricted stock units	Seller	Complete	

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
3		Seller Compensation Committee meeting approving: • Arrangements in accordance with Rule 14d-10 • Cash bonus plan for certain employees • Revise period for cash bonus plan • Bonuses/retention agreements in connection with the Offer/Merger • Establishment of a bonus pool • Treatment of stock option plans, unvested stock options, restricted stock and restricted stock units pursuant to merger agreement • Sections _____ of the merger agreement • Special transaction committee payment • Acceleration of payouts to executive officers to be paid immediately prior to Appointment Time	Seller	Complete	
4		Obtain Fairness Opinion from I-Banker	I-Banker	Complete	
5		Parent Board of Directors meeting approving the transaction and related documents	Parent	Complete	
6		Purchaser Board of Directors written consent approving the transaction and documents	Purchaser	Complete	
7		Written consent of sole stockholder of Purchaser approving the transaction and documents	Purchaser, Parent	Complete	
8		Confirm good standing of Seller in DE	Seller	Complete	
B.	*Draft and Negotiate Agreements with Third Parties*				
1		Select Dealer Manager and enter into agreement	Parent, PC	Complete	

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
2		Select Information Agent and enter into agreement	Parent, PC	Complete	
3		Select Depositary Agent and enter into agreement	Parent, PC	Complete	
4		Select Financial Printers and enter into agreement	Parent, PC, Seller, SC	Complete	
SIGNING (May 1, 2008)					
A.	*Principal Documents*				
1		Execute Agreement and Plan of Merger (with exhibits), deliver signatures of Parent, Seller, Purchaser	Parent, Seller	Complete	
2		Seller Disclosure Schedule	Seller	Complete	
3		Execute Share Tender and Voting Agreement (from Seller directors and officers) ▪ [*list of individuals*]	Parent, Seller	Complete	
4		Amendment to Shareholder Rights Agreement and related officer's certificate	Seller, SC, Transfer Agent	Complete	
5		Acknowledgement letters for certain termination payments (signed by Parent and each Seller executive officer) ▪ [*list of individuals*]	Parent, Seller	Complete	
6		Retention Agreements with ▪ [*list of individuals*]	Parent, Seller	Complete	
B.	*Other Matters*				
1		Parent /Seller joint press release announcing the signing	Parent, Seller	Complete	
2		Notice to Fidelity, AG Edwards and Merrill Lynch regarding termination of 10b5-1 trading plans	Seller	Complete	

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
3		Notice of transaction to Nasdaq Coordinator immediately prior to execution of merger agreement	Parent, PC	Complete	
4		Parent/Purchaser to file Form 8-K with SEC	Parent, PC	Complete	
5		Seller file Form 8-K with SEC: ▪ Describing and attaching the Merger Agreement ▪ Attaching joint press release regarding the signing ▪ Amendment to shareholder rights agreement ▪ Tender and Voting Agreement ▪ Disclosing bonus/retention agreements with executive officers ▪ Disclosing acceleration of payments upon a change in control ▪ Disclosing Top-Up Option (sale of unregistered securities)	Seller	Complete	
6		File Form 8-A/A (amendment to shareholder rights agreement)	Seller	Complete	
7		Prepare for analyst calls and other pre-commencement communications	Parent, Seller	Complete	
8		Seller Q&A	Seller	Complete	
9		Communications to/meeting with employees regarding Offer and Merger	Seller	Complete	
10		Parent's HSR filing	Parent, PC	Filed	
11		Seller's HSR filing	Seller, SC	Filed	
12		Determination of any foreign antitrust filings	Seller, SC	Complete	
		▪ [*list of foreign jurisdictions, if any*]	Seller, SC	Complete	
OFFER DOCUMENTS AND RELATED SEC FILINGS					

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
1		File Schedules TO-C and Schedules 14D-9C for all pre-commencement communications ▪ Attaching joint press release regarding the signing ▪ Communications regarding Parent/Purchaser ▪ Investor relations conference call transcript ▪ Communications to employees	SC, PC	Complete	File on Day of Signing and on any day announced prior to Commencement of Tender Offer
2		Request mailing labels and shareholder and NOBO list from Transfer Agent	Seller, Parent	Complete	
3		Telephonic Notice to stock exchange	Parent, Seller	Complete	
4		Reserve space in the Wall Street Journal for summary advertisement	Parent, PC	Complete	Note 48 hours prior to publishing to avoid premium fee
5		Deliver text of summary advertisement to printer and finalize proof	Parent, PC	Complete	Prior to Commencement of Tender Offer
6		Summary advertisement published	Parent	Complete	1 Day prior to Commencement of Tender Offer
7		Schedule TO and all accompanying offering materials: ▪ Offer to purchase ▪ Letter of transmittal (including Guidelines for Certification of Taxpayer Identification Number (TIN) on Substitute Form W-9) ▪ Letter to brokers, dealers, Commercial Banks, Trust Companies and Other Nominees ▪ Letter to clients ▪ Summary advertisement ▪ Notice of guaranteed delivery ▪ Non-disclosure agreement	Parent, PC	Complete	Date of Commencing Tender Offer

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
8		Schedule 14D-9, File and Print and mail offering materials and copy of Schedule 14D-9 to Seller shareholders	Seller, SC	Complete	Date of Commencing Tender Offer
9		Information Statement (per Rule 14f-1) with SEC in connection with the possible election of persons designated by Purchaser, pursuant to the Merger Agreement and mail to Seller shareholders	Seller, SC	Complete	Date of Commencing Tender Offer
DURING PENDENCY OF TENDER OFFER					
1		Press Release announcing expiration period under HSR and satisfaction of such condition under the Offer	Parent, Seller	None	During Offering Period
2		File amendments to each of Schedule TO and Schedule 14D-9 with press release regarding HSR	SC, PC	Complete	During Offering Period
3		If reviewed by SEC, respond to any comments from SEC and amend Schedule TO and Schedule 14D-9 accordingly	SC, PC	SEC confirmed “no review” on Schedule TO and Schedule 14D-9	During Offering Period
4		Amend Schedule TO and Schedule 14D-9 and file with SEC as necessary to reflect developments in the transaction	SC, PC		During Offering Period
5		Monitor status of shares tendered	SC, PC		During Offering Period
6		Ascertain whether conditions to the Offer have been satisfied	SC, PC		During Offering Period
7		Notify Transfer Agent of Appointment Time (Midnight June 12, 2008)	SC, Seller	Complete	
8		Obtain third party consents and waivers: ▪ [*list of entities*]	Parent, PC, Seller, SC	Drafts sent to Parent	Once we receive comments from Parent, Seller will mail consents
9		Purchase D&O tail insurance policy	Seller	Quote obtained	
10		Determine whether Seller’s 410(k) plan or any group severance or group separation plans need to be terminated	Seller, Parent		

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
11		Obtain 280G determination from nationally recognized accounting firm pursuant to the terms of Mr. XXX's employment agreement	Seller	In progress	
12		Set up rabbi trust on XXX's behalf with [____] Bank	Seller, SC	In progress	
13		Meeting of Seller's Board of Directors to approve establishment of rabbi trust on XXX's behalf	Seller, SC		
14		Meeting of Seller Compensation Committee to allocate $450,000 bonus pool and payment of bonuses	Seller, SC		
15		Respond to FINRA requests	Seller, SC		
EXPIRATION OF TENDER OFFER (MIDNIGHT JUNE 12, 2008)					
1		Confirm minimum tender condition and the other conditions to the Offer have been satisfied	Parent, PC, Seller, SC	NOTE: If not satisfied, Parent issues press release before 9AM EST 6/13/08 announcing extension of Offer	Appointment Time (6/12)
2		Issue press release announcing closing of TO and acceptance of tendered shares, report preliminary result of shares tendered	Parent, PC	Note: May offer a "Subsequent Offering Period" for an additional 3 to 20 business days following the close of the initial tender offer	
3		Amend Schedule TO to disclose acceptance of the tendered securities and expiration of Offer	Parent, PC		
4		Amend Schedule 14D-9 to disclose acceptance of the tendered securities and expiration of Offer	Seller, SC		
5		Provide written notice to Nasdaq Coordinator of material corporate action	Parent, PC		

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
6		If necessary, Parent or Purchaser exercises Top-Up Option to acquire from Seller sufficient number of shares to hold 90% If exercised, Seller issues such shares to Parent or Purchaser in exchange for payment in the form of cash or promissory note: • Exercise Notice/ Receipt for Top-Up Option • Receipt and Notice from Seller of Number of Top-Up Shares • Determine whether Top-Up shares will be entered in Book Entry form or Certificated Form • Full Recourse Promissory Note for payment of shares purchased pursuant to Top-Up Option • Instructions to Transfer Agent to issue shares • Book Entry with respect to Purchaser's shares of Seller common stock by Transfer Agent • Transfer Agent Certificate verifying Purchaser's Book Entry Position	Parent, PC, Seller, SC		
7		Payment of severance amounts to Seller executives: • [*list of individuals*]	Parent, Seller		
8		Provide payment to Seller directors for RSUs: • [*list of individuals*]	Parent, Seller		
9		Letter from Purchaser to Depositary (accepting for payment all shares of Seller common stock tendered in the Tender Offer)	Parent, PC		
10		Notice to Dealer Manager regarding expiration of the Offer	Parent, PC		
11		Letter from Depositary (confirming the acceptance of shares in the Tender Offer)	Depositary		

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
12		Upon the Appointment Time, Parent exercises its right to designate directors to fill at least a majority of the Seller Board and any committees thereof If exercised, Seller takes all actions necessary including seeking resignations or increasing size of Board: • Determine (2) Seller directors who will remain on the Board • Letters of resignation for resigning Seller directors	Parent, PC, Seller, SC		
13		Form 4 reporting obligation for acceleration and cashing out of RSUs: • [*list of individuals*] • Form 4 reporting obligation for Section 16 officers – See Post Closing	Seller, SC		
14		Complete Transition Agreements between Parent and each of: • [*list of individuals*]	Parent, Seller		
SECOND STEP MERGER					
1		Closing of Merger – either (a) filing of short-form merger certificate with the Secretary of State of Delaware if more than 90% of shares have tendered or (b) schedule a stockholder meeting and distribute a proxy statement if more than 50% but less than 90% of the shares tendered, i.e., a long form merger (Will provide an Annex if contemplating anything other than a short-form merger)	Parent, PC		
2		Prepare flow of funds	Parent, PC		
3		Notify Nasdaq to delist Seller from trading	Seller, SC		
4		Parent Board approved short-form merger of Purchaser into Seller	Parent, PC		
5		Draft and file Certificate of Merger with Delaware Secretary of State	Parent, PC		

No.		Item	Primary Responsibility	Status / Notes	Due Date (where applicable)
6		Notify Nasdaq of approval and effectiveness of merger and request suspension of Seller trading as of the close of trading on the Effective Date of the Merger	Parent, PC, Seller, SC		
7		Issue press release announcing closing of short form merger	Parent, PC		
8		Parent (through Purchaser) transfers funds to Depositary to pay for remaining Seller shares converted into cash via the merger	Parent, PC		
9		Payment by Parent or Surviving Corporation for Seller Options and Seller Restricted Stock	Parent, Seller		
10		Draft and file Form 15 with SEC to deregister Seller as a reporting company	Seller, SC		
11		Nasdaq files Form 25 with SEC	Nasdaq		
12		Mailing of Appraisal Rights Notice to Seller stockholders (who did not tender in the Offer) per Delaware law	Parent, PC		
POST CLOSING					
1		File Forms 4 for Seller Section 16 filers: For acceleration of options and cash out of options; For tendering of common stock; for acceleration and cashing out of restricted stock: • [*list of individuals*]	Seller, SC		
2		Parent file Form 3 and Schedule 13D	Parent, PC		

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SHAREHOLDER ACTIVISM

What is Shareholder Activism?

- Shareholder activism refers to a range of activities undertaken by shareholders for the purpose of effecting change at the corporations that they own.

- Shareholder activism activities range from asking companies to present proposals at annual meetings regarding environmental, social and governance matters to seeking to cause a change of control.

- A wide spectrum of investors engage in shareholder activism, including individuals, hedge funds, pension funds and other institutional investors.

The Legal Framework for Activism

Director Duties

- A director of a Maryland corporation must perform his or her duties:
  - In good faith;
  - In a manner the trustee reasonably believes to be in the best interests of the company; and
  - With the care that an ordinarily prudent person in a like position would use under similar circumstances.

Director Duties

- Additionally, directors must:
  - Subjectively believe that the action taken is in the company's best interests, which belief must be objectively reasonable.
  - Exercise his or her own judgment as to the best interests of the company.
  - Inform themselves of all reasonably available information that is material to their decision.
- Whenever confronted with shareholder activism, directors must consider their duties to the corporation.

Federal Securities Laws

- In addition to state corporation laws, US federal securities laws must also be considered.

- The federal proxy rules provide for a mechanism by which shareholders are able to vote by proxy on matters raised by both shareholders and companies at annual and special meetings.

- SEC Rule 14a-8 provides a means by which a shareholder meeting certain eligibility requirements can have shareholder proposal included in a company's proxy statement.

- Exchange Act Section 14A requires that public companies hold an advisory vote on executive compensation.

The Legal Framework for Activism
Shareholder Proposals
Securities Exchange Act of 1934
Rule 14a-8

Shareholder Proposals

- Exchange Act Rule 14a-8.

- Shareholder Eligibility – Rule 14a-8(b)(1) –
  - Own $2000 or 1% for one year;
  - Own continuously for at least one year by the date proposal is submitted; and
  - Must continue to hold those securities through the date of the meeting.

- Number – Rule 14a-8(c) –
  - One proposal per shareholder.

Shareholder Proposals

- Length of proposal and supporting statement – Rule 14a-8(d) –
  - No more than 500 words.

- Timing – Rule 14a-8(e) –
  - Proposal must be submitted not less than 120 calendar days before the date of the proxy statement for the prior year's annual meeting.

- Presentation of proposal at annual meeting – Rule 14a-8(h) –
  - Proponent or representative must attend annual meeting and present proposal.

Shareholder Proposals

- Substantive Matters – Rule 14a-8(i) –
  – The issuer may exclude a proposal if its falls into one or more of 13 categories.

- Rule 14a-8(i) Categories –
  – (1) *Improper under state law*: The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the issuer's organization.
  – (2) *Violation of law*: The proposal would, if implemented, cause the issuer to violate any state, federal, or foreign law to which it is subject.
  – (3) *Violation of proxy rules*: The proposal or supporting statement is contrary to any of the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials.

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
  - (4) *Personal grievance or special interest*: The proposal relates to the redress of a personal claim or grievance against the issuer or any other person, or if it is designed to result in a benefit to the proponent, or to further a personal interest, which is not shared by the other shareholders at large.
  - (5) *Relevance*: The proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business.
  - (6) *Absence of power/authority*: The issuer would lack the power or authority to implement the proposal.
  - (7) *Management functions*: The proposal deals with a matter relating to the issuer's ordinary business operations.

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
  - (8) *Relates to election*: The proposal –
    - Would disqualify a nominee who is standing for election;
    - Would remove a director from office before his or her term expired;
    - Questions the competence, business judgment, or character of one or more nominees or directors;
    - Seeks to include a specific individual in the issuer's proxy materials for election to the board of directors; or
    - Otherwise could affect the outcome of the upcoming election of directors.

NOTE – Rule 14a-8(i)(8) Does NOT permit exclusion of "proxy access" proposals.

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
  - (9) *Conflicts with an issuer proposal*: The proposal directly conflicts with one of the is issuer's own proposals to be submitted to shareholders at the same meeting.

<u>NOTE</u> – SEC is reconsidering Rule 14a-8(i)(9) and is not currently taking no-action positions.

  - (10) *Substantially implemented*: The issuer has already substantially implemented the proposal;
  - (11) *Duplication*: The proposal substantially duplicates another proposal previously submitted to the issuer by another proponent that will be included in the issuer's proxy materials for the same meeting;

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
  - (12) *Resubmissions*: The proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the issuer's proxy materials within the preceding 5 calendar years and the last time it was included the proposal received:
    - Less than 3% if proposed once in last 5 calendar years;
    - Less than 10% on its last submission if proposed three times or more within the last 5 calendar years.
    - Less than 6% on its last submission if proposed twice within the last 5 calendar years; or

  NOTE – In these situations, the issuer may exclude the proposal it from its proxy materials for any meeting held within 3 calendar years of the last time it was included.

  - (13) *Specific amount of dividends*: The proposal relates to specific amounts of cash or stock dividends.

Shareholder Proposals

- Burden of Proof – Rule 14a-8(g) –
  - The issuer has the burden to demonstrate an ability to exclude a proposal.

- Issuer obligation to submit notice to the SEC – Rule 14a-8(j) –
  - Notice demonstrating basis to exclude must be presented to the SEC no later than 80 calendar days before the issuer mails its proxy statement for the annual meeting.
  - Issuer must provide a copy of the notice to the proponent.
  - If the basis relies on state or foreign law, the notice must include an opinion of counsel.

The Profile of Activist Investors

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Hedge Fund Activism Is Increasing

Activist funds have outperformed the market and other asset classes

Increased investment allocations to activist funds

Generates more activist campaigns and larger targets

Higher-profile success for activists

Greater institutional shareholder focus on corporate governance and acceptance of activist strategies

Notable Activist Funds

- Appaloosa Management
- Barrington Capital
- Bulldog Investors
- Cannell Capital
- Chapman Capital
- Elliott Management* (*Paul Singer*)
- ESL Investments
- Greenlight Capital* (*David Einhorn)*
- Highland Capital
- Icahn Partners* (*Carl Icahn*)
- JANA Partners* (*Barry Rosenstein*)
- Knight Vinke
- Perry Capital
- Pershing Square Capital* (*William Ackman*)
- Relational Investors* (*Ralph Whitworth*)
- Schoenfeld Asset Management
- Starboard Value* (*Jeffrey Smith*)
- Steel Partners
- Stilwell Value
- Third Point* (*Daniel Loeb*)
- TPG-Axon
- Tracinda (*Kirk Kerkorian*)
- Trian Partners* (*Nelson Peltz*)
- ValueAct Capital* (*Jeffrey Ubben*)

* Largest funds.

Traditional Investors As Activists

- Long-term institutional investors have embraced activist tactics
  - Fidelity, CalSTRS, CalPERS, T. Rowe Price and BlackRock
  - “Shareholder democracy” movement has made activism more acceptable
  - Many institutional investors also invest in activist funds
- Still rare for institutional investors to lead an activist campaign
- More common for institutional investors to publicly support activist campaigns
- Non-public institutional investor support of activist campaigns is now quite commonplace

Companies can no longer assume the support of their long-term institutional shareholders.

No Company Is "Too Big"

Select companies with market caps > $10BB with recent hedge fund activism

Agrium

Adobe

Canadian Pacific Railway

Microsoft

DuPont

Yahoo!

Forest Laboratories, Inc.

ITW

P&G

ebay

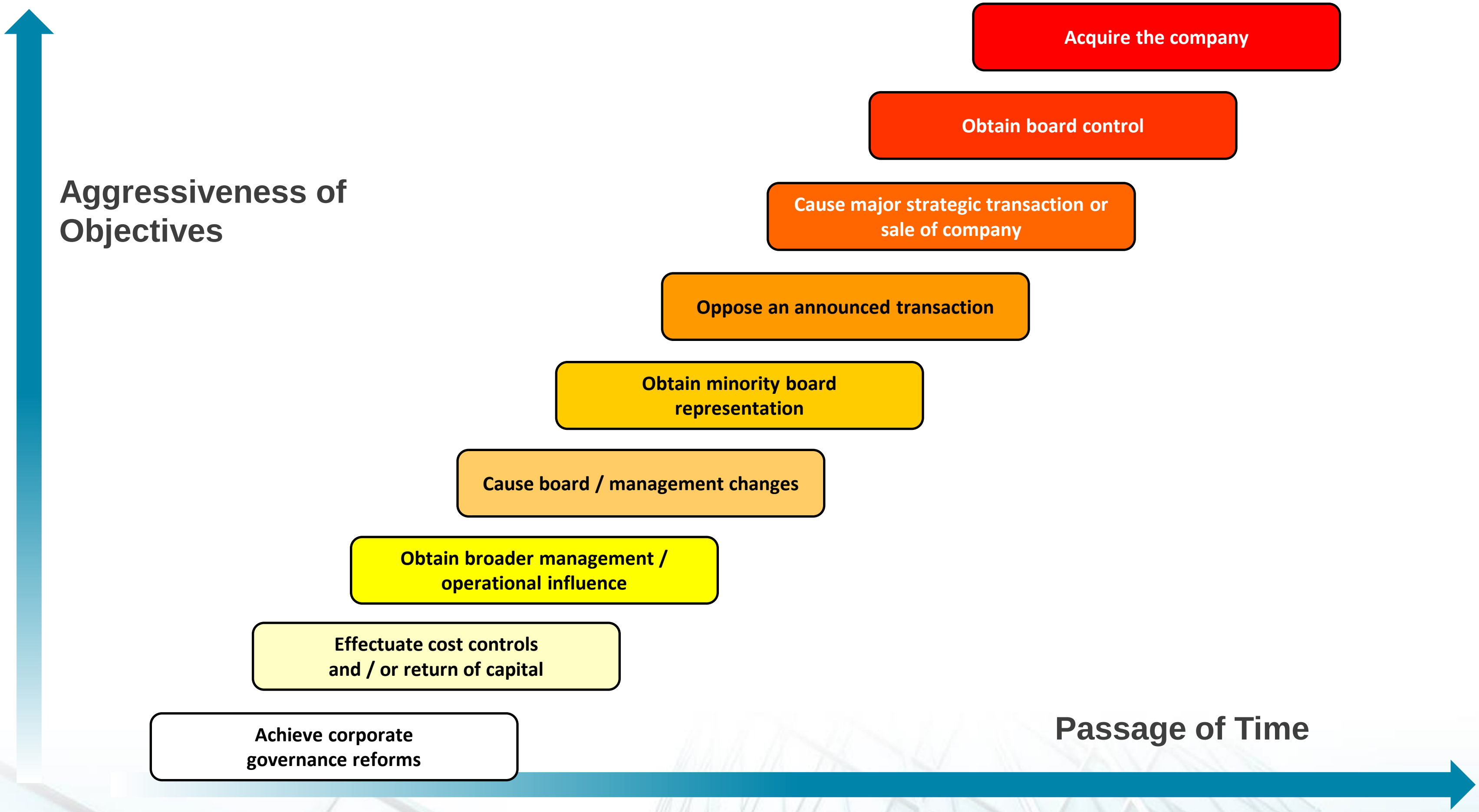
Motorola

Although most activist campaigns target small and mid-sized companies, no company is too large to be subject to hedge fund activism.

Impact of Proxy Advisors Services

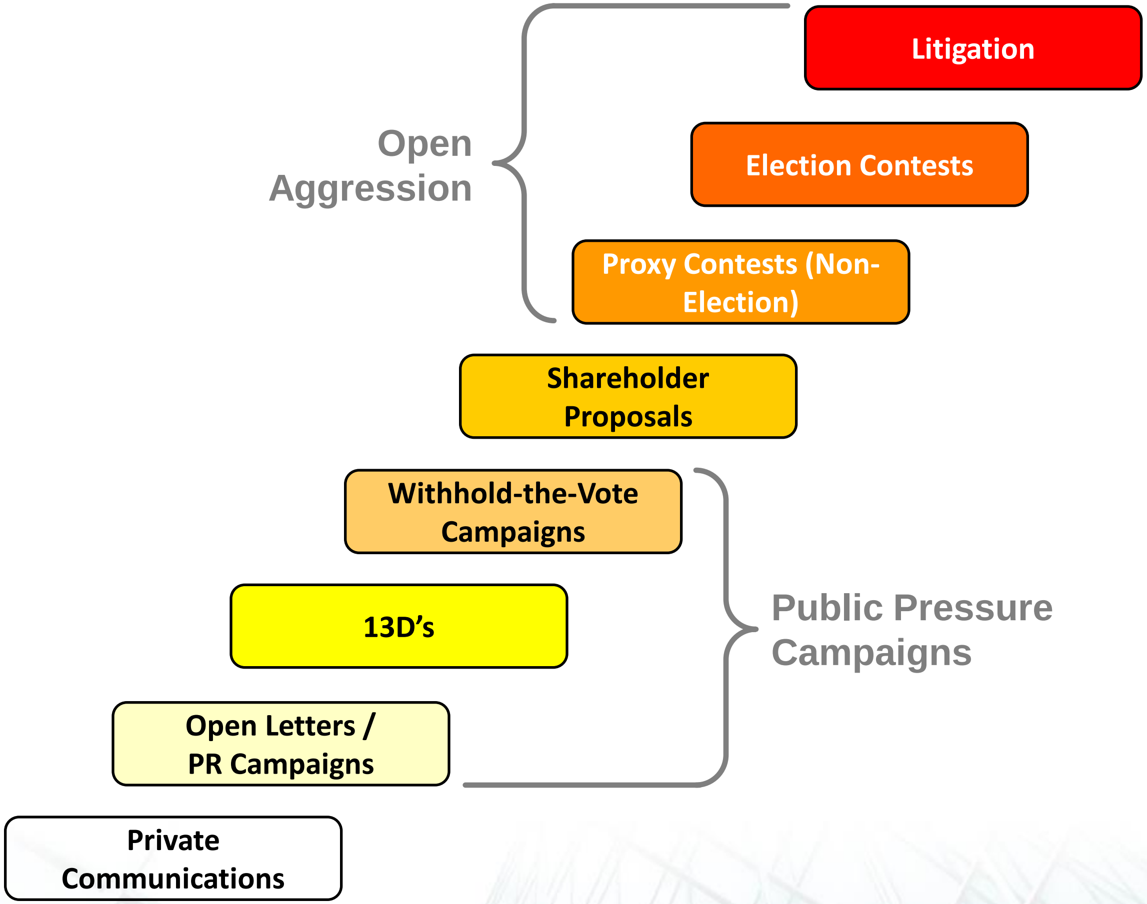
- Proxy advisory services exert significant influence on stockholder voting and governance
- ***Institutional Shareholder Services (ISS)*** — *the* largest and most influential advisory firm
  - Can directly influence the vote of 25% or more of shares outstanding
  - Most institutional investors review ISS research in some capacity
  - ISS voting policies are transparent, for the most part
  - ISS staff is willing to engage with corporate issuers in many instances
  - ISS provides services to issuers, as well as to institutional investor clients
- ***Glass Lewis & Co***. — the largest competitor to ISS
  - Significantly less influential than ISS, given a more limited client base
  - Does not provide services to issuers
  - Is willing to engage with companies only outside of the solicitation process
- **Egan Jones Proxy Services** — much smaller and less influential than ISS and Glass Lewis
- SEC staff recently published guidance on the activities of proxy advisory services under existing SEC rules

Activist Campaign Objectives



Objectives can, and often do, change over time as activist demands are not met.

The Range of Hedge Fund Tactics



"Open Aggression" tactics are much more costly and, therefore, not as common. However, success of aggressive actions has made them popular.

Tactics — Derivatives / Empty Voting

- Opportunistic investors can adjust their exposure to the issuer in order to decouple their economic and voting interests
  - Contra hedge can distort incentive to vote in a manner that benefits all shareholders
- Forcing activist disclosure is critical, so a target can attack the investor's "empty vote"
  - Schedule 13D requires disclosure of contracts concerning "any securities of the issuer," which can include derivatives, but often derivatives do not trigger Schedule 13D filing obligation
- Advance notice bylaw provision can require stockholders to disclose their derivative positions (and more) before submitting nominations or proposals for a stockholder meeting
- Recent rights plans also attempt to address the issue of derivative ownership
  - Include derivative positions in the definition of "Beneficial Ownership"
  - Aggregating Beneficial Ownership of persons "acting in concert" (aka wolf-packs) has faded due to concerns regarding the validity of such provisions under state law

Tactics — Short Slates

- Activist may solicit proxies for a minority of the board of directors
  - Proxy rules allow dissident to round out slate by including nominees named in the company's proxy without obtaining their consent
- Continue to be popular
  - More likely to be supported by institutional shareholders than control slates
  - Often supported by ISS and other proxy advisory firms and, if supported, often successful
  - Allows dissident to exercise influence without having to run the company
  - Allows dissident to leave certain incumbents on the board and support nominees of another dissident—dissident can round out its slate with nominees of the company or another dissident
  - Useful when election of a control slate would trigger change-of-control provisions in company debt agreements, severance agreements and other material contracts
  - However, activists are seeking control of boards more frequently than in the recent past, and getting surprisingly strong support
    - Notwithstanding strong activist pressure with backing from ISS, successful defense against short slate campaign still possible (*see, e.g.*, 2012 AOL proxy contest)

Tactics — Proxy Access

- "Proxy access" describes when a qualifying shareholder or group of qualifying shareholders has the ability to nominate one or more directors through the company's proxy statement.
- The SEC adopted a mandatory proxy access rule in August 2010, which was vacated by the United States Court of Appeals for the DC Circuit in July 2011; the SEC did not appeal or seek re-hearing of the court's decision.
- The SEC adopted amendments to its shareholder proposal rule (Rule 14a-8) to pave the way for "private ordering" of proxy access through the use of the shareholder proposal process.
- There are a number of options available under Rule 14a-8 for a company that receives a proxy access shareholder proposal:
  - Argue that the proposal is contrary to the proxy rules under Rule 14a-8(i)(3), *i.e.*, the resolution contained in the proposal is inherently vague or indefinite
  - Propose a company proxy access proposal that conflicts with the shareholder proposal under Rule 14a-8(i)(9), although the SEC has recently stopped expressing a view on 14a-8(i)(9)
  - Adopt a proxy access bylaw amendment and argue that proxy access has been "substantially implemented" under Rule 14a-8(i)(10)
  - Argue other substantive and procedural bases for exclusion, as applicable
- Many companies continue to take a "wait and see" approach to proxy access; however, some large companies – *e.g.*, Hewlett-Packard, Verizon and McKesson – have adopted, or announced their intention to propose, a proxy access bylaw.

Countering Activists — Investor Relations

- Regularly communicate with and court large shareholders (subject to Reg FD)
- Constantly monitor statements by shareholders and financial press
- Focus on accumulations of shares and movements of significant positions, particularly involving activists that often work together
- Review ISS corporate governance analysis for potential issues
- Make sure the company has a clear communications policy and speaks with one voice
- Anticipate activist issues and address them proactively:
  - Address Board composition issues
  - Formulate plans for cash and articulate them to the market
  - Consider divestiture (or other alternatives) for non-core, underperforming or unused assets

Activists typically take minority positions and need the support of other shareholders to succeed.

Countering Activists — Readiness

- Monitor the activity of activist investors, particularly in the technology sector, to better anticipate any potential threats
- Different activists employ different strategies and have different risk tolerances
    - Know the activists you're dealing with and craft your strategy accordingly
- Have an advisory team ready, including key management, investment bankers, inside and outside legal counsel, a proxy solicitor, and a financial public relations firm
- Respond to any activist approach promptly
- With activism increasing, periodically assess the vulnerability of the Company to hedge fund activism
    - Evaluate the Company's corporate governance profile and bylaws, seeking to identify any potential areas of weakness
    - Evaluate the Company's strategy, and be prepared to defend that strategy in the event of a challenge by an activist investor
    - Based on the Company's profile, develop a response plan that can be implemented if the Company is targeted in the future

Countering Activists — Readiness

- Shareholder engagement should be a centralized and coordinated effort
  - ➢ Board members can be an important part of shareholder engagement but it should be coordinated through the company
  - ➢ All requests to speak with board members should be referred to the company
  - ➢ Essential to speak with one voice
  - ➢ Remember that communications with shareholders are regulated—for example, Reg FD and proxy communication rules
- Shareholder activism may lead to litigation
  - ➢ Emails and other written communications may be taken out of context; consider oral communications when appropriate

Case Studies

Case Study — Apple Inc. (Return-of-Capital Objective)

- At the end of 2012, Apple had over $130 billion in cash and had announced plans to return some cash to shareholders through dividends and buybacks but many investors thought it was insufficient.
- In 2013, Greenlight Capital proposed that Apple issue preferred stock to shareholders that would provide shareholders with higher dividend income over time.
- Apple responded by proposing to amend its Articles of Incorporation to remove preferred stock authority. Apple combined the proposal with other amendments to the Articles.
- Greenlight sued Apple, alleging improper "bundling" of the amendment proposals. The court agreed with Greenlight, and Apple withdrew the proposal from the annual 2013 meeting agenda.
- In 2013-14, Carl Icahn pushed for a larger stock buyback. He submitted a proposal for Apple's Annual Meeting for a non-binding shareholder vote on a $50 billion buy back but dropped proposal due to lack of support.

Case Study — eBay Inc. (Spin-off Objective)

- January 2014, eBay announces receipt of notice from Icahn of
  (1) a non-binding proposal to spin-off eBay's PayPal business and
  (2) nomination of two Icahn nominees for the eBay board.
  - eBay / PayPal release materials arguing that eBay and PayPal are more valuable together
- February 2014, Icahn sends open letter to eBay shareholders stating there is "complete disregard for accountability at eBay" and directors should resign "out of pure decency or sheer embarrassment." The letter asks shareholders to approve Icahn's nominees and the spin-off proposal.
- February / March 2014, Substantial back and forth between eBay and Icahn regarding Icahn's allegations. Icahn remained very critical of certain Board members (in part to garner support for his nominees).
- March 2014, eBay and Icahn each file proxy materials in support of their nominees / positions on Icahn's spin-off proposal.
- April 2014, eBay announces settlement with Icahn that results in Icahn's withdrawal of the proposal and his nominees, and eBay's addition of another independent director to the Board (not one of Icahn's nominees).

Case Study — Microsoft (Strategic Direction Objective)

- April 2013, ValueAct Capital disclosed approximate $2 billion stake in Microsoft
- ValueAct operates less publicly than other activists (such as Icahn, Ackman and Einhorn)
  - ValueAct supported long-term investment in Microsoft, believing it was undervalued
  - ValueAct presented its views to management, which included a return of capital to shareholders and a strategic focus on core business software and Internet-based cloud services and less emphasis on consumer products
  - ValueAct apparently left open the possibility of a proxy contest to add a board member(s)
- August 2013, Microsoft announces agreement with ValueAct under which:
  - ValueAct was awarded a board seat in the first quarter of 2014
  - ValueAct agreed not to pursue a proxy contest or extraordinary transaction, and agreed to other restrictions on its activities
- The agreement was announced on deadline for shareholder nominations / proposals and one week after Ballmer announced his retirement (though said not to be related)

Case Study — Allergan Inc. (Acquisition Objective)

Valeant, Pershing bid for Allergan

•February 2014, Pershing Square and Valeant Pharmaceuticals create a joint fund and accumulate shares of to acquire Allergan. Current holdings are 9.7% of outstanding Allergan shares.

•April 2014, Valeant offers $48.30 in cash + 0.83 shares of Valeant stock for each Allergan share, Allergan adopts a poison pill to expire in 1 year.

•May 12, 2014, Allergan rejects Valeant's offer.

•May 13, 2014, Pershing files a proxy statement with the SEC announcing a meeting of Allergan stockholders to vote on a non-binding resolution requesting the Allergan board to engage in good faith discussions with Valeant regarding Valeant's proposal.

•May 28, 2014, Valeant offers $58.30 in cash + 0.83 shares of Valeant stock for each Allergan share.

•May 30, 2014, Without waiting for a reply from Allergan, Valeant revises its offer to $72 in cash + 0.83 shares of Valeant stock for each Allergan share.

•June 2, 2014, Pershing and Valeant take their bid to Allergan's shareholders by requesting, in an SEC filing, a Special Meeting for the purpose of removing a majority of the Allergan board.

Allergan share price = $169.22 on 6/30/2014 (NYSE:AGN)

SAMPLE EXCESS SHARE PROVISIONS

The following excess share provisions were excerpted from the charters of various real estate investment trusts. These excerpts demonstrate a variety of approaches to imposing share ownership and transfer limitations and will serve as a reference for our discussion of the validity of excess share provisions as a takeover defense. The following excerpts are presented below:

1. An excess share provision applicable to 13D groups
2. An excess share provision not applicable to 13D groups
3. An excess share provision directly addressing related party rent issues
4. An excess share provision not directly addressing related party rent issues
5. An excess share provision giving the board broad discretion to grant exemptions
6. An excess share provision giving the board very limited discretion to grant exemptions

Prepared by:

Donald A. Hammett Jr.
Partner
donald.hammett@dentons.com
D +1 214 259 0917

Dentons US LLP
2000 McKinney Avenue
Suite 1900
Dallas, TX 75201-1858 USA

Jonathan Olsen
jonathan.olsen@dentons.com
D +1 214 259 1887

Dentons US LLP
2000 McKinney Avenue
Suite 1900
Dallas, TX 75201-1858 USA

1. **An excess share provision applicable to 13D groups**

ARTICLE X
RESTRICTIONS ON TRANSFER AND OWNERSHIP OF SHARES

10.1 Definitions. For the purpose of this Article X, the following terms shall have the following meanings:

…

"Person" The term "Person" shall mean an individual, corporation, partnership, limited liability company, estate, trust (including, without limitation, a trust qualified under Sections 401(a) or 501(c)(17) of the Code), a portion of a trust permanently set aside for or to be used exclusively for the purposes described in Section 642(c) of the Code, association, private foundation within the meaning of Section 509(a) of the Code, joint stock company or other entity and also includes a group as that term is used for purposes of Section 13(d)(3) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

…

10.2 Share Ownership Limitations.

(a) Basic Restrictions.

(i) No Person shall Beneficially Own or Constructively Own Common Shares in excess of the Common Share Ownership Limit unless, as provided in Section 10.2(i), the Board of Directors, in its sole and absolute discretion, increases the Common Share Ownership Limit, in which case no Person shall Beneficially Own or Constructively Own Common Shares in excess of such modified Common Share Ownership Limit.

(ii) No Person shall Beneficially Own or Constructively Own Preferred Shares in excess of the Preferred Share Ownership Limit unless, as provided in Section 10.2(i), the Board of Directors, in its sole and absolute discretion, increases the Preferred Share Ownership Limit, in which case no Person shall Beneficially Own or Constructively Own Preferred Shares in excess of such modified Preferred Share Ownership Limit.

(iii) No Person shall Beneficially Own or Constructively Own Shares to the extent that:

(1) such Beneficial Ownership or Constructive Ownership of Shares would result in the Corporation being "closely held" within the meaning of Section 856(h) of the Code (without regard to whether the ownership interest is held during the last half of a taxable year);

(2) such Beneficial Ownership or Constructive Ownership of Shares would result in (a) the Corporation owning (directly or indirectly) an interest in a tenant that is described in Section 856(d)(2)(B) of the Code if the income derived by the Corporation (either directly or indirectly through one or more partnerships or limited liability companies) from such tenant for the taxable year of the Corporation during which such determination is being made would reasonably be expected to equal or exceed the lesser of (I) one percent (1%) of the Corporation's gross income (as determined for purposes of Section 856(c) of the Code), or (II) an amount that would cause the Corporation to fail to satisfy any of the gross income requirements of Section 856(c) of the Code or (b) any

manager or operator of a “qualified lodging facility,” within the meaning of Section 856(d)(9)(D) of the Code, leased by the Corporation (or any subsidiary of the Corporation) to one of its taxable REIT subsidiaries with respect to the Corporation failing to qualify as an “eligible independent contractor,” within the meaning of Section 856(d)(9)(A) of the Code, in either case if the income derived by the Corporation from such tenant or such taxable REIT subsidiary, taking into account any other income of the Corporation that would not qualify under the gross income requirements of Section 856(c) of the Code, would (or in the sole judgment of the Board of Directors, could) cause the Corporation to fail to satisfy any of such gross income requirements; or

(3) such Beneficial Ownership or Constructive Ownership of Shares would result in the Corporation otherwise failing to qualify as a REIT.

(iv) No Person shall Transfer any Shares if, as a result of the Transfer, the Shares would be Beneficially Owned by fewer than 100 Persons (determined without reference to the rules of attribution under the Code). Subject to Section 10.4 and notwithstanding any other provisions contained herein, any Transfer of Shares (whether or not such Transfer is the result of a transaction entered into through the facilities of the NYSE or any other national securities exchange or automated inter-dealer quotation system) that, if effective, would result in Shares being Beneficially Owned by fewer than 100 Persons (determined under the principles of Section 856(a)(5) of the Code) shall be void *ab initio*, and the intended transferee shall acquire no rights in such Shares.

2. **An excess share provision not applicable to 13D groups**

SECTION 2. REIT-RELATED RESTRICTIONS AND LIMITATIONS ON THE EQUITY STOCK.

Until the "Restriction Termination Date," as defined below, all Equity Stock shall be subject to the following restrictions and limitations intended to preserve the Corporation's status as a REIT:

(a) Definitions. As used in this Article V, the following terms shall have the indicated meanings:

…

"Person" shall mean an individual, corporation, partnership, estate, trust (including a trust qualified under Section 401(a) or 501(c)(17) of the Code), a portion of a trust permanently set aside for or to be used exclusively for the purposes described in Section 642(c) of the Code, association, private foundation within the meaning of Section 509(a) of the Code, joint stock company or other entity; but does not include an underwriter that participated in a public offering of any Equity Stock for a period of 25 days following the purchase by such underwriter of such Equity Stock.

…

(b) Ownership Limitation and Transfer Restrictions with Respect to Equity Stock.

(i) Except as provided in Section 2(f) of this Article V, prior to the Restriction Termination Date, no Person shall Beneficially Own or Constructively Own Equity Stock in excess of the Ownership Limit.

(ii) Except as provided in Section 2(f) of this Article V, prior to the Restriction Termination Date, any Transfer that, if effective would result in any Person Beneficially Owning or Constructively Owning Equity Stock in excess of the Ownership Limit shall be void ab initio as to the Transfer of such Equity Stock that would be otherwise Beneficial Owned or Constructively Owned (as the case may be) by such Person in excess of the Ownership Limit; and the Purported Record Transferee (and the Purported Beneficial Transferee, if different) shall acquire no rights in such Equity Stock.

(iii) Except as provided in Section 2(f) of this Article V, prior to the Restriction Termination Date, any Transfer that, if effective, would result in the outstanding Equity Stock being Beneficially Owned by less than 100 Persons (determined without reference to any rules of attribution) shall be void ab initio as to the Transfer of such Equity Stock which would be otherwise Beneficially Owned by the transferee; and the Purported Record Transferee (and the Purported Beneficial Transferee, if different) shall acquire no rights in such Equity Stock.

(iv) Prior to the Restriction Termination Date, any Transfer that, if effective, would result in the Corporation being "closely held" within the meaning of Section 856(h) of the Code, or would otherwise result in the Corporation failing to qualify as a REIT, shall be void ab initio as to the Transfer of the Equity Stock that would cause the Corporation to be "closely held" within the meaning of Section 856(h) of the Code or otherwise to fail to qualify as a REIT, as the case may be; and the Purported Record Transferee (and the Purported Beneficial Transferee, if different) shall acquire no rights in such Equity Stock.

(v) If the Board of Directors or its designee shall at any time determine in good faith that a Transfer of Equity Stock has taken place in violation of this Section 2(b) or that a Person intends to acquire or has attempted to acquire beneficial ownership (determined without reference to any rules of attribution), Beneficial Ownership or Constructive Ownership of any Equity Stock of the Corporation in violation of this Section 2(b), the Board of Directors or its designee shall take such action as it deems advisable to refuse to give effect to or to prevent such Transfer, including but not limited to, refusing to give effect to such Transfer on the books of the Corporation or instituting proceedings to enjoin such Transfer; provided, however; that any Transfers or attempted Transfers in violation of Section 2(b)(ii), Section 2(b)(iii) or Section 2(b)(iv) of this Article V shall automatically result in the conversion and exchange described in Section 2(c), irrespective of any action (or non-action) by the Board of Directors, except as provided in Section 2(f) of this Article V.

3. **<u>An excess share provision directly addressing related party rent issues</u>**

2. <u>Capital Stock</u>.

(1) <u>Ownership Limitations</u>. During the period commencing on the Initial Date and prior to the Restriction Termination Date, but subject to <u>Section 4</u>:

(A) <u>Basic Restrictions</u>.

(i) (1) No Person, other than an Excepted Holder, shall Beneficially Own or Constructively Own shares of Capital Stock in excess of the Aggregate Stock Ownership Limit, (2) no Person, other than an Excepted Holder, shall Beneficially Own or Constructively Own shares of Common Stock in excess of the Common Stock Ownership Limit and (3) no Excepted Holder shall Beneficially Own or Constructively Own shares of Capital Stock in excess of the Excepted Holder Limit for such Excepted Holder.

(ii) No Person shall Beneficially Own shares of Capital Stock to the extent that such Beneficial Ownership of Capital Stock would result in the Corporation being "closely held" within the meaning of Section 856(h) of the Code (without regard to whether the ownership interest is held during the last half of a taxable year).

(iii) No Person shall Beneficially Own or Constructively Own shares of Capital Stock to the extent that such Beneficial Ownership or Constructive Ownership of Capital Stock would otherwise result in the Corporation failing to qualify as a REIT (including, but not limited to, Beneficial Ownership or Constructive Ownership that would result in the Corporation actually owning or Constructively Owning an interest in a tenant that is described in Section 856(d)(2)(B) of the Code if the income derived by the Corporation from such tenant would cause the Corporation to fail to satisfy any of the gross income requirements of Section 856(c) of the Code).

(iv) No Person shall Beneficially Own or Constructively Own shares of Capital Stock to the extent that such Beneficial Ownership or Constructive Ownership of Capital Stock could result in the Corporation failing to qualify as a "domestically controlled qualified investment entity" within the meaning of Section 897(h)(4)(B) of the Code.

(v) Notwithstanding any other provision contained herein, any Transfer of shares of Capital Stock that, if effective, would result in the shares of Capital Stock being beneficially owned by less than 100 Persons (determined under the principles of Section 856(a)(5) of the Code) shall be void <u>ab initio</u>, and the intended transferee shall acquire no rights in such shares of Capital Stock.

The number and value of the outstanding shares of Capital Stock (or any class or series thereof) Beneficially Owned or Constructively Owned by any Person shall be determined by the Board of Directors, which determination shall be final and conclusive for all purposes hereof. For purposes of determining the percentage ownership of Capital Stock (or any class or series thereof) by any Person, shares of Capital Stock that may be acquired upon conversion, exchange or exercise of any securities of the Corporation directly or Constructively held by such Person, but not shares of Capital Stock issuable with respect to the conversion, exchange or exercise of securities for the Corporation held by other Persons, shall be deemed to be outstanding prior to conversion, exchange or exercise.

4. **An excess share provision not directly addressing related party rent issues**

[*Note: this is the same provision seen above in Section 2 as an example of a "non-13D group" provision*]

(b) Ownership Limitation and Transfer Restrictions with Respect to Equity Stock.

(i) Except as provided in Section 2(f) of this Article V, prior to the Restriction Termination Date, no Person shall Beneficially Own or Constructively Own Equity Stock in excess of the Ownership Limit.

(ii) Except as provided in Section 2(f) of this Article V, prior to the Restriction Termination Date, any Transfer that, if effective would result in any Person Beneficially Owning or Constructively Owning Equity Stock in excess of the Ownership Limit shall be void ab initio as to the Transfer of such Equity Stock that would be otherwise Beneficial Owned or Constructively Owned (as the case may be) by such Person in excess of the Ownership Limit; and the Purported Record Transferee (and the Purported Beneficial Transferee, if different) shall acquire no rights in such Equity Stock.

(iii) Except as provided in Section 2(f) of this Article V, prior to the Restriction Termination Date, any Transfer that, if effective, would result in the outstanding Equity Stock being Beneficially Owned by less than 100 Persons (determined without reference to any rules of attribution) shall be void ab initio as to the Transfer of such Equity Stock which would be otherwise Beneficially Owned by the transferee; and the Purported Record Transferee (and the Purported Beneficial Transferee, if different) shall acquire no rights in such Equity Stock.

(iv) Prior to the Restriction Termination Date, any Transfer that, if effective, would result in the Corporation being "closely held" within the meaning of Section 856(h) of the Code, or would otherwise result in the Corporation failing to qualify as a REIT, shall be void ab initio as to the Transfer of the Equity Stock that would cause the Corporation to be "closely held" within the meaning of Section 856(h) of the Code or otherwise to fail to qualify as a REIT, as the case may be; and the Purported Record Transferee (and the Purported Beneficial Transferee, if different) shall acquire no rights in such Equity Stock.

(v) If the Board of Directors or its designee shall at any time determine in good faith that a Transfer of Equity Stock has taken place in violation of this Section 2(b) or that a Person intends to acquire or has attempted to acquire beneficial ownership (determined without reference to any rules of attribution), Beneficial Ownership or Constructive Ownership of any Equity Stock of the Corporation in violation of this Section 2(b), the Board of Directors or its designee shall take such action as it deems advisable to refuse to give effect to or to prevent such Transfer, including but not limited to, refusing to give effect to such Transfer on the books of the Corporation or instituting proceedings to enjoin such Transfer; provided, however; that any Transfers or attempted Transfers in violation of Section 2(b)(ii), Section 2(b)(iii) or Section 2(b)(iv) of this Article V shall automatically result in the conversion and exchange described in Section 2(c), irrespective of any action (or non-action) by the Board of Directors, except as provided in Section 2(f) of this Article V.

5. **An excess share provision giving the board broad discretion to grant exemptions**

Section 3. Limit on Ownership; Excess Shares .

a. Except as otherwise provided by Subparagraph (f), no person shall at any time directly or indirectly acquire or hold beneficial ownership in the aggregate of more than the percentage limit (“Limit”) set forth in Subparagraph (b) of the outstanding Stock of any class of the Corporation. Such shares of Stock held by a Stockholder over the Limit, including any shares of Stock that would exceed the Limit if Stock was redeemed in accordance with Subparagraph (e) (but excluding any shares exempted by the Board of Directors in accordance with Subparagraph (f), are herein referred to as “Excess Common Shares” if originally shares of Common Stock and as “Excess Preferred Shares” if originally shares of Preferred Stock and collectively as “Excess Shares”. For purposes of this Section 3 a person shall be deemed to be the beneficial owner of the Stock that such person (i) actually owns, (ii) constructively owns after applying the rules of Section 544 of the Code as modified in the case of a REIT by Sections 856(a)(6) and Section 856(h) of the Code, and (iii) has the right to acquire upon exercise of outstanding rights, options and warrants, and upon conversion of any securities convertible into Stock, if any, if such inclusion will cause such person to own more than the Limit.

…

f. Shares described in this Subparagraph shall not be deemed to be Excess Shares at the times and subject to the terms and conditions set forth in this Subparagraph.

…

(ii) Subject to the provisions of Subparagraph (g), Shares which the Board of Directors in its sole discretion may exempt from the Limit while owned by a person who has provided the Corporation with evidence and assurances acceptable to the Board that the qualification of the Corporation as a REIT would not be jeopardized thereby.

…

g. The Board of Directors, in its sole discretion, may at any time revoke any exception in the case of any Stockholder pursuant to Subparagraph (f)(i) or (f)(ii), and upon such revocation, the provisions of Subparagraphs (d) and (e) shall immediately become applicable to such Stockholder and all shares of which such Stockholder may be the beneficial owner. The decision to exempt or refuse to exempt from the Limit ownerships of certain designated shares of Stock, or to revoke an exemption previously granted, shall be made by the Board of Directors at its sole discretion, based on any reason whatsoever, including but not limited to, the preservation of the Corporation’s qualification as a REIT.

6. **<u>An excess share provision giving the board very limited discretion to grant exemptions</u>**

Exception. The Ownership Limit shall not apply to the acquisition of shares of Equity Stock by an underwriter that participates in a public offering of such shares for a period of 90 days following the purchase by such underwriter of such shares provided that the restrictions contained in Section (A)(2) of Article IX hereof will not be violated following the distribution by such underwriter of such shares. In addition, the Board of Directors, upon receipt of a ruling from the Internal Revenue Service or an opinion of counsel in each case to the effect that the restrictions contained in Section (A)(2)(b), Section (A)(2)(c), and/or Section (A)(2)(d) of Article IX hereof will not be violated, may exempt a Person from the Ownership Limit provided that (i) the Board of Directors obtains such representations and undertakings from such Person as are reasonably necessary to ascertain that no individual's Beneficial Ownership or Constructive Ownership of shares of Equity Stock will violate the Ownership Limit and (ii) such Person agrees in writing that any violation or attempted violation will result in such transfer to the Trust of shares of Equity Stock pursuant to Section (A)(3) of Article IX hereof.

SAMPLE RESPONSES TO SEC COMMENTS

REGISTRATION STATEMENTS ON FORM S-4

April 2015

Prepared by:
Lauren Burnham Prevost
Partner
Morris, Manning & Martin, LLP
lprevost@mmmlaw.com
(404) 504-7744

Morris, Manning & Martin, LLP
1600 Atlanta Financial Center
3343 Peachtree Road NE
Atlanta, Georgia 30326

Direct Line: (212) 859-8622
Fax: (212) 859-4000
abigail.bomba@friedfrank.com

July 26, 2013

Jessica Barberich
Division of Corporate Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re:Brookfield DTLA Fund Office Trust Investor Inc.
Registration Statement on Form S-4
Filed June 12, 2013
File No.: 333-189273

Dear Ms. Barberich:

This letter sets forth the response of Brookfield DTLA Fund Office Trust Investor Inc. (the "Company" or "Sub REIT") to the comment letter, dated July 9, 2013 (the "Comment Letter"), of the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "SEC") with respect to the Company's Registration Statement on Form S-4 filed on June 12, 2013 (the "Registration Statement"). This letter is being filed with Amendment No. 1 to the Registration Statement (as so amended, the "Amended Registration Statement"), which reflects certain revisions in response to the Comment Letter. In order to facilitate your review, we have repeated each comment in its entirety in the original numbered sequence. The Amended Registration Statement also contains other changes for information that has been updated since the filing of the Registration Statement on June 12, 2013. We have sent to your attention via courier courtesy copies of the Amended Registration Statement marked to show changes from the Registration Statement. Capitalized terms used but not defined in this letter have the meanings ascribed to such terms in the Amended Registration Statement.

General

1. *We note that you incorporate by reference certain Exchange Act filings by MPG Office Trust, Inc. and Brookfield Office Properties, Inc. To the extent that there are any outstanding comments relating to any filing incorporated by reference, please note that we will not be able to accelerate the effectiveness of this registration statement until all outstanding comments are resolved.*

Response:

The Company acknowledges the Staff's comment and understands that you will not be able to accelerate the effectiveness of the Registration Statement until all outstanding comments relating to any filing incorporated by reference have been resolved. Please note that we have amended our disclosure and no longer incorporate by reference any of BPO's Exchange Act filings. Any required disclosure regarding BPO that was previously incorporated by reference has been included in the Amended Registration Statement.

2. *Please provide us with copies of the "board books" or similar documentation provided to the boards and management in connection with the proposed transaction. Such materials should include all presentations made by the financial advisors. Please revise to include all the information required by Item 1015 of Regulation M-A with respect to written presentations and analyses prepared by financial advisors. Refer to Item 4(b) of Form S-4.*

Response:

The Company advises the Staff that no external report, opinion or appraisal was provided to the Company or its affiliated transaction parties.

As discussed in more detail in connection with Comment 22 below, MPG has informed us that there are no "board books" or similar documentation provided to the board and management of MPG that are "materially relating" to the issuance of Company Series A Preferred Stock that would be required to be disclosed pursuant to Item 4(b) of Form S-4.

3. *We note your statement on page 4 that no vote of the holders of the MPG Preferred Stock is required to consummate the mergers. Please provide us with your legal analysis that details the basis of your statement.*

Response:

The Company advises the Staff that, under the terms of the Articles Supplementary of MPG with respect to the MPG Preferred Stock (filed as Exhibit 3.2 to MPG's Annual Report on Form 10-K for the fiscal year ended December 31, 2012), the affirmative vote or consent of the holders of MPG Preferred Stock is required to amend, alter or repeal the provisions of MPG's charter or the terms of the MPG Preferred Stock, whether by merger, consolidation, transfer or conveyance of all or substantially all of its assets or otherwise (an "Event"), so as to "materially and adversely affect any right, preference, privilege or voting power" of the MPG Preferred Stock. As described in the section of the Registration Statement entitled "Comparison of Stockholders' Rights" beginning on page 116, the rights and preferences of the Company Series A Preferred Stock are substantially the same as the current rights and preferences of the MPG Preferred Stock and are materially unchanged. The charter of the Company is substantially the same as MPG's charter, and the Company Series A Articles Supplementary are substantially similar to the Articles Supplementary classifying and designating the MPG Preferred Stock, as described in detail in the section of the Registration Statement entitled "Description of the Company Series A Preferred Stock" beginning on page 107. In addition, Section 6(f) of Article Third of the Articles Supplementary of MPG with respect to the MPG Preferred Stock expressly provides that, with respect to the occurrence of any Event, so long as the MPG Preferred Stock remains outstanding with the terms thereof materially unchanged, taking into account that, upon the occurrence of an Event, MPG may not be the surviving entity, "the occurrence of such Event shall not be deemed to materially and adversely affect such rights, preferences, privileges or voting power of the holders of MPG Preferred Stock, and in such case such holders shall not have any voting rights with respect to the occurrence of" such Event.

Accordingly, we respectfully advise the Staff that no vote of the holders of the MPG Preferred Stock is required to consummate the Mergers. We also note that this was the conclusion reached by MPG. As noted in the definitive proxy statement on Form DEF 14A filed by MPG with the SEC on June 7, 2013, only MPG's common stockholders of record were entitled to vote at the special meeting called to approve the REIT Merger and the other transactions contemplated by the Merger Agreement.

4. *We note the Merger Agreement dated as of April 24, 2013 filed as Exhibit No. 2.1. Pursuant to Item 601(b)(2) of Regulation S-K, please file a list briefly identifying the contents of all omitted schedules or similar supplements. In addition, please file an agreement to furnish the staff with a copy of any omitted schedule upon request. The agreement to furnish staff with copies of omitted schedules may be included in the exhibit index to the registration statement.*

   Response:

   In response to the Staff's comment the Company has filed with the Amended Registration Statement a list briefly identifying the contents of all omitted schedules, which includes the Company's agreement to furnish the Staff with a copy of any omitted schedule upon request. Please see Exhibit 2.4 to the Amended Registration Statement.

5. *We note references to Ernst & Young Tower and Ernst & Young Plaza throughout your document. Please clarify if the Tower and the Plaza are the same property. If not, explain and disclose if the property 7th and Figueroa is included in either. Also, tell us why the occupancy rates for both the Tower and the Plaza are the same. See pages 126 and 139 for reference.*

   Response:

   In response to the Staff's comment the Company has clarified and revised the disclosure to reflect that Ernst & Young Tower is the office tower subset of Ernst & Young Plaza. Ernst & Young Plaza is the combination of Ernst & Young Tower and the 7th and Figueroa retail space. Please see pages 130 and 143 of the Amended Registration Statement.

Summary Term Sheet, page 3

6. *Please include in the summary a description of the material transaction fees that have been and will be incurred in connection with this transaction. Please clarify, as applicable, which fees are contingent on approval and consummation of the merger.*

   Response:

   As discussed briefly with the Staff via teleconference on July 12, 2013, the material fees of the Brookfield Parties with respect to the transaction have been incurred by, and have been (or will be) paid by, Brookfield DTLA (Brookfield DTLA Holdings LLC), the direct parent of the Company. Accordingly, because these fees are not liabilities of the Company and will not have any impact on the Company going forward, the Company respectfully submits that they are not relevant to a holder of Company Series A Preferred Stock and therefore has not included a description of such fees in the Amended Registration Statement.

   In response to the Staff's comment the Company has revised the disclosure to include a description of the material transaction fees that have been and will be incurred by MPG in connection with the transaction, to the extent they are known or can be estimated at this time. Please see pages 3 and 88 of the Amended Registration Statement.

7. *We note the ownership structure diagram included on page 49. Please revise your disclosure to clarify, as applicable, that this chart represents the ownership structure of the company, post-merger. In addition, please highlight the position of the company and the holders of Series A Preferred post-merger.*

   Response:

   In response to the Staff's comment the Company has revised the diagram and related disclosure with respect to the ownership structure of the Company post-merger. Please see pages 54-55 of the Amended Registration Statement.

<u>Structure of the Company and its Subsidiaries Following the Mergers and the Subsequent Transactions, page 6</u>

8. *We note your disclosure on page 7 which states that you currently expect that leasing activities at your real properties will also require material amounts of cash to be invested in the real property assets for at least several years. Please be more specific about the material amounts of cash that you expect to invest over the next several years. Describe the expected expenditures and tell us if you are referring to renovations or re-developments. We may have further comment.*

   Response:

   In response to the Staff's comment the Company has revised the disclosure to describe the expected expenditures that will require investments of cash over the next several years. Excluding tenant improvements and leasing commissions, the Company projects spending between $35 million and $40 million in the next ten years, with the majority ($25 million to $30 million) in the next five years. The expected expenditures include, but are not limited to, renovations and physical capital upgrades to the Company's properties, such as new fire alarm systems, elevator repairs and modernizations, façade work, roof replacements and new turbines. Please see pages 5 and 159 of the Amended Registration Statement.

Unaudited Pro Forma Condensed Combined Consolidated Financial Statements, page 13

9. *It appears that you intend to consolidate New OP subsequent to the Mergers and Subsequent Transactions. Please provide us with your consolidation analysis and tell us the guidance that you relied upon. Clarify whether New OP will be a VIE and how you came to your conclusion.*

Response:

The consolidation analysis was performed in accordance with the guidance at ASC 810 – Consolidation. Although the Company determined that New OP is a variable interest entity (VIE), and therefore subject to the VIE subsections of ASC 810, the Company also considered the consolidation analysis under the voting interest entity guidance in ASC 810.

In determining the relevant subsections of ASC 810, we first performed an analysis to determine whether New OP is a VIE. After evaluating the exceptions from the VIE guidance in ASC 810-10-15-12, and concluding that none of these exceptions apply to New OP, we focused our analysis on the definition of a VIE in ASC 810-10-15-14. The Company determined that, under ASC 810-10-15-14(c), New OP is considered a VIE. ASC 810-10-15-14(c) indicates that an entity is a VIE if both of the following conditions are met:

1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.
2. Substantially all of the legal entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights.

Regarding the first condition above, the voting rights of Brookfield DTLA are not proportional to its rights to absorb the expected losses and to receive the expected returns of New OP because Brookfield DTLA has all the common equity interests in New OP but the power to direct the activities of New OP rests with Surviving LLC as its managing member. Furthermore, we concluded that any rights of Brookfield DTLA to unilaterally remove Surviving LLC as the managing member would not be considered substantive given the common control relationship.

Regarding the second condition above, since New OP was designed on behalf of Brookfield DTLA and the Company, which are considered related parties under common control, substantially all of the activities of New OP would be considered to be conducted on behalf of Brookfield DTLA and its related parties (i.e., since all the potential variable interests in New OP are held by a related party group, this second condition above is considered met as all of the activities of New OP would be considered to be conducted on behalf of such related party group).

After determining that New OP is a VIE, we then focused on which variable interest holder would be considered the primary beneficiary of New OP.

New OP is owned within a group of related parties controlled by Brookfield DTLA. Please see the structure chart on page 54 of the Amended Registration Statement.

At the Brookfield DTLA level, it is clear that New OP is controlled (either directly or indirectly), and therefore should be consolidated. However, for purposes of the Company's separate financial statements, it is necessary to determine which party in the related party group is the direct primary beneficiary of New OP.

In accordance with ASC 810-10-25-44, If two or more related parties . . . hold variable interests in the same VIE, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

a. The existence of a principal-agency relationship between parties within the related party group;
b. The relationship and significance of the activities of the VIE to the various parties within the related party group;
c. A party's exposure to the expected losses of the VIE; and
d. The design of the VIE.

Performing the analysis under ASC 810-10-25-44 requires significant judgment when all the variable interest holders are within a commonly controlled group. In this regard, our focus was on whether Brookfield DTLA or the Company (through its consolidated subsidiaries REIT Merger Sub and Surviving LLC) would be considered most closely associated with New OP. Also, as noted above, since Brookfield DTLA would nevertheless consolidate New OP (either directly if considered to be most closely associated with New OP under ASC 810-10-25-44 or indirectly through the consolidation of the Company), the analysis under ASC 810-10-25-44 is relevant only to the conclusion as to whether New OP should or should not be included in the consolidated financial statements of the Company.

Our analysis under ASC 810-10-25-44 focused on conditions (b) and (d). We did not give significant consideration to conditions (a) and (c) since Brookfield DTLA and the Company are under common control. Within a common control group, we do not believe the assessment should give any significant consideration to a principal-agency relationship or exposure to expected losses because the ultimate parent of the common control group would typically have the ability to control members of the common control group and therefore potentially dictate a principal-agency relationship or assign economics to any entity within the group it chooses. Therefore, we believe the focus should be on the substance of the arrangements related to the VIE, and therefore the consideration of conditions (b) and (d).

Regarding conditions (b) and (d) of ASC 810-10-25-44, New OP is significant to both the Company and Brookfield DTLA and was designed on behalf of both the Company and Brookfield DTLA. However, in the context of the design and purpose of the Company, and considering the role of the managing member of New OP which is controlled by the Company, we concluded that these conditions pointed more closely to the Company. The Company was designed solely to issue preferred stock to third party investors whose cash flows are dependent solely on the properties owned by New OP. Absent the decision to issue preferred stock to third parties, there would have been no substantive reason to include the Company and REIT Merger Sub in the ownership structure. Additionally, the managing member of New OP (Surviving LLC) is controlled by the Company, and conducts the significant activities of New OP (i.e., managing the operations and leasing of the properties). For these reasons, we believed the relationship and significance of the activities of the VIE, along with its design, pointed towards the Company as being most closely associated, and therefore the direct primary beneficiary of New OP.

It should be noted that, in reaching the conclusion that the Company should consolidate New OP, we gave consideration to the consolidation analysis under the voting interest entity model under ASC 810. We concluded that if New OP were considered a voting interest entity, the Company would still consolidate New OP. This conclusion was reached based on the guidance in ASC 810-20-25-3 through 25-5. According to that guidance, since the Company, through its subsidiary Surviving LLC, is the managing member of New OP, and the ability of Brookfield DTLA to remove the managing member will not be considered substantive under ASC 810-20-25-8 through 25-10 since Brookfield DTLA and the Company are under common control, it would consolidate New OP.

In summary, whether analyzed as a VIE or voting interest entity, we believe the Company should consolidate New OP. This conclusion results in the most meaningful and transparent financial statement presentation for the users of the financial statements of the Company. In particular, this presentation allows the holders of the Company Series A Preferred Stock to transparently see the results of operations of the properties underlying New OP which will be the sole source of cash flows on these preferred stock instruments.

In response to the Staff's comment the Company has revised the disclosure to include a statement indicating that New OP is a VIE and that the Company is the primary beneficiary and will consolidate New OP. Please see page 17 of the Amended Registration Statement.

Note 3 – Significant Accounting Policies

(b) Common Control Transactions, page 18

10. *We note that your basis for common control is sharing the same parent and no change in control at the parent level. Please further clarify for us how you determined that 333 South Hope, EYP Realty, and you are all controlled by BPO; clarify the ownership form (e.g., managing member units, etc.) and percentage owned of each entity.*

Response:

BPO's current control of 333 South Hope and EYP Realty

333 South Hope and EYP Realty are controlled by BPO through its indirect ownership interest in TRZ Holding IV, LLC ("TRZ"). TRZ owns 100% of the member units of 333 South Hope and EYP Realty, and BPO indirectly owns 84% of the member units of TRZ. As TRZ does not have any of the conditions set out in ASC 810-10-15-14 which stipulate that consolidation should be analyzed under the VIE subsections, we applied the voting interest model. In accordance with ASC 810-10-15-8 the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50% of the outstanding voting shares of another entity is a condition pointing toward consolidation. As BPO indirectly owns 84% of the member units of TRZ, and there are no other factors that would impact the assessment (such as removal rights or participating rights of minority investors), we concluded that BPO controls 333 South Hope and EYP Realty.

BPO's control of the Company

BPO controls the Company through an indirect ownership of 100% of the common shares of BOP Management Inc. and BPOP Investor Subsidiary Inc. BOP Management Inc. and BPOP Investor Subsidiary Inc. own 33% and 15% of Brookfield DTLA, respectively (which in turn, owns 100% of the common shares of the Company). The remaining interest in Brookfield DTLA is held by three investors that own approximately 17%, 17% and 18% of the interests in Brookfield DTLA, respectively.

The voting interest model was applied in performing an analysis to determine whether BPO will control and consolidate Brookfield DTLA, as Brookfield DTLA does not meet any of the conditions in ASC 810-10-15-14.

As the entity is not considered a VIE, ASC 810-10-15-8 and ASC 970-810-25-3 are the relevant sections of guidance to determine whether or not an entity is to be consolidated. Thus, we must review if BPO has a controlling financial interest in Brookfield DTLA. Brookfield DTLA owns 100% of the common shares of the Company. BPO is the sole owner of BOP Management Inc. (the general partner of Brookfield DTLA), which has broad authorities in regard to the operations of the entity. Since the entity is a limited partnership, the general partner is presumed to control the limited partnership, unless rights of the limited partners overcome that presumption of control.

As the rights of the limited partners (through the LP Advisory Board and Board of Managers) are protective in nature (no abilities to carry out and direct ordinary operations of the entity), we can conclude that the rights of the limited partners do not overcome the presumption of control by the general partner. Thus, based on this assessment, BPO controls the Company through its indirect ownership of the general partnership interest in Brookfield DTLA.

Note 4 – Pro Forma Adjustments

(a) MPG Acquisition, page 19

11. *We note that consideration for the acquisition of MPG will be in the form of cash of approximately $190 million and exchange of $243 million shares of preferred stock with roughly the same terms and conditions. Given the involvement of cash and equity, please disclose the entity determined to be the accounting acquirer in this transaction and your basis in Topic 805 of the Financial Accounting Standards Codification that supports your conclusion.*

    Response:

    Per ASC 805-10-55-11, "In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer usually is the entity that transfers the cash or other assets or incurs the liabilities." The Company, through its subsidiary REIT Merger Sub, is considered to be the acquirer, transferring consideration in the form of cash of approximately $190 million and exchanging approximately $243 million in shares of Company Series A Preferred Stock with roughly the same terms and conditions, as noted above.

    The net assets obtained through the Mergers will be contributed into the subsidiary New OP. The accounting conclusions related to New OP are discussed in more detail in the response to Comment 9 above.

    We considered the guidance at ASC 805-10-55-12, which addresses business combinations effected primarily by exchanging equity interests; however, the Company is not issuing any common stock as part of the transaction. All common interest will be held by the parent company, Brookfield DTLA. The Company Series A Preferred Stock being issued in exchange for the outstanding MPG Preferred Stock has limited voting rights. Further, only those holders of shares of MPG Preferred Stock that do not agree to tender their shares in the Tender Offer will hold Company Series A Preferred Stock.

12. *We note that MPG will be acquired for approximately $433 million and that no goodwill or bargain purchase option is anticipated to be recorded as a result of this transaction. We also note that the merger agreement will be amended from time to time, please clarify whether the purchase price will change prior to effectiveness. Also, expand your disclosure to show how you calculated the purchase price including number of shares and your basis for prices per share used to determine the fair value of the consideration to be transferred. In addition, address your consideration of the merger consideration related to restricted stock, stock options, and restricted stock units disclosed on page 71 when determining the purchase price.*

Response:

The Company advises the Staff that at present the Company does not anticipate making any further amendments to the Merger Agreement nor is the purchase price expected to change prior to effectiveness. The $243 million value ascribed to the Company Series A Preferred Stock as part of the purchase consideration was based on the Company's estimate of what similar securities would be worth, which is $25 per share. This valuation took into consideration the risks associated with owning this type of security, underlying cash flow projections of the Company's properties (discounted to present value), projections on the timing for dividend payments, and the projected period these securities would be outstanding. We note that although the Company will have interests in a larger and more diverse pool of assets than MPG, the holders of Company Series A Preferred Stock will not be entitled to any greater return or liquidation preference than they were as holders of MPG Preferred Stock. The benefit of holding an indirect interest in the Brookfield DTLA Contributed Assets is uncertain and may be limited, as described in detail on pages 47-49 of the Amended Registration Statement.

The $190 million cash consideration to be paid is comprised of the following:

Purchase Price (REIT Merger Consideration)	Shares	Description
	57,445,249	Common Shares outstanding at June 30, 2013
	2,211,060	Restricted Stock Units
	417,477	Converted Options based on bid price per share
	25,526	OP Units
	60,099,312	Total Shares
$3.15	$189,312,833	Total Consideration

The $3.15 price to be paid for each share of MPG Common Stock (and common stock equivalents) was determined through a negotiation process which is described in detail in the section "Background of the Mergers" which begins on page 58 of the Amended Registration Statement. The Company performed an analysis to measure the identifiable assets to be acquired and liabilities to be assumed in connection with the MPG acquisition and determined that the amount is consistent with the fair value of the consideration transferred of $433 million. Therefore, no goodwill or bargain purchase gain will be recognized.

In response to the Staff's comment the Company has revised the disclosure to include the above table in the notes to the Unaudited Pro Forma Condensed Combined Consolidated Financial Statements. Please see page 19 of the Amended Registration Statement.

13. *Please revise to provide a description of the valuation techniques and significant inputs used to determine the fair value of the identifiable assets and liabilities used in your preliminary purchase price allocation. Please address each material asset and liability category separately.*

Response:

Valuation techniques followed in determining the fair value of the identifiable assets and liabilities used in our preliminary purchase price allocation were done pursuant to ASC 820 (Fair Value Measurements and Disclosures), which defines fair value and provides a framework for measuring fair value in accordance with Generally Accepted Accounting Principles. Key aspects of valuation techniques to be followed include the market approach, income approach and/or cost approach. The market approach uses prices and other relevant information generated by similar market transactions for comparable assets. The income approach uses valuation techniques to convert future amounts to a single present amount. The cost approach is based on the amount that currently would be required to replace the asset being measured.

The principal valuation technique employed by the Company in determining the fair value of the identifiable assets and liabilities was the income approach, which was supported primarily by the cost approach. Tangible values for land, building, site improvements and tenant improvements were calculated based on replacement costs for like type quality assets. Above and below market lease values were determined comparing in place rents with current market rents. In place lease amounts were determined by calculating the potential lost revenue during the replacement of the current lease in place.

Leasing commissions and legal/marketing fees were determined based upon current market allowances prorated over remaining lease terms. After calculating the value of each asset component such amounts were adjusted based upon the conclusion drawn by the income approach.

Liabilities were for the most part current trade payables or short term obligations, so the current carrying value approximates the recorded value. Property debt was also analyzed with current market terms for similar debt. The results produced an immaterial difference, so no adjustment to the carrying value was recorded.

In response to the Staff's comment the Company has revised the disclosure to include a description of the valuation techniques and inputs used in the preliminary purchase price allocation. Please see pages 19-20 of the Amended Registration Statement.

14. *Please revise to include a table broken down by line item that shows how you determined the fair value adjustments in the MPG Acquisition column on the unaudited pro forma condensed combined consolidated balance sheet.*

Response:

The fair value adjustments are determined as the difference between the historical book value of MPG's identifiable assets and liabilities and the fair value as determined by the Company with the assistance of a third party analyst. See response to Comment 13 above regarding the valuation techniques used by the Company.

In response to the Staff's comment the Company has revised the disclosure to include a table broken down by line item that shows the fair value adjustments. Please see page 20 of the Amended Registration Statement.

15. *We note you have adjusted rental revenue and depreciation and amortization within your un-audited pro-forma consolidated statement of operations, please tell us and expand disclosures to discuss what each adjustment represents and provide a calculation of the amounts adjusted for within the pro forma financial statements.*

Response:

The adjustments made to the income statements are to adjust the amortization and depreciation expense for the change in the value of real estate and intangibles shown in the table referenced in our response to Comment 14 (included on page 20 of the Amended Registration Statement).

In response to the Staff's comment the Company has expanded the disclosure to include a table showing the calculation of the adjustments made to amortization and depreciation expense within the pro forma financial statements. Please see page 20 of the Amended Registration Statement.

<u>(b) USBT Reclass & (c) PLF Reclass, page 19</u>

16. *Please clarify whether the sale of US Bank Tower and the Westlawn off-site parking garage (USBT) or Plaza Las Fuentes (PLF) will result in the recognition of a gain or loss on disposal. To the extent it does, please disclose.*

    Response:

    The Company has revised disclosure to reflect that MPG will recognize a gain on the disposal of USBT and PLF. The Company did not reflect these gains in the Unaudited Pro Forma Consolidated Statement of Operations because it only includes income (loss) from continuing operations. Please see page 21 of the Amended Registration Statement.

<u>Risk Factors, page 20</u>

17. *We note your statement that the risks and uncertainties described below are not the only ones facing you and that additional risks and uncertainties not presently know to you or that are currently deemed immaterial could negatively impact your business. Please revise to clarify that all material risks are disclosed.*

    Response:

    In response to the Staff's comment the Company has revised the introductory language to the section of the Registration Statement entitled "Risk Factors" to clarify that all known material risks are disclosed. Please see page 22 of the Amended Registration Statement.

<u>Risks Related to the Ownership of the Company Series A Preferred Stock, page 20</u>

<u>The Company's subsidiaries may in the future, issue equity securities..., page 20</u>

18. *You state that after the consummation of the transactions contemplated by the Merger Agreement and as part of the Subsequent Transactions, subsidiaries of the Company will issue equity interests that rank senior to the equity securities of such subsidiaries held indirectly by the Company, and as a result, will effectively rank senior to the Company Series A Preferred Stock. You also state on page 22 that the Company may not, without a vote of the holders of Company Series A Preferred Stock, authorize, create, issue or increase the authorized or issued amount of any class of capital stock ranking senior to the Company Series A Preferred Stock. Please revise to reconcile or explain these statements.*

Response:

The Company advises the Staff that the restriction on authorizing, creating, issuing or increasing the authorized or issued amount of any class of capital stock ranking senior to the Company Series A Preferred Stock, without a vote of the holders of Company Series A Preferred Stock, is a restriction under Section 6(g) of Article THIRD of the Company Series A Articles Supplementary (and mirrors the corresponding restriction that is currently found in the Articles Supplementary of the MPG Preferred Stock), and applies to issuances by the Company. Section 6(h) of Article THIRD of the Company Series A Articles Supplementary further provides that the Company may not cause or permit Brookfield DTLA Fund Office Trust Inc., a direct subsidiary of the Company and the surviving entity in the REIT Merger, to authorize, create, issue or increase the authorized or issued amount of any class of capital stock ranking senior to the Series A Preferred Stock of Brookfield DTLA Fund Office Trust Inc. without a vote of the holders of Company Series A Preferred Stock. As to all other direct or indirect subsidiaries of the Company, their respective organizational documents generally do not restrict the issuance of debt or equity by such subsidiaries, and the terms of the Company Series A Preferred Stock do not grant the holders thereof any consent or voting rights with respect to the actions of any subsidiaries other than Brookfield DTLA Fund Office Trust Inc. Accordingly, the consent of the holders of the Company Series A Preferred Stock is not required in connection with the issuance of debt or equity by any of the Company's subsidiaries (other than Brookfield DTLA Fund Office Trust Inc.). We note that this structure (and the relative rights of the holders of the Company Series A Preferred Stock below Brookfield DTLA Fund Office Trust Inc.) is consistent with the structure (and the relative rights of the holders of MPG Preferred Stock) currently in place at MPG.

Brookfield DTLA Fund Office Trust Investor Inc., page 36

19. *Please tell us whether you intend to register the 12.5% Series B Cumulative Nonvoting Preferred Stock. If not, please tell us the exemption upon which you intend to rely.*

Response:

The Company advises the Staff that it does not intend to register its Series B Preferred Stock, which, as described in the Amended Registration Statement, is now contemplated to be 15% Series B Cumulative Nonvoting Preferred Stock. The Company intends to rely on the private offering exemption of Rule 506 under Regulation D of the Securities Act of 1933, as amended.

20. *We note that the Brookfield DTLA Contributed Assets has an approximately $595 million fair value based on the price being made for an approximately 35% in these assets by two investors in Brookfield DTLA that did not own any interest prior to the Merger agreement. Please clarify what consideration is being exchanged by the investors for the 35% interest.*

Response:

In response to the Staff's comment the Company has revised the disclosure to clarify that the consideration being exchanged by the two investors for the 35% interest in the Brookfield DTLA Contributed Assets is cash. Please see page 48 of the Amended Registration Statement.

Structure of the Company and its Subsidiaries Following the Mergers and the Subsequent Transactions, page 40

21. *We note your disclosure on the top of page 47 regarding the distribution priorities. Please revise your disclosure to quantify and provide an example, as applicable, explaining these distribution priorities. In addition, we note the reference on page 48 to the New OP Waterfall 'plus an 11% per annum return.' Please clarify how the additional 11% per annum return relates to the distribution priorities and whether the additional return is reflected in the ownership chart on page 49.*

    Response:

    In response to the Staff's comment the Company has revised the disclosure to provide examples that illustrate the New OP distribution priorities and to clarify how the additional 11% per annum return relates to the distribution priorities. Please see pages 51-53 of the Amended Registration Statement.

Background to the Mergers, page 52

22. *We note your disclosure on page 61 that the MPG Board considered the separate financial presentations and written opinions of Wells Fargo Securities and BofA Merrill Lynch as to the fairness, from a financial point of view, of the merger consideration to be received pursuant to the Merger Agreement. Please disclose the information as required by Item 4(b) of Form S-4, including all the information required by Item 1015(b) of Regulation M-A. In addition, please file any reports, opinions or appraisals as exhibits in accordance with Item 21(c) of Form S-4.*

    Response:

    As disclosed on page 61 of the Registration Statement, the opinions of Wells Fargo Securities and BofA Merrill Lynch that were received by MPG's board of directors related solely to the fairness, from a financial point of view, of the merger consideration to be received pursuant to the Merger Agreement by holders of MPG Common Stock. Neither of the opinions related in any way to MPG's Preferred Stock. Rather, both of these opinions specifically disclaimed expressing any view as to the treatment of the MPG Preferred Stock under the Merger Agreement (see pages D3 and E2 of MPG's definitive proxy statement on Form 14A filed with the SEC on June 7, 2013, which summarized those opinions and included the full text as annexes thereto). Accordingly, we do not believe that either of the opinions is "materially relating" to the issuance of Company Series A Preferred Stock contemplated by the Form S-4. The transactions contemplated by the Merger Agreement have resulted in the filing and mailing of a number of disclosure documents, including a proxy statement, tender offer documents, a Schedule 14D-9 and the Registration Statement. Given the volume of disclosures, the parties to these transactions initially had determined to harmonize similar disclosures across these various documents. However, in light of the Staff's comments here and in Comment 2, the Company has revised the disclosure to delete references to the opinions received by MPG's board of directors to avoid confusion and to ensure that holders of MPG Preferred Stock do not mistakenly conclude that the opinions address the issuance of Company Series A Preferred Stock contemplated by the Registration Statement. Similarly, the Company will not be filing copies of the opinions as exhibits to the Amended Registration Statement.

23. *We note your disclosure on page 67 that certain directors and executive officers of MPG have interests in the mergers that may be different from, or in addition to, the interests of the holders of MPG Common Stock and MPG Preferred Stock generally. Please revise your disclosure here or elsewhere as appropriate to identify these certain directors and executive officers and describe these conflicts of interest. In addition, when describing the background of the merger, please revise to identify the representatives of MPG senior management that were present at the meetings.*

    Response:

    In response to the Staff's comment the Company has revised the disclosure to include a new section entitled "Interests of MPG's Directors and Executive Officer's in the REIT Merger" beginning on page 151 of the Amended Registration Statement.

    In addition, as requested the Company has revised the background disclosure to identify the representatives of MPG senior management that were present at each of the meetings described in that section. Please see pages 59-63 of the Amended Registration Statement.

24. *We note your disclosure that "as a result of BPO's due diligence and BPO's ownership of three assets in the Downtown Los Angeles office market, BPO was familiar with MPG's assets and the Downtown Los Angeles office market." Please disclose whether BPO sought third party appraisals in connection with its determination of MPG's value.*

    Response:

    In response to the Staff's comment the Company has revised the disclosure to reflect the fact that BPO did not seek third party appraisals in connection with its determination of MPG's value. Please see page 59 of the Amended Registration Statement.

25. *Please revise to elaborate on the BPO board's consideration of the debt load of MPG.*

    Response:

    In response to the Staff's comment the Company has revised the disclosure in the section entitled, "The Company's Reasons for the Merger" to make clear that the BPO board considered the debt load of MPG, among other things, in its consideration of MPG and its business. Please see page 70 of the Amended Registration Statement. We also refer the Staff to the disclosure on pages 5 and 53 of the Amended Registration Statement, which describes certain actions that the Company intends to take in the future with respect to the mortgage debt that encumbers certain of the MPG Contributed Properties.

26. *We note your disclosure on page 60 that the Merger Agreement resulted from a third-party solicitation and negotiation process lasting more than eight months as well as the three bullet points describing certain proposals. Please revise to briefly describe the other bids and alternatives to the merger.*

Response:

The Company acknowledges the Staff's comment and respectfully advises the Staff that representatives of MPG have informed the Company that the Registration Statement includes all material information with respect to MPG's sale process. Accordingly, no additional disclosure has been incorporated into the Amended Registration Statement.

Projections, page 65

27. *We note your disclosure on page 66 that the projections necessarily were based on numerous assumptions that are inherently uncertain. Please revise to more specifically describe the material assumptions on which the projections were based.*

Response:

In response to the Staff's comment and consistent with our discussion with the Staff via teleconference on July 12, 2013, the section of the Registration Statement entitled "Projections" has been removed and is not included in the Amended Registration Statement.

Material U.S. Federal Income Tax Consequences, page 86

28. *We note your disclosure on page 95 that the Company expects to have an election to be taxed as a REIT for its taxable year ending on December 31, 2013. Please file an opinion of counsel regarding your ability to satisfy the requirements for such REIT qualification commencing with such taxable year or advise.*

Response:

As discussed with the Staff via teleconference on July 12, 2013 and consistent with materials submitted to the Staff via electronic mail on July 15, 2013, the Company respectfully advises the Staff that it is revising its disclosure to state clearly that the Company is not receiving a REIT opinion and also to provide the reasons why an opinion is not being rendered. The Company has also added a risk factor and other relevant disclosure providing a discussion of the alternative tax consequences if the Company is not able to qualify as a REIT.

The REIT tests contained in Sections 856 et. seq. of the Code include tests that require an analysis of certain asset composition and gross income tests. For example, in order to qualify as a REIT, at least 95% of an entity's gross income in each taxable year generally must be derived from investments relating to real property or mortgages on real property, including "rents from real property," dividends received from and gains from the disposition of other shares of REITs, interest income derived from loans secured by real property, and gains from the sale of real estate assets, as well as other dividends, interest, and gain from the sale or disposition of other stock or securities.

The Company's parent entity, Brookfield DTLA Holdings LLC ("Brookfield DTLA"), is funding the acquisition of MPG in part with funds contributed by unaffiliated investors. As a condition to making this investment, the investors required that, in contrast to MPG's organizational structure in which a single REIT owns all of MPG's assets, the Company's acquisition structure involves the division of MPG's assets into multiple individual entities. In order for the Company to qualify as a REIT, these separate subsidiary companies must satisfy the REIT tests discussed above, including the income and assets tests, on an individual company by company basis[1]. Because the assets of the Company will consist almost exclusively of interests in these individual subsidiary companies, the Company's ability to qualify as a REIT after the consummation of the Mergers and the Subsequent Transactions will depend on the ability of each subsidiary company to qualify as a REIT. Whether each individual subsidiary company will be able to qualify for taxation as a REIT, and therefore whether the Company will able to qualify as a REIT, is a question of fact.

In connection with the closing of the REIT Merger, Brookfield DTLA expects to receive an opinion from counsel to MPG that MPG has been organized and operated in conformity with the requirements for qualification and taxation as a REIT under the Code and its actual method of operation has enabled MPG to meet, through the closing date, the requirements for qualification and taxation as a REIT under the Code. MPG, however, has operated its historical assets so as to qualify as a REIT on an aggregate basis, and not on an individual property-by-property basis. As noted by MPG's counsel during our teleconference on July 9, 2013, MPG has maintained its records consistent with its application of the various tests for qualification as a REIT on an aggregate basis and not on an individual asset or property basis. In the absence of information and records that maintain the various REIT qualification tests on a property-by-property basis, we cannot know for certain if each new entity that will hold one of MPG's properties, and therefore the Company, will be able to satisfy the requirements for REIT qualification on a going forward basis. These facts will not be known until after the consummation of the Mergers and the Subsequent Transactions.

Not rendering an opinion in these circumstances is contemplated in SEC Staff Legal Bulletin No. 19 (Oct. 2011). Staff Legal Bulletin No. 19 notes that:

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[1] An entity may qualify as a REIT if at least 75% of its assets are qualifying real estate assets. Stock of any entity that is not a REIT is not a qualifying asset.

If the author of the opinion is unable to opine on a material tax consequence, the opinion should:

- state this fact clearly;
- provide the reason for the author's inability to opine on a material tax consequence (for example, the facts are currently unknown or the law is unclear); and
- discuss the possible alternatives and risks to investors of that tax consequence.

SEC Staff Legal Bulletin No. 19 (Oct. 2011), Para. III(C)(1).

In accordance with SEC Staff Legal Bulletin No. 19, the Company has revised the tax disclosure in the Amended Registration Statement to state clearly that Company counsel is not rendering an opinion in this case, to explain the reasons why our counsel is not rendering an opinion at this time, to describe how holders of Company Series A Preferred Shares will be taxed if the Company qualifies as a REIT, as well as the tax consequences to holders of Company Series A Preferred Shares and the Company if the Company fails to qualify as a REIT and to add a risk factor with respect to the foregoing. (With respect to the last point, the Company does not anticipate paying dividends on the Company Series A Preferred Stock for at least 5 years following the REIT Merger.) Please see pages 90-106 of the Amended Registration Statement. In light of the foregoing and based on guidance of the Staff provided via teleconference on July 25, 2013, the Company is not filing an opinion of counsel regarding its ability to satisfy the REIT requirements.

Description of Real Estate and Operating Data of the Company, page 117

29. *We note the data relating to the lease expirations for each of the properties. Please revise, here or elsewhere, as applicable, to discuss the relationship between current market rents and leases expected to expire in the next reporting period.*

Response:

In response to the Staff's comment the Company has revised disclosure to discuss the relationship between current market rents and leases expected to expire in 2013. Please see page 132 of the Amended Registration Statement.

Exhibit Index, page 162

30. *We note that you will be filing certain exhibits by amendment. If you are not in a position to file the legal opinion with the next amendment, please provide us with a draft copy for our review.*

Response:

The Company acknowledges the Staff comment and has enclosed as Exhibit A hereto a draft copy of the legal opinion as to the validity of the shares of Company Series A Preferred Stock.

<u>Exhibits</u>

<u>333 South Hope Co. LLC & EYP Realty, LLC</u>

31. *Please tell us how you factored any fixed rate renewal options into the calculation of the fair value of the below market lease intangibles and the period over which your below market lease intangibles are amortized. Your response should also discuss how you determine the likelihood that a lessee will execute a below-market lease renewal, and how you consider the likelihood, if at all, in determining the amortization period.*

   Response:

   The Company acknowledges the Staff's comment and respectfully advises the Staff that 333 South Hope and EYP Realty do not have any leases with fixed rate renewal options and, therefore, the below market lease intangible is amortized only over the noncancelable term of the lease.

32. *Please provide an affirmative statement that the un-audited interim financial statements furnished reflects all adjustments, which are, in the opinion of management, necessary to a fair statement of the results for the interim periods presented. If all such adjustments are of a normal recurring nature, a statement to that effect shall be made; otherwise, there shall be furnished information describing in appropriate detail the nature and amount of any adjustments other than normal and recurring. Reference is made to Rule 10-01(b)(8) of Regulation S-X.*

   Response:

   In response to the Staff's comment the Company has included statements satisfying the requirements of Rule 10-01(b)(8) of Regulation S-X. Please see the revised Exhibits 99.2 and 99.4 to the Amended Registration Statement.

   Should you have any questions or comments with respect to this filing, please call me at (212) 859-8622.

Sincerely,
/s/ Abigail P. Bomba
Abigail P. Bomba

cc: Wilson Lee, Securities & Exchange Commission
Folake Ayoola, Securities & Exchange Commission
Jennifer Gowetski, Securities & Exchange Commission
Kathleen G. Kane, Brookfield DTLA Fund Office Trust Investor Inc.
Lee S. Parks, Fried, Frank, Harris, Shriver & Jacobson LLP

Exhibit A

[MILES AND STOCKBRIDGE DRAFT]

EXHIBIT 5.1

[LETTERHEAD OF MILES & STOCKBRIDGE P.C.]

August [_], 2013

Brookfield DTLA Fund Office Trust Investor Inc.
250 Vesey Street, 15th Floor
New York, New York 10281

Re:Registration Statement on Form S-4 (Reg. No. 333-189273)

Ladies and Gentlemen:

We have acted as special Maryland counsel to Brookfield DTLA Fund Office Trust Investor Inc., a Maryland corporation (the “Company”), in connection with the issuance of up to 10,000,000 shares of the Company’s 7.625% Series A Cumulative Redeemable Preferred Stock, par value $0.01 per share (the “Shares”). The issuance of the Shares will be registered under the Securities Act of 1933, as amended, in a Registration Statement on Form S–4 (Registration Number 333-189273), as amended through the date hereof (the “Registration Statement”).

We have examined the Registration Statement, the Agreement and Plan of Merger, dated as of April 24, 2013, by and among the Company, MPG Office Trust, Inc., Brookfield DTLA Holdings L.P., Brookfield DTLA Fund Office Trust Inc., Brookfield DTLA Fund Properties LLC and MPG Office, L.P. (as amended by that Waiver and First Amendment to Agreement and Plan of Merger dated as of May 19, 2013 and that Second Amendment to Agreement and Plan of Merger dated as of July 10, 2013) (the “ Merger Agreement”), pursuant to which the Shares will be issued, the charter of the Company, including the Articles Supplementary with respect to the Shares accepted for record by the State Department of Assessment and Taxation of the State of Maryland on July [_], 2013, the bylaws of the Company, certain records of proceedings of the board of directors of the Company with respect to the authorization and issuance of the Shares and the transactions contemplated by the Merger Agreement, and such other corporate records, certificates and documents as we deemed necessary for the purpose of this opinion. We have relied as to certain factual matters on information obtained from public officials and from officers of the Company. Based on that examination, it is our opinion that the Shares, when issued under the circumstances contemplated in the Registration Statement, will be legally issued, fully paid and non-assessable.

We express no opinion with respect to the laws of, or the effect or applicability of the laws of, any jurisdiction other than, and our opinion expressed herein is limited to, the laws of the State of Maryland. The opinion expressed herein is limited to the matters expressly set forth in this letter and no other opinion should be inferred beyond the matters expressly stated.

We hereby consent to the use of our name under the heading "Legal Matters" in the prospectus that is a part of the Registration Statement and to the filing of this opinion as an exhibit to the Registration Statement. In giving our consent, we do not thereby admit that we are in the category of persons whose consent is required under Section 7 of the Securities Act or the rules and regulations of the Securities and Exchange Commission thereunder.

Very truly yours,

Miles & Stockbridge P.C.

By:____________________________________
Principal

Direct Line: (212) 859-8622
Fax: (212) 859-4000
abigail.bomba@friedfrank.com

August 27, 2013

Jessica Barberich
Division of Corporate Finance
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Brookfield DTLA Fund Office Trust Investor Inc.
Amendment No. 1 to Registration Statement on Form S-4
Filed July 26, 2013
File No.: 333-189273

Dear Ms. Barberich:

This letter sets forth the response of Brookfield DTLA Fund Office Trust Investor Inc. (the "Company" or "Sub REIT") to the comment letter, dated August 16, 2013 (the "Comment Letter"), of the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "SEC") with respect to Amendment No. 1 to the Company's Registration Statement on Form S-4 filed on July 26, 2013 (the "Registration Statement"). This letter is being filed with Amendment No. 2 to the Registration Statement (as so amended, the "Amended Registration Statement"), which reflects certain revisions in response to the Comment Letter. In order to facilitate your review, we have repeated each comment in its entirety in the original numbered sequence. The Amended Registration Statement also contains other changes for information that has been updated since the filing of the Registration Statement on July 26, 2013. We have sent to your attention via courier courtesy copies of the Amended Registration Statement marked to show changes from Amendment No. 1 to the Registration Statement. Capitalized terms used but not defined in this letter have the meanings ascribed to such terms in the Amended Registration Statement.

Summary Term Sheet, page 1

1. *We note your response to comment 6 of our comment letter dated July 9, 2013. Please revise your disclosure to provide a summary of the material transactions fees, including quantifying those fees that have been incurred by the parent of the company, Brookfield DTLA Holdings LLC. Also, tell us how you intend to account for these fees in your financial statements.*

   Response:

   In response to the Staff's comment, the disclosure has been revised to provide a summary of the material transaction fees of the Brookfield Parties, including those fees that have been or will be incurred by Brookfield DTLA Holdings LLC. Please see pages 3 and 90 of the Amended Registration Statement. These costs will be reported as a transaction expense of the Company and funded through an equity contribution from Brookfield DTLA Holdings LLC.

Unaudited Pro Forma Condensed Combined Consolidated Financial Statements, page 13

2. *We note that you and MPG entered into an MOU on July 10, 2013 regarding a proposed settlement related to the Common Stock Actions. Please explain in your disclosure how you considered this proposed settlement in preparing your pro forma financial statements. Please clarify which entity will pay the proposed settlement amount, if approved, and provide an estimate or an estimated range of the possible payment, if known.*

   Response:

   In connection with the proposed settlement, the plaintiffs in the Common Stock Actions intend to seek, and the defendants have agreed to pay, an award of attorneys' fees and expenses in an amount to be determined by the court. The MOU states that the payment of the attorneys' fees and expenses shall be paid by MPG or its successors, which could be the Company if the REIT Merger closes prior to the resolution and court approval of the proposed settlement. Given that the stipulation of settlement is currently in negotiation and will be submitted to the court for approval, the amount of the potential settlement or range of possible payment cannot be reasonably estimated; therefore, neither the MPG financial statements nor the unaudited pro forma condensed combined consolidated financial statements of the Company include an accrual in respect of the proposed settlement.

   In response to the Staff's comment, the disclosure has been revised to incorporate the foregoing information. Please see page 44 of the Amended Registration Statement.

3. *We have considered your response to comment 9 of our letter dated July 9, 2013 and reviewed your revised disclosures. Please expand your disclosures further to include some of the information highlighted within your response related to how you determined that New OP is a VIE and that you are the primary beneficiary of New OP. Also, in your response, please further address your consideration of the design of the VIE and the relationship with its members as well as the economics of the common and preferred interests in the VIE. In this regard, we note that all of the common interests are held by Brookfield DTLA and that Surviving LLC is only entitled to a limited amount of distributions. Although the cash flows that will ultimately be paid to the third party preferred stock investors in your company are dependent on the properties owned by New OP, the return to your company has a cap since after all of the distributions have been made to Surviving LLC based on the terms of the New OP Series A Interests, Brookfield DTLA will be entitled to 100% of any further distributions from New OP. In light of these terms, please expand on how you still determined that your company (through REIT Merger Sub and Surviving LLC) is most closely associated with the VIE.*

   Response:

   In response to the comment from the Staff, we have revised disclosure 3(a) in the notes to the Unaudited Pro Forma Condensed Combined Consolidated Financial Statements to disclose how the Company determined that New OP is a VIE and that the Company is the primary beneficiary of New OP. Please see page 18 of the Amended Registration Statement.

As stated in our July 26 response letter to the Staff and reiterated in your question above, Brookfield DTLA will own all of the common interests of New OP and Surviving LLC will hold a preferred interest, the New OP Series A Interest. Therefore, all income from operations, after payment of dividends on the New OP Series A Interest, will be allocated to Brookfield DTLA. This is consistent with the presentation of the Unaudited Pro Forma Condensed Combined Consolidated Financial Statements which present all of the members' equity as non-controlling interest and income (loss) from continuing operations as amounts attributable to non-controlling interest to reflect the common interest in New OP held directly by Brookfield DTLA.

As stated in the Amended Registration Statement, the Company currently anticipates that it will receive no substantial distributions from New OP for a period of at least five years, unless the Company or DTLA OP changes its current plans and determines to sell one or more of its real property assets prior to such time. The section of the Amended Registration Statement "*Structure of the Company and its Subsidiaries Following the Mergers and the Subsequent Transactions*," beginning on page 47, discloses the distribution and liquidation preferences in detail.

There will be a preferred interest, the New Op Series A1 Interest, that will be issued to Brookfield DTLA, through Properties Holding Inc., in exchange for the contribution of equity of the Brookfield Contributed Assets, that will carry mirror rights to the New OP Series A Interest held by Surviving LLC. The purpose of this structure is to meet certain requirements relating to domestic control of the MPG Asset REITs and the Brookfield Asset REITs.

We recognize that if a liquidation event occurred subsequent to the REIT Merger, the holders of the New OP Series A Interest would be entitled to all unpaid and accrued dividends on the New OP Series A Interest and the remaining distributions would be made to the common shareholders. This is consistent with the discussion above that all the profits and losses after payments of dividends on the New OP Series A Interest will be allocated to Brookfield DTLA.

As stated in our July 26 response letter to the Staff, in accordance with ASC 810-10-25-44, if two or more related parties hold variable interests in the same VIE, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary.

The guidance in ASC 810-10-25-44 is technically only applicable if one party within a related party group does not possess both of the characteristics in ASC 810-10-25-38A (power and economic interest). In this regard, we concluded that the Company possesses both characteristics with respect to New OP:

1. The managing member of New OP, which has power to make the decisions that most significantly impact the economic performance of New OP, is controlled by the Company.

2. Through the variability absorbed by the New OP Series A Preferred Interest, the Company has variable interests in New OP that contain an obligation to absorb losses and a right to receive returns of New OP that could potentially be significant.

Notwithstanding that the two conditions in ASC 810-10-25-44 are met with respect to the Company's involvement in New OP, given that the Company is ultimately controlled by Brookfield DTLA, we believed it was appropriate to also consider the guidance in ASC 810-10-25-44.

As indicated in our July 26 response letter, in analyzing the conditions in ASC 810-10-25-44, we did not give significant consideration to conditions (a) and (c) since Brookfield DTLA and the Company are under common control. Within a common control group, we do not believe the assessment should give any significant consideration to a principal-agency relationship or exposure to expected losses because the ultimate parent of the common control group would typically have the ability to control members of the common control group and therefore potentially dictate a principal-agency relationship or assign economics to any entity within the group it chooses. Therefore, we believe the focus should be on the substance of the arrangements related to the VIE, and therefore the consideration of conditions (b) the relationship and significance of the activities of the VIE to the various parties within the related party group and (d) the overall design of the VIE.

The Company was designed solely to issue Company Series A Preferred Stock to third party investors whose cash flows are dependent solely on the properties owned by New OP. Absent the decision to issue this preferred stock to third parties, there would have been no substantive reason to include the Company and REIT Merger Sub in the ownership structure. Additionally, the managing member of New OP (Surviving LLC) is controlled by the Company, and conducts the significant activities of New OP (i.e., managing the operations and leasing of the properties). For these reasons, we believed the relationship and significance of the activities of the VIE, along with its design, pointed towards the Company as being most closely associated, and therefore the direct primary beneficiary of New OP.

If we had given significant consideration to the remaining conditions (a) and (c), this would not have changed our conclusion. Given the common control relationship between the Company and Brookfield DTLA, we believe the determination of the principal versus the agent is indeterminate. By virtue of its control of the managing member, and the rights related to the managing member that are conferred to the Company as a result of the shares of Company Series A Preferred Stock held by third parties, it could be concluded that the Company is acting as a principal with regards to New OP. However, given that the Company is ultimately controlled by Brookfield DTLA, this is indeterminate.

With respect to the exposure to variability of New OP, since all the common interests are held by Brookfield DTLA, this would point to Brookfield DTLA, but when considered in the context of all the conditions in ASC 810-10-25-44 (see above), we do not believe this would change our conclusion that under ASC 810-10-25-44, the Company would consolidate New OP.

It should be noted that absent consolidation of New OP, the Company would account for its economic interest in New OP using the cost method of accounting; since it does not have a common ownership interest, the equity method of accounting would not be applicable. The financial statements of the Company would therefore primarily reflect a one line item investment in New OP and a one line item amount on the income statement for dividends received from New OP. As previously indicated, the sole reason for Company’s existence, and the registration statement of which the Company’s financial statements are included, is because of the shares of Company Series A Preferred Stock that will be held by third parties. Considering this, and the results of our consolidation analysis above, we believe that the Company should consolidate New OP. This conclusion results in the most meaningful and transparent financial statement presentation for the users of the financial statements of the Company. In particular, this presentation allows the third party holders of the Company Series A Preferred Stock to transparently see the results of operations of the properties underlying New OP, which will be the sole source of cash flows with respect to the Company Series A Preferred Stock.

This conclusion results in the most meaningful and transparent financial statement presentation for the users of the financial statements of the Company. In particular, this presentation allows the third party holders of the Company Series A Preferred Stock to transparently see the results of operations of the properties underlying New OP, which will be the sole source of cash flows with respect to the Company Series A Preferred Stock.

We acknowledge that there are inherently significant judgments involved in determining which party within a common control group is most closely associated with a VIE. The authoritative guidance in ASC 810 is limited to ASC 810-10-25-44. That guidance does not specifically address the accounting for down-stream common control relationships when it is apparent that the ultimate parent will consolidate the VIE, either directly or indirectly through a down-stream consolidated subsidiary. As mentioned in our prior response letter, since Brookfield DTLA controls the Company, it will consolidate New OP under ASC 810. As a result, the analysis under ASC 810-10-25-44 is only relevant to whether, in its stand-alone financial statements, the Company should consolidate New OP. Given that both the conditions in ASC 810-10-25-38A are met (see above) and it appears the Company is most closely associated with New OP under ASC 810-10-25-44 (see above), we believe consolidation of New OP by the Company is required under ASC 810. We believe any conclusion to the contrary is not appropriate under GAAP, and it would be potentially misleading for the financial statements of the Company included in the registration statement and in future filings under the securities laws to omit New OP, which contains all the substantive assets and operations underlying the cash flows available for payment of dividends and other amounts on the Company Series A Preferred Stock held by third party investors (which is the reason for the filing of the Registration Statement).

Note 4 – Pro Forma Adjustments

(a) MPG Acquisition, page 19

4. *You disclose that the principal valuation technique that you employed in determining the fair value of the identifiable assets and liabilities was the income approach which was supported primarily by the cost approach. You also state that after calculating the value of each asset component such amounts were adjusted based upon the conclusion drawn by the income approach. Please further advise us of the extent to which the values determined under the replacement cost method were adjusted as a result of the income method conclusions. To the extent the adjustments were significant, please clarify the role of the replacement cost method if the values determined using that method were just adjusted to be consistent with the values determined using the income method.*

Response:

In response to the Staff's comment the Company has revised the disclosure to remove the statement that "after calculating the value of each asset component such amounts were adjusted based on the conclusion drawn by the income approach". The Company has revised the disclosure to state that the primary valuation technique employed was the income approach which was validated by the cost approach. The Company believes that the income approach is the more reliable approach and the one that would be used by a market participant in a similar transaction. The Company has revised the disclosure to state that the role of the replacement cost approach was to validate the conclusions reached by the income approach. The cost approach resulted in values that were approximately 6.3% higher than the conclusions reached under the income approach. The Company believes this margin is acceptable, as all valuations involve some level of imprecision, and supports the Company's ultimate value conclusions based on the income approach. Please see page 21 of the Amended Registration Statement.

5. *Please clarify how the MPG Preferred Accrual was reflected with your pro-forma financial statements and/or explain in your disclosure why such an accrual would not be reflected or disclosed as a part of preparing your pro forma financial statements.*

   Response:

   The MPG Preferred Accrual relates to all accrued and unpaid dividends (whether or not such dividends are declared) on each share of MPG Preferred Stock. These dividends were accumulated by MPG but not accrued as an obligation because MPG had not declared a dividend. As described on pages 47 and 48 of the Amended Registration Statement, these dividends will remain cumulative and unpaid when the MPG Preferred Stock is exchanged for the Company's Series A Preferred Stock in the REIT Merger. This MPG Preferred Accrual was not reflected in the Company's pro-forma financial statements because the unpaid dividends will not be a liability until declared.

<u>Risk Factors, page 22</u>

6. *We note your response to comment 17 of our comment letter dated July 9, 2013 and the revised language, "the risks and uncertainties described below include all of the known material risks facing us." All material risks should be disclosed. Please revise to remove the disclosure referencing "known" risks and the statement that "[a]dditional risks and uncertainties not presently known to us, or that are currently deemed immaterial, could negatively impact our business."*

   Response:

   In response to the Staff's comment, the disclosure has been revised to remove both the reference to "known" risks and the statement that "[a]dditional risks and uncertainties not presently known to us, or that are currently deemed immaterial, could negatively impact our business." Please see page 24 of the Amended Registration Statement.

<u>The Company's subsidiaries may in the future, issue equity securities..., page 22</u>

7. *We note your response to comment 18 of our comment letter dated July 9, 2013. Please revise your summary to briefly clarify and explain, if true, that after the consummation of the transactions contemplated by the Merger Agreement and as part of the Subsequent Transactions, subsidiaries of the Company will issue equity interests that rank senior to the equity securities of such subsidiaries held indirectly by the Company, and as a result, will effectively rank senior to the Company Series A Preferred Stock.*

Response:

We respectfully advise the Staff that the Registration Statement included disclosure advising the holders of Company Series A Preferred Stock that after the consummation of the transactions contemplated by the Merger Agreement and as part of the Subsequent Transactions, subsidiaries of the Company will issue equity interests that rank senior to the equity securities of such subsidiaries held indirectly by the Company. Please see pages 24 and 25 of the Amended Registration Statement. However, in response to the Staff's comment, additional disclosure has been included to further clarify this point and explain that equity interests issued by subsidiaries of the Company will rank senior to the equity securities of such subsidiaries held indirectly by the Company, and as a result, will effectively rank senior to the Company Series A Preferred Stock. Please see the revised disclosure on page 48 of the Amended Registration Statement.

Background to the Mergers, page 58

8. *We note your response to comment 24 of our comment letter dated July 9, 2013 where you state that BPO did not seek third party appraisals in connection with its determination of MPG's value. If material, please revise the risk factors section to include related risk factors.*

Response:

In response to the Staff's comment, the risk factors section has been revised to include a risk factor noting that BPO did not seek any third party appraisal in connection with its determination of MPG's value. Please see page 25 of the Amended Registration Statement.

Draft Legal Opinion

9. *We note that the registration statement on Form S-4 is registering 9,730,370 shares of the company's 7.625% Series A Cumulative Redeemable Preferred Stock. Please tell us why counsel's opinion refers to "the issuance of up to 10,000,000 shares of the Company's 7.625% Series A Cumulative Redeemable Preferred Stock."*

Response:

In response to the Staff's comment, counsel has revised the form of legal opinion relating to the validity of the shares of Company Series A Preferred Stock to refer to the issuance of 9,730,370 shares of Company Series A Preferred Stock. The revised form of opinion and a copy marked to show this change are attached hereto as Exhibits A-1 and A-2, respectively.

Should you have any questions or comments with respect to this filing, please call me at (212) 859-8622.

Sincerely,

/s/ Abigail P. Bomba
Abigail P. Bomba

cc: Wilson Lee, Securities & Exchange Commission
Folake Ayoola, Securities & Exchange Commission
Jennifer Gowetski, Securities & Exchange Commission
Kathleen G. Kane, Brookfield DTLA Fund Office Trust Investor Inc.
Lee S. Parks, Fried, Frank, Harris, Shriver & Jacobson LLP

Exhibit A-1

DRAFT FORM OF LEGAL OPINION
OF
MILES AND STOCKBRIDGE

EXHIBIT 5.1

[LETTERHEAD OF MILES & STOCKBRIDGE P.C.]

August [_], 2013

Brookfield DTLA Fund Office Trust Investor Inc.
250 Vesey Street, 15th Floor
New York, New York 10281

Re: Registration Statement on Form S-4 (Reg. No. 333-189273)

Ladies and Gentlemen:

We have acted as special Maryland counsel to Brookfield DTLA Fund Office Trust Investor Inc., a Maryland corporation (the "Company"), in connection with the issuance of up to 9,730,370 shares of the Company's 7.625% Series A Cumulative Redeemable Preferred Stock, par value $0.01 per share (the "Shares"). The issuance of the Shares will be registered under the Securities Act of 1933, as amended, in a Registration Statement on Form S–4 (Registration Number 333-189273), as amended through the date hereof (the "Registration Statement").

We have examined the Registration Statement, the Agreement and Plan of Merger, dated as of April 24, 2013, by and among the Company, MPG Office Trust, Inc., Brookfield DTLA Holdings L.P., Brookfield DTLA Fund Office Trust Inc., Brookfield DTLA Fund Properties LLC and MPG Office, L.P. (as amended by that Waiver and First Amendment to Agreement and Plan of Merger dated as of May 19, 2013, that Second Amendment to Agreement and Plan of Merger dated as of July 10, 2013 and that Third Amendment to Agreement and Plan of Merger dated as of August 14, 2013) (the " Merger Agreement"), pursuant to which the Shares will be issued, the charter of the Company, including the Articles Supplementary with respect to the Shares accepted for record by the State Department of Assessment and Taxation of the State of Maryland on August 23, 2013, the bylaws of the Company, certain records of proceedings of the board of directors of the Company with respect to the authorization and issuance of the Shares and the transactions contemplated by the Merger Agreement, and such other corporate records, certificates and documents as we deemed necessary for the purpose of this opinion. We have relied as to certain factual matters on information obtained from public officials and from officers of the Company. Based on that examination, it is our opinion that the Shares, when issued under the circumstances contemplated in the Registration Statement, will be legally issued, fully paid and non-assessable.

We express no opinion with respect to the laws of, or the effect or applicability of the laws of, any jurisdiction other than, and our opinion expressed herein is limited to, the laws of the State of Maryland. The opinion expressed herein is limited to the matters expressly set forth in this letter and no other opinion should be inferred beyond the matters expressly stated.

We hereby consent to the use of our name under the heading “Legal Matters” in the prospectus that is a part of the Registration Statement and to the filing of this opinion as an exhibit to the Registration Statement. In giving our consent, we do not thereby admit that we are in the category of persons whose consent is required under Section 7 of the Securities Act or the rules and regulations of the Securities and Exchange Commission thereunder.

Very truly yours,

Miles & Stockbridge P.C.

By: ______________________________

Principal

Exhibit A-2

MARKED COPY OF
DRAFT FORM OF LEGAL OPINION OF
MILES AND STOCKBRIDGE

EXHIBIT 5.1

[LETTERHEAD OF MILES & STOCKBRIDGE P.C.]

August [_], 2013

Brookfield DTLA Fund Office Trust Investor Inc.
250 Vesey Street, 15^{th} Floor
New York, New York 10281

Re: Registration Statement on Form S-4 (Reg. No. 333-189273)

Ladies and Gentlemen:

We have acted as special Maryland counsel to Brookfield DTLA Fund Office Trust Investor Inc., a Maryland corporation (the "Company"), in connection with the issuance of up to ~~10,000,000~~9,730,370 shares of the Company's 7.625% Series A Cumulative Redeemable Preferred Stock, par value $0.01 per share (the "Shares"). The issuance of the Shares will be registered under the Securities Act of 1933, as amended, in a Registration Statement on Form S–4 (Registration Number 333-189273), as amended through the date hereof (the "Registration Statement").

We have examined the Registration Statement, the Agreement and Plan of Merger, dated as of April 24, 2013, by and among the Company, MPG Office Trust, Inc., Brookfield DTLA Holdings L.P., Brookfield DTLA Fund Office Trust Inc., Brookfield DTLA Fund Properties LLC and MPG Office, L.P. (as amended by that Waiver and First Amendment to Agreement and Plan of Merger dated as of May 19, ~~2013 and~~2013, that Second Amendment to Agreement and Plan of Merger dated as of July 10, 2013 and that Third Amendment to Agreement and Plan of Merger dated as of August 14, 2013) (the " Merger Agreement"), pursuant to which the Shares will be issued, the charter of the Company, including the Articles Supplementary with respect to the Shares accepted for record by the State Department of Assessment and Taxation of the State of Maryland on ~~July [ ],~~August 23, 2013, the bylaws of the Company, certain records of proceedings of the board of directors of the Company with respect to the authorization and issuance of the Shares and the transactions contemplated by the Merger Agreement, and such other corporate records, certificates and documents as we deemed necessary for the purpose of this opinion. We have relied as to certain factual matters on information obtained from public officials and from officers of the Company. Based on that examination, it is our opinion that the Shares, when issued under the circumstances contemplated in the Registration Statement, will be legally issued, fully paid and non-assessable.

We express no opinion with respect to the laws of, or the effect or applicability of the laws of, any jurisdiction other than, and our opinion expressed herein is limited to, the laws of the State of Maryland. The opinion expressed herein is limited to the matters expressly set forth in this letter and no other opinion should be inferred beyond the matters expressly stated.

We hereby consent to the use of our name under the heading “Legal Matters” in the prospectus that is a part of the Registration Statement and to the filing of this opinion as an exhibit to the Registration Statement. In giving our consent, we do not thereby admit that we are in the category of persons whose consent is required under Section 7 of the Securities Act or the rules and regulations of the Securities and Exchange Commission thereunder.

Very truly yours,

Miles & Stockbridge P.C.

By: ______________________________
Principal

Locke Lord LLP
Attorneys & Counselors

2200 Ross Avenue, Suite 2200
Dallas, Texas 75201
Telephone: 214-740-8000
Fax: 214-740-8800
www.lockelord.com

John B. McKnight
Direct Telephone: 214-740-8675
Direct Fax: 214-756-8675
jmcknight@lockelord.com

November 20, 2013

VIA EDGAR AND FEDEX

Jessica Barberich
Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: PMC Commercial Trust
Registration Statement on Form S-4
Initially filed August 30, 2013
File No. 333-190934

Dear Ms. Barberich:

Set forth below are the responses of PMC Commercial Trust ("**PMC Commercial**") to the Staff's comment letter dated November 1, 2013 (the "**Comment Letter**") regarding Amendment No. 1 to the referenced Registration Statement on Form S-4, which was filed on October 11, 2013 ("**Amendment No. 1**").

For your convenience, we have set forth below the Staff's comments followed by PMC Commercial's responses thereto in bold typeface. The numbered paragraphs and headings below correspond to the numbered paragraphs and headings contained in the Comment Letter. The page numbers referenced below refer to the page numbers of Amendment No. 2 to the referenced Registration Statement on Form S-4 (the "**Registration Statement**"), which is filed herewith. You will note that the Registration Statement includes financial and other information through September 30, 2013, so to the extent that the Staff's comments relate to June 30, 2013 information we have responded with reference to September 30 information. Capitalized terms used but not defined herein have the meanings given to such terms in the Registration Statement.

To expedite your review, we are sending to you and Jennifer Gowetski via FedEx a copy of this letter, together with clean and marked copies of the Registration Statement showing changes made to Amendment No. 1.

General

1. We note your response to comment 3 of our letter dated September 27, 2013, and continue to note that you intend to issue convertible preferred shares to CIM REIT and affiliates. We reissue our comment as it is not clear how you can register the conversion of the preferred shares when you do not have a sufficient number of common shares currently authorized. Please provide a more detailed legal analysis regarding how the preferred shares and the common shares to be issued upon conversion will be duly authorized and validly issued in light of the fact that you currently do not have sufficient authorized shares. As part of your analysis, please explain how you can register shares that are not currently authorized and how counsel will be able to opine on the legality of the preferred shares as well as the underlying common shares.

   In light of the Staff's positions regarding the registration of shares that are not yet authorized and regarding Exhibit 5 legal opinions with respect to shares not yet authorized, PMC Commercial is amending the Registration Statement to remove the registration of the PMC Commercial Preferred Shares and the underlying PMC Commercial Common Shares. Appropriate revisions to reflect that change have been made to the cover page of the Registration Statement. The Exhibit 5 legal opinion has likewise been revised to exclude the PMC Commercial Preferred Shares and the underlying PMC Commercial Common Shares, as they are no longer being registered, which eliminated the need to assume an increase in the number of PMC Commercial's authorized shares in the opinion.

   The PMC Commercial Preferred Shares and the underlying PMC Commercial Common Shares will be issued in a private placement in compliance with the requirements of the Securities Act of 1933, as amended, under the authority of the guidance provided in CDI 139.25 and Securities Act Release 8828. With respect to such guidance, please note that PMC Commercial's relationship with the CIM entities long predates the preparation and filing of the Registration Statement, as is discussed under "THE MERGER—Background of the Merger." The filing of the Registration Statement played no part in soliciting the CIM entities' interest in acquiring the PMC Commercial Preferred Shares and the underlying PMC Commercial Common Shares, which was pre-existing.

2. We note your response to comment 4 of our letter dated September 27, 2013. We reissue our comment. We note that your shareholders are voting on the share issuance proposal to approve the issuance of common shares and preferred shares pursuant to the merger agreement as well as to vote, through a non-binding advisory vote, on the merger-related compensation proposal. Please provide a more detailed legal analysis as to how you determined that your shareholders did not need to approve the agreement and plan of merger.

   You have requested that PMC Commercial provide a more detailed legal analysis as to how it has determined that its shareholders do not need to approve the Merger Agreement.

   Texas Law:

   PMC Commercial is Not Deemed "A Party to the Merger*"*. PMC Commercial is a real estate investment trust organized under the Texas Business Organizations Code (the "TBOC"). The requirements for voting on mergers of real estate investment**

trusts are set forth in Chapter 10 of the TBOC applicable to mergers and other similar transactions of entities generally (and specifically, Sections 10.001, 10.002, 10.004, 10.007, 10.008, 10.151, 10.153 and 10.156 thereof), and in Chapter 200, Subchapter I, of the TBOC, applicable to mergers and similar transactions involving real estate investment trusts (and specifically, Sections 200.401, 200.402, 200.406, 200.407 and 200.408 - 410 thereof). In these provisions the TBOC distinguishes between entities that are merely signatories to a merger agreement and the entities that are themselves merging. The shareholders of the former are explicitly not required to vote on the merger, as discussed below.

The definitions section of the TBOC, Section 1.002, in subsection (69), defines "party to the merger" as:

> **"a domestic or non-code organization that under a plan of merger is divided or combined by a merger. The term does not include a domestic entity or non-code organization that is not to be divided or combined into or with one or more domestic entities or non-code organizations, regardless of whether ownership interest (*sic*) of the entity are to be issued under the plan of merger."**

While PMC Commercial is a party to the Merger Agreement and its shares are being issued, it is not an entity that is being combined and therefore it is not a "party to the merger".

Section 10.002(b), of general applicability, provides that "[t]o effect a merger, each domestic entity that is a party to the merger must act on and approve the plan of merger in the manner prescribed by this code for the approval of mergers by the domestic entity". Section 200.402 provides in subsection (a) that "[a]real estate investment trust that is a party to the merger under Chapter 10 must approve the merger by complying with this section". Section 200.402(c) provides, "[e]xcept as provided by this subchapter or Chapter 10, the plan of merger shall be submitted to the shareholders of the real estate investment trust for approval as provided by this subchapter" and Section 200.402(e) provides, "[e]xcept as provided by Chapter 10 or Sections 200.407-409, the shareholders of the real estate investment trust shall approve the plan of merger as provided by this subchapter" (emphasis added to each of the above).

Section 200.407, applicable to real estate investment trusts, specifies the vote required for mergers. Section 200.407(d) provides, "Unless required by the certificate of formation, approval of a merger by shareholders is not required under this code for a real estate investment trust that is a party to the plan of merger unless that real estate investment trust is also a party to the merger" (emphasis added).

Thus, under Section 200.407(d) as applied to this transaction, it is expressly provided that no vote of PMC Commercial shareholders is required because PMC Commercial is not a "party to the merger" under the TBOC. Further, Sections 10.002(b) and 200.402(a) discussed above do not by their terms require a vote by PMC Commercial because it is not a "party to the merger".

***Contribution of Assets Analysis*. The Merger Agreement also includes provisions for the contribution of the assets of PMC Commercial to PMC Merger Sub. Section 10.252 of the TBOC provides in pertinent part that "[e]xcept as otherwise provided by this code, the governing documents of the domestic entity, or specific limitations established by the governing authority, a sale, lease, assignment, conveyance, … or other transfer of an interest in real property or other property made by a domestic entity does not require the approval of the members or owners of the entity" (emphasis added).**

Section 200.405 of the TBOC includes provisions for voting by shareholders on a "sale of all or substantially all of the assets" of a real estate investment trust. That term is defined in Section 200.401, which provides in pertinent part:

> **"'Sale of all or substantially all of the assets' means the sale, lease, exchange, or other disposition … of all or substantially all of the property and assets of a domestic real estate investment trust that is not made in the usual and regular course of the trust's business without regard to whether the disposition is made with the goodwill of the business. The term does not include a transaction that results in the real estate investment trust directly or indirectly: (A) continuing to engage in one or more businesses; or (B) applying a portion of the consideration received in connection with the transaction to the conduct of a business that the real estate investment trust engages in after the transaction." (emphasis added).**

PMC Commercial will, after the contribution of assets to PMC Merger Sub, continue to engage in its former business indirectly through its ownership of PMC Merger Sub. Thus the voting provisions of Section 200.405 do not apply to the contribution of assets to PMC Merger Sub because under the TBOC it does not constitute a "sale of all or substantially all of the assets" of PMC Commercial, and under Section 10.252 no vote of the shareholders of PMC Commercial is required to approve the contribution of assets to PMC Merger Sub for the reasons discussed above and below.

***Declaration of Trust Analysis*. Article Eight of PMC Commercial's Declaration of Trust, as amended, contains the relevant voting requirements. It provides in pertinent part:**

> **"Except as specifically required by law or this Declaration of Trust or as specifically provided in any resolution or resolutions of the Trust Managers providing for the issuance of any particular series of Preferred Shares, the Common Shares shall have the exclusive right to vote on all matters (as to which common shareholders shall be entitled to vote pursuant to applicable law) at all meetings of the shareholders of [PMC Commercial]. Subject to the provisions of the Texas REIT Act and this Declaration of Trust that may require a greater voting requirement, any matter to be voted upon by the holders of Common Shares shall be approved if the matter receives the affirmative vote of the holders of at least a majority of the Common Shares that are represented in person or by proxy at a meeting of shareholders at which a quorum is present." (emphasis added).**

Shareholders of PMC Commercial thus have the right to vote on matters as to which they are entitled to vote pursuant to applicable law. No special voting rights on mergers, dispositions of assets, or other matters are granted under the Declaration of Trust. As discussed above, the TBOC does not grant voting rights with respect to the merger of PMC Merger Sub or the contribution of assets to PMC Merger Sub. To the extent applicable law may be deemed to include the voting requirements of Corporate Governance Rules of the NYSE MKT with respect to the issuance of additional shares, those voting requirements are being complied with. No voting rights or other "special limitations" have been granted by action of the governing authority of PMC Commercial – its Board of Trust Managers. No other requirements of applicable law impose additional voting rights with respect to the Merger Agreement. Therefore, under Texas law and PMC Commercial's Declaration of Trust, no vote of the holders of shares of PMC Commercial is required on the Merger Agreement.

Delaware Law:

The merging parties involved in the Merger are CIM Merger Sub and PMC Merger Sub, both of which are Delaware limited liability companies. PMC Commercial owns 100% of the equity interests in PMC Merger Sub. PMC Commercial, as a Texas real estate investment trust, is not subject to the Delaware Limited Liability Company Act provisions on voting on mergers except insofar as those provisions pertain to the vote required by the owners of Delaware entities. As the sole owner of PMC Merger Sub, the approval of the merger by PMC Commercial itself as an entity is required, but no vote is required of the owners of PMC Commercial (i.e., its shareholders), as discussed in more detail below:

Section 18-209(b) of the Delaware Limited Liability Company Act, which governs mergers of Delaware limited liability companies, provides in pertinent part:

> **"Pursuant to an agreement of merger …, 1 or more domestic limited liability companies may merge … with or into 1 or more domestic limited liability companies …with such domestic limited liability company … as the agreement may provide being the surviving or resulting domestic limited liability company … . Unless otherwise provided in the limited liability company agreement, an agreement of merger … or a plan of merger shall be approved by each domestic limited liability company which is to merge … by the members … by members who own more than 50 percent of the then current percentage or other interest in the profits of the domestic limited liability company owned by all of the members …" (emphasis added).**

The vote thus required for approval of the Merger on the PMC Merger Sub side is the vote by PMC Commercial itself, because only members are entitled to vote and it is the sole member of PMC Merger Sub. The statute makes no reference to any other vote by holders of ownership interests in the member (i.e., the shareholders of

PMC Commercial). The Board of Managers of PMC Commercial has authority to direct the voting of shares that it holds in subsidiaries, as it is authorized to manage the assets of PMC Commercial. Therefore, under Delaware law no other vote besides the approval of PMC Commercial itself is required for approval of the Merger Agreement. Further, nothing in the limited liability company agreement of PMC Merger Sub requires a vote by the holders of shares of PMC Commercial on the Merger Agreement.

Sample Registered Transactions:

In addition to the foregoing analysis, we note that the subsidiary merger structure in which public company shareholders are asked to approve the issuance of shares in the merger, rather than the merger itself, is a relatively common transaction structure that has been used in numerous other public transactions, several of which recent transactions are referenced below.

Registrant	Registration Number	Initial Filing Date	Counterparty	Legal Counsel: Registrant/Counterparty
Enerjex Resources, Inc.	**333-190590**	**8/13/13 (S-4)**	**Black Raven Energy, Inc.**	**Reicker, Pfau, Pyle & McRoy LLP/ Levine, Garfinkel and Eckersley, L.L.P.**
Alexander & Baldwin, Inc.	**333-189822**	**7/5/13 (S-4)**	**GPC Holdings, Inc.**	**Skadden, Arps, Slate, Meagher & Flom LLP/ Sidley Austin LLP**
Integrated Electrical Services, Inc.	**333-188182**	**4/26/13 (S-4)**	**MISCOR Group, Ltd.**	**Andrews Kurth LLP/ Ulmer & Berne LLP**
Office Depot, Inc.	**333-187807**	**4/9/13 (S-4)**	**OfficeMax Incorporated**	**Simpson Thacher & Bartlett LLP/ Skadden, Arps, Slate, Meagher & Flom LLP**
Tranzyme, Inc.	**N/A**	**05/14/13 (PREM14A)**	**Ocera Therapeutics, Inc.**	**Skadden, Arps, Slate, Meagher & Flom LLP/Reed Smith LLP**
Parametric Sound Corporation,	**N/A**	**11/4/13 (PREM14A)**	**VTB Holdings, Inc.**	**Sheppard Mullin Richter & Hampton LLP/Dechert LLP**
American Realty Capital Properties, Inc.	**333-185935**	**1/9/13 (S-4)**	**American Realty Capital Trust IV, Inc.**	**Duane Morris LLP/ Proskauer Rose LLP**

3. We note your response to comment 5 of our letter dated September 27, 2013. We note that the Smith Travel Research Inc. report was commissioned by CIM. Please tell us why this is not expertized disclosure requiring a consent as per Rule 436. Refer to Securities Act Sections Compliance and Disclosure Interpretation 141.02. Alternatively, please file their consent as an exhibit.

PMC Commercial respectfully submits that Smith Travel Research, Inc. ("STR") is not an "expert" within the meaning of Rule 436. Rule 436 requires that a consent be filed if any portion of a report or opinion of an expert is quoted or summarized as such in a registration statement. Section 7 of the Securities Act of 1933, as amended (the "Securities Act"), provides that an expert is "any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him." PMC Commercial respectfully submits that statistical data providers are not among the class of persons subject to Section 7 and Rule 436 as "experts" unless PMC Commercial expressly identifies such providers as experts or the statements are purported to be made on the authority of such providers as "experts." Accordingly, absent a specific statement asserting that STR is an "expert" or that the data obtained from STR are purported to be made on the authority of STR as an "expert," PMC Commercial believes that STR should not be considered an "expert" within the meaning of the federal securities laws. PMC Commercial further notes that STR does not consider itself to be an "expert" within the meaning of the federal securities laws, as it states that it "tracks supply and demand data for the hotel industry." In light of the foregoing, the disclosure on page 143 is included to clearly indicate that the data obtained from STR have not been expertized.

In addition, PMC Commercial notes that the consent requirements of Rule 436 are generally directed at circumstances in which an issuer has engaged a third party expert or counsel to prepare a valuation, opinion or other report specifically for use in connection with a registration statement. In this instance, the STR data included in the Registration Statement were not prepared in connection with PMC Commercial's Registration Statement; rather, CIM Urban and/or its affiliates subscribe to STR reports in the ordinary course of managing their limited number of hotel properties and have referenced data from those reports in the Registration Statement. As a result of the foregoing, PMC Commercial respectfully submits that STR should not be considered an expert for purposes of Rule 436 and thus a consent is not required to be filed as an exhibit to the Registration Statement.

Interests of PMC Commercial … page 18

4. We note your response to comment 11 of our letter dated September 27, 2013. Please revise your disclosure on page 18 to briefly explain or quantify the certain benefits to be provided to Messrs. Salit and Berlin as well as the continued employee benefits for Messrs. Salit and Berlin.

The disclosure on page 18 has been revised to briefly explain and, where possible, quantify the benefits to be provided to Messrs. Salit and Berlin under their Restated Executive Employment Agreements, as well as the continued employee benefits for Messrs. Salit and Berlin provided under the terms of the Merger Agreement.

Estimated Transactions Fees, page 18

5. We note your response to comment 10 of our letter dated September 27, 2013. Please provide a more detailed breakdown of the fees incurred to date and the fees to be incurred upon consummation of the Merger.

   As requested, a more detailed breakdown of fees is provided on page 19 of the Registration Statement.

Unaudited Pro Forma Condensed Combined Financial Statements, page 25

Note 3: Preliminary Purchase Accounting Allocation, page 31

6. We note your response to comment 13 of our letter dated September 27, 2013 and your revised purchase price allocation. Your disclosure indicates that the purchase price is based on the amount of PMC Commercial shares outstanding and the per share price of those shares. You also indicate that there are two components of the purchase price: the special dividend and the residual value of the share consideration. Please explain these two components to us in more detail and clarify how the special dividend impacts the purchase price. Also, tell us how you considered the dividend liability of PMC in the purchase price allocation.

   In accordance with ASC 805-30-30-2, in a reverse acquisition the accounting acquirer typically issues no consideration for the acquiree. Instead, the accounting acquiree typically issues its equity shares to the owners of the accounting acquirer. Accordingly, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. In connection with the proposed business combination, we determined that CIM Urban is the accounting acquirer and PMC Commercial is the accounting acquiree (primarily because CIM Urban will obtain effective control of PMC Commercial).

   Furthermore, in a reverse acquisition involving only the exchange of equity, the fair value of the equity of the accounting acquiree may be used to measure consideration transferred if the value of the accounting acquiree's equity interests are more reliably measurable than the value of the accounting acquirer's equity interests. This may occur if a private company acquires a public company with a quoted and reliable market price. If so, the acquirer should determine the purchase consideration by using the acquisition-date fair value of the accounting acquiree's equity interests per ASC 805-30-30-2 and 805-30-30-3. As CIM Urban is a private company without a readily determinable market price, the most factually supportable measure available to determine the purchase consideration is the quoted market price of PMC Commercial's Common Shares. Notwithstanding that a portion of the consideration is in the form of cash, based on ASC 805, the quoted price of the PMC Commercial Common Shares has been determined to be the most factually supportable measure available to support the determination of total consideration.

The terms of the proposed business combination involve the issuance of PMC Commercial Common Shares to the owners of CIM Urban as well as a cash component equal to $5.50 per outstanding share to the record holders of PMC Commercial Common Shares prior to the effective date of the Merger. The $10.50 per share price disclosed in the initially filed Registration Statement (dated August 30, 2013) was based on the aggregate of (1) an estimated $5.00 per share for the fair value of PMC Commercial's Common Shares upon consummation of the proposed Merger and (2) $5.50 per share for the cash dividend to existing holders of PMC Commercial Common Shares to be declared in conjunction with the Merger effectiveness and paid within 10 business days of the Effective Date of the Merger.

As we noted in footnote 3 to the unaudited Pro Forma Condensed Combined Financial Statements filed on August 30, 2013, we did not utilize the quoted market price of PMC Commercial Common Shares in the determination of the purchase consideration because the financial information of CIM Urban had not been publicly available prior to the filing of the initial registration statement, and accordingly, the market price of PMC Commercial Common Shares may not have been fully adjusted to consider the historical financial and other non-public information of CIM Urban. We further disclosed in the initial registration statement that had the closing price of PMC Commercial Common Shares as of August 28, 2013 been utilized, the purchase price would have been reduced, resulting in a bargain purchase gain of approximately $6.5 million.

With the filing of Amendment No. 1, we updated the pro forma presentation to utilize the then current (October 8, 2013) price of PMC Commercial Common Shares in determining the purchase consideration. This was consistent with our previous disclosure regarding information of CIM Urban being available to the market via the registration statement and the PMC Commercial Common Share price having some period of time to take into account the impact of the proposed transaction. Although we continue to believe, from a business perspective, that the value of the PMC Commercial Common Shares was in excess of the then current trading price, the accounting practices established have provided that the most factually supportable method of valuation of purchase consideration would be (per the guidance for business combinations in ASC 805) utilization of the current trading price of those shares. Therefore, this is the most factually supportable for purposes of the pro forma financial presentation.

In determining the purchase price to be utilized when establishing the consideration paid pursuant to the Merger, there are two independently determinable and measurable points of reference, (1) the quoted market price of the publicly traded PMC Commercial Common Shares and (2) the contractual obligation to pay a Special Dividend of $5.50 per share upon completion of the Merger. Since only the record holders of PMC Commercial Common Shares prior to the consummation of the Merger have the right to receive the Special Dividend upon completion of the Merger, the best available information supports that the value of the cash payment is reflected in the quoted market price of the PMC Commercial Common Shares. Accordingly, in the absence of a more readily determinable measure, the total

consideration to existing PMC Commercial shareholders is based on (1) the $5.50 cash component (the Special Dividend) and (2) the estimated closing price of the PMC Commercial Common Shares immediately prior to closing of the transaction adjusted by the $5.50 per share impact of the proposed dividend discussed above.

In accordance with guidance in ASC 805-40-55-08 through 55-10, we measured the consideration transferred as follows (in thousands, except per share amount):

PMC Commercial shares outstanding(a)	**10,596**
Equity consideration price per common share(b)	**$ 3.40**
Estimated fair value of the equity consideration(c)	**$36,027**
Payment in cash—Special Dividend(d)	**58,279**
Estimated total purchase price	**$94,306**

(a) Number of shares of PMC Commercial Common Shares issued and outstanding as of September 30, 2013.

(b) Closing price of PMC Commercial Common Shares on the NYSE MKT on November 14, 2013 of $8.90 per share, adjusted by the $5.50 per PMC Commercial Common Share impact of the Special Dividend cash payment as discussed in (d) below.

(c) Number of PMC Commercial Common Shares outstanding multiplied by the estimated equity consideration price per common share.

(d) The cash payment is the Special Dividend made in connection with the Merger to the PMC Commercial shareholders. PMC Commercial will make the $58,279 cash payment (or $5.50 per share) on or prior to the tenth business day after the consummation of the Merger, without interest, in the aggregate to the holders of PMC Commercial Common Shares on the last business day prior to the consummation of the Merger.

We have updated our disclosure in the footnotes to the unaudited Pro Forma Condensed Combined Financial Statements to more clearly identify the components of the purchase price, including the Special Dividend per common share utilized based on the current trading price of the PMC Commercial Common Shares. In addition, as the Special Dividend is due to the record holders of PMC Commercial Common Shares on the last business day prior to the consummation of the Merger, we have adjusted the purchase price allocation to reflect the Special Dividend as a component of the purchase price allocation rather than a balance sheet adjustment as part of the funding of the transaction.

7. We note that you adjust for $6 million of transaction costs to be incurred by the acquiree when calculating net book value of PMC's net assets at June 30, 2013. Please clarify your basis for this adjustment and tell us if these costs are the same transaction costs discussed in footnote (C). In footnote (C), you state that those costs will be paid out in cash or accrued by CIM Urban.

In the preliminary purchase price allocation, when we calculated the net book value of PMC Commercial's net assets at June 30, 2013, we adjusted the net worth for $6.0 million direct, incremental estimated fees and costs of the transaction to be incurred by the acquiree which have not been reflected in the historical consolidated financial statements of PMC Commercial. As of September 30, 2013, the adjustment for these estimated transaction fees and costs has been reduced to approximately $4.6 million primarily as a result of costs paid by PMC Commercial during the quarter ended September 30, 2013. The accompanying pro forma financial statements have been updated for third quarter financial results.

These transaction fees and costs are the same costs discussed in footnote (C) and are the same fees and costs discussed on page 19 of the amended Registration Statement. In footnote (C), we have updated the note to more accurately reflect that those costs will be paid out in cash or accrued by PMC Commercial and not by CIM Urban.

8. We note that your purchase price allocation results in a bargain purchase gain. Please confirm to us that you have reassessed whether you have correctly identified all of the assets acquired and all of the liabilities assumed and that you have properly measured the consideration transferred. Please address why you believe that it is reasonable that this transaction would result in a bargain purchase gain. See ASC 805-30-25-4 for reference.

We confirm that, as the acquirer, CIM Urban management has reassessed whether they have correctly identified all of the assets acquired and all of the liabilities assumed and that they have properly measured the consideration transferred in the preliminary purchase price allocation.

The guidance regarding recognition of a gain is contained in paragraphs 2 and 3 of ASC 805-30-25. In addition, the guidance of paragraph 4 of ASC 805-30-25 states:

> **"Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. See paragraphs 805-30-30-4 through 30-6 for guidance on the review of measurement procedures in connection with a reassessment required by this paragraph."**

Paragraph 6 of ASC 805-30-30 goes on to state that:

> **"The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date."**

In addition, all fair values have been updated as part of updating the Pro Forma Condensed Combined Financial Statements to include operations through September 30, 2013. The preliminary purchase price allocation established in accordance with ASC 805 currently indicates that based on the range of reasonable fair values for the identifiable assets to be acquired and liabilities to be assumed, a bargain purchase gain will result from the proposed business combination.

The pro forma adjustments and disclosures regarding the acquisition accounting, including the adjustment and disclosure regarding the possibility that the transactions may ultimately result in a bargain purchase gain, were based on CIM Urban management's best estimates of the fair values of the assets and liabilities as of September 30, 2013, which it believes includes a comprehensive internal effort to identify all possible intangible assets and contingent liabilities in connection with the proposed business combination.

Furthermore, CIM Urban management has concluded that prior to recognizing a gain on a bargain purchase, it will wait until it has all available information to complete the fair value allocation as well as the reassessment process provided in ASC 805-30-30-4 through 30-6. In addition, it is acknowledged that, while best efforts are being used to identify all of the assets to be acquired and all of the liabilities to be assumed and recording such at their estimated fair value, the possibility that these transactions would result in a bargain purchase gain is further impacted by the closing share price of PMC Commercial Common Shares immediately prior to the closing of the transactions. As discussed in our response to Comment #6, we have utilized the acquisition-date fair value of the acquiree's equity interests in accordance with ASC 805-30-30-2.

<u>Note 4: Reclassification and Pro Forma Adjustments (I), page 32</u>

9. We note that you recorded the issuance of preferred stock. Please provide us with your analysis of how you determined the appropriate accounting treatment for this preferred stock; address your consideration of the conversion feature in your response.

Pursuant to the Merger Agreement, PMC Commercial will issue approximately 22 million PMC Commercial Common Shares and approximately 65 million PMC Commercial Preferred Shares. As of the date of the Merger Agreement, PMC Commercial is authorized to issue these shares. We have considered the terms of the PMC Commercial Preferred Shares and have concluded that such amounts are appropriately classified as equity for purposes of the unaudited Pro Forma Condensed Combined Financial Statements primarily based on the fact that such preferred shares are not redeemable and they automatically convert to PMC Commercial Common Shares at a 7:1 ratio immediately upon the availability of sufficient authorized shares.

As of the pro forma balance sheet date, the PMC Commercial Preferred Shares are still subject to a shareholder vote to increase the number of authorized shares before such preferred shares are automatically converted to PMC Commercial Common Shares, thus the preferred shares are not assumed to be converted into common shares for purposes of the pro forma balance sheet. As we discuss in footnote (P) to the Pro Forma Condensed Combined Financial Statements, for purposes of the earnings per share calculations in the pro forma historical income statements presented, we have assumed conversion for purposes of the basic earnings per share calculation since Urban II has agreed, as part of the Merger Agreement, to vote the post-Merger PMC Commercial Common Shares over which it has voting control, approximately 97.8%, in favor of an increase in the number of

authorized PMC Commercial Common Shares to one billion. This increase in the number of authorized shares satisfies the condition for the automatic conversion of the preferred shares into common shares. However, as the preferred shares are neither redeemable nor convertible as of the Merger date, the preferred shares are appropriately classified as equity in the unaudited pro forma condensed combined balance sheet.

Note 4: Reclassification and Pro Forma Adjustments (J), page 33

10. We have reviewed your response to comment 19 of our letter dated September 27, 2013 and note that you have recorded the value of the noncontrolling interest based on the par value of the shares. Please tell us your basis in GAAP for utilizing the par value as the fair value of the shares.

As disclosed in Note 4(J) to the Unaudited Pro Forma Condensed Combined Financial Statements, PMC Commercial's noncontrolling interest represents cumulative preferred stock held by the SBA. The preferred stock was issued by a specialized small business investment company ("SSBIC") pursuant to the Small Business Investment Act of 1958. The SSBIC which issued the preferred stock is required to be structured as a taxable REIT subsidiary ("TRS") solely as a result of the outstanding preferred stock. Additionally, SSBICs have more restrictive lending requirements than many other forms of regulated entities.

CIM Urban reassessed the fair value of the underlying preferred stock instrument based on current market data and all relevant costs related to the security instrument. Based on available market data for preferred obligations of mortgage REIT's, the current market rate for public preferred stock instruments ranged from approximately 8% to 9% per annum. Furthermore, the preferred stock issued by the SSBIC is a privately held investment and has no call protection as it is redeemable at any time and a resultant yield expectation for the investment is estimated by CIM Urban to be approximately 10%. In addition, CIM Urban determined the annual cost to the SSBIC for the outstanding instrument ranged from approximately 10% to 11% based on the par value of $3.0 million. The preliminary estimate of fair value was also influenced by the projected carrying costs of the preferred instrument by CIM Urban relative to the redemption option, which is stipulated by the instrument as the $3.0 million par value.

Accordingly, CIM Urban's preliminary conclusion for the fair value of the SSBIC preferred stock held by the noncontrolling interest was $3.0 million in accordance with ASC 820 based on the various distinctive characteristics of the security instrument.

Note 4: Reclassification and Pro Forma Adjustments (N), page 33

11. We note that on page 33 you included an adjustment for incremental compensation expense that is based on the per share price of $8.78 on October 8, 2013 less the Special Dividend of $5.50 per share. Please clarify your basis for using a value of $3.28 per share to value these awards; explain why you believe it is appropriate to adjust the per share price of the PMC shares in your valuation.

Please see our response to Comment #6 regarding our discussion of the determination of the purchase price, including our consideration of the cash (Special Dividend) and share components of the purchase price, based on the required use of the acquiree (PMC Commercial) share price in accordance with ASC 805-30-30-2 in determining the Merger consideration. As noted therein, in determining the purchase price for the Merger, there are two independently determinable and measurable points of reference: (1) the quoted market price of the publicly traded PMC Commercial Common Shares, and (2) the contractual obligation to pay the Special Dividend of $5.50 per share to the record holders of PMC Commercial Common Shares prior to the effective date of the Merger, which is payable within 10 business days subsequent to the consummation of the Merger. As the PMC Commercial shareholders of record prior to the effective time of the Merger own the right to the Special Dividend, to be paid within 10 business days after consummation of the Merger, we assume that the value of the cash payment is reflected in the quoted market price of the PMC Commercial Common Shares for purposes of the pro forma financial statement presentation. Accordingly, in the absence of a more readily determinable measure, the equity consideration component of the total consideration provided to the PMC Commercial common shareholders was determined to be $3.40 per PMC Commercial Common Share. Such amount is independent and separate from the $5.50 per share Special Dividend.

ASC 718 establishes that the fair value of restricted stock should be the grant date price of the company's shares, reduced by the amount of dividends that the employees are not entitled to earn. Furthermore, with respect to the incremental compensation expense reflected in the unaudited Pro Forma Condensed Combined Financial Statements, the executives entitled to the incremental compensation as a result of the Merger are not entitled to the Special Dividend on any restricted share awards. Therefore, the $3.40 per share value of the equity consideration was utilized as the grant date fair value of the restricted shares. Given that the award is issued to only the two employees who are currently executives of PMC Commercial, the forfeiture rate was assumed to be zero over the two year vesting period.

Risk Factors, page 38

In connection with the proposed Merger …, page 42

12. We note your statement that the "allegations in the complaint are without merit." We note that this appears to be a legal conclusion that you are not qualified to make. Please provide an opinion of counsel upon which you are relying or remove this statement. Please make similar revisions throughout your registration statement as appropriate, including page 88.

The disclosure on page 43 and throughout the Registration Statement has been modified to indicate that PMC Commercial and CIM REIT management deny the allegations in the complaint and intend to vigorously defend against the allegations, thus eliminating any statement that may constitute a legal conclusion.

PMC Commercial and CIM Urban face other risks, page 60

13. We note your response to comment 22 of our letter dated September 27, 2013. We note your statement that "PMC Commercial and CIM Urban will face various other risks." Please remove this statement and clarify that all material risks are disclosed or incorporated by reference.

    The disclosure on page 61 has been modified, as requested.

The Merger, page 66

14. We note your response to comment 23 of our letter dated September 27, 2013. We continue to believe that you should revise to identify the third party that summarized the results of its due diligence report. Please revise accordingly.

    As previously indicated in Locke Lord's letter to the Staff dated October 11, 2013, the due diligence work performed by the third party service provider was only a part of the overall due diligence effort conducted by PMC Commercial with respect to CIM REIT. While PMC Commercial considered the conduct of its overall due diligence efforts important to its evaluation of the transaction, the due diligence performed by the third party service provider was no more important than that conducted by PMC Commercial's management, Sandler O'Neill or legal counsel on other aspects of CIM REIT. The due diligence conducted by the third party service provider was intended to confirm PMC Commercial's understanding of certain financial and tax aspects of CIM REIT; such due diligence revealed nothing materially negative about CIM REIT and therefore was not regarded as material by the Board of Trust Managers of PMC Commercial. Rather, the Board of Trust Managers was kept apprised by PMC Commercial's management of these and other due diligence efforts and results throughout the transaction evaluation process. As previously indicated in Locke Lord's response letter of October 11, the third-party service provider's summary of its due diligence work that was presented at the July 5 meeting of the Board of Trust Managers was included because the timing of the completion of its work happened to coincide with the time of that meeting. The summary did not convey any meaningful new information to the Board of Trust Managers, and the Board of Trust Managers did not consider the summary to be material in its evaluation of the transaction. Hence, the references to the summary on page 72 have been removed.

Transactional Services, page 107

15. We note your response to comment 28 of our letter dated September 27, 2013. Please revise your disclosure to state whether you intend to hire third parties to operate your business or whether you intend to rely primarily on affiliates. To the extent you intend to use affiliates to operate your business, please disclose the amounts you will pay to affiliates for providing these services. In addition, please revise to quantify the "certain agreed limits" referenced on the top of page 108.

PMC Commercial has revised the disclosure on page 109 to state that the Manager has not made any determination at this time as to whether third parties or affiliates will be retained to perform Transactional Services. In addition, the disclosure relating to "certain agreed limits" on page 109 has been changed to refer to the limitations as set forth in the CIM Urban Partnership Agreement.

Term, page 109

16. We note your disclosure that "removal of [the manager] will not, in and of itself, affect the rights of the Manager under the Master Services Agreement." Please clarify the rights that the manager will retain under the agreement and add a risk factor to address this risk, as applicable.

    The disclosure on page 111 has been revised to clarify the rights that the Manager will retain under the Master Services Agreement. In addition, the risk factor "Following the Merger, the Manager will have the right to manage the business of PMC Commercial and its subsidiaries pursuant to the Master Services Agreement…" on page 58 has been expanded to include this risk.

Investment Management Agreement, page 160

17. We note your response to comment 27 of our letter dated September 27, 2013. Please expand your disclosure in this section to disclose the role of your advisor after the merger.

    The disclosure on page 162 has been expanded to disclose the role of the Advisor after the Merger.

C IM Urban's Management's Discussion and Analysis, page 163

18. We note your response to comments 35 and 36 of our letter dated September 27, 2013. Please revise your disclosure in this section regarding new rents, tenant improvement costs and leasing commissions to provide information with respect to both new rents on second generation leases and renewed leases.

    We have revised our disclosure on page 167 to provide additional information regarding rental rates, tenant improvement costs and leasing commissions for new leases, renewals and in total.

Results of Operations, page 166

19. We note your response to comment 38 of our letter dated September 27, 2013. Please provide more detailed disclosure regarding the role CIM's board has in determining the ultimate property valuations.

    The disclosure on pages 170-171 has been expanded to clarify the role CIM's board has in determining property valuations.

Draft Tax Opinion 8.1

20. Please revise the disclosure in the "Material U.S. Federal Income Tax Consequences" section to state the relevant disclosure is the opinion of Locke Lord and likewise revise the opinion to state the disclosure in the registration statement is the opinion of counsel.

    We have revised the disclosure on pages 114-115 under "Material U.S. Federal Income Tax Consequences" to clarify that the entire section has been reviewed and opined upon by either Locke Lord or DLA Piper, and to clearly indicate which Firm reviewed each subsection. In addition, Locke Lord's draft Exhibit 8.1 tax opinion is revised to clarify that the portion of the disclosure reviewed by Locke Lord is the opinion of Locke Lord. The remainder of the disclosure is covered by the opinion of DLA Piper, as set forth in its Exhibit 8.2 tax opinion. Please note that revised drafts of the tax opinions are attached hereto as Exhibit A, which are marked to show the changes thereto from the prior drafts submitted with Locke Lord's last letter to the Staff dated October 11, 2013.

Draft Tax Opinion 8.2

21. Please have counsel revise the last paragraph to clarify that shareholders may rely on the opinion.

    The first sentence of the last paragraph of the opinion ("This opinion is rendered only to you and may not be quoted in whole or in part or otherwise referred to, nor be filed with, or furnished to, any other person or entity…") has been deleted, thus eliminating any suggestion that shareholders cannot rely upon the opinion.

If you have any questions regarding the above responses, please do not hesitate to contact the undersigned by phone at 214-740-8675 or by email at jmcknight@lockelord.com, or Mr. Jan Salit by phone at 972-349-3200, or by email at j.salit@pmctrust.com. We look forward to working with you to complete the Registration Statement. Thank you.

Very truly yours,

/s/ John B. McKnight

John B. McKnight

cc: Jan F. Salit

EXHIBIT A

Draft Tax Opinions Attached Hereto

[Locke Lord LLP Letterhead]

__, 2013

PMC Commercial Trust
17950 Preston Road, Suite 600
Dallas, Texas 75252

Ladies and Gentlemen:

We have acted as counsel to PMC Commercial Trust, a Texas real estate investment trust ("PMC Commercial"), in connection with the Special Dividend (defined below) and Merger (as defined below) as described in a Registration Statement on Form S-4, File No. 333-190934, and the related joint proxy statement/prospectus filed by PMC Commercial, Southfork Merger Sub, LLC, a Delaware limited liability company ("PMC Merger Sub"), CIM Urban REIT, LLC, a Delaware limited liability company ("CIM REIT"), and CIM Merger Sub, LLC, a Delaware limited liability ("CIM Merger Sub"), with the United States Securities and Exchange Commission on **November** __, 2013 (the "Registration Statement"). In connection with the filing of the Registration Statement, we have been asked to provide you with this letter regarding the United States federal income tax treatment of the Special Dividend (as defined below).

CIM REIT, CIM Merger Sub, PMC Commercial and PMC Merger Sub are parties to that certain Agreement and Plan of Merger, dated July 8, 2013 (as amended, the "Merger Agreement"). Pursuant to the Merger Agreement, CIM Merger Sub will merge with and into PMC Merger Sub (the "Merger"). Pursuant to the Merger Agreement, the board of trust managers of PMC Commercial will declare a dividend to be paid to the holders of PMC Commercial common shares (each, a "PMC Commercial Common Share") as of the last business day prior to consummation of the Merger, providing for the payment of $5.50 per PMC Commercial Common Share plus that portion of PMC Commercial's regular quarterly dividend accrued through that day, which in accordance with the terms of the Merger Agreement shall be payable on or prior to the tenth business day after consummation of the Merger (the "Special Dividend").

In rendering our opinion, we are relying upon the accuracy and completeness at all relevant times of the facts, information, statements, representations, warranties and covenants contained in (i) the Merger Agreement, (ii) the Registration Statement, and (iii) such other information and documentation as we have deemed necessary or appropriate. In addition, we have assumed that the Special Dividend will be paid in the manner contemplated by, and in accordance with the provisions of, the Merger Agreement and the Registration Statement, and that none of the terms or conditions contained in the Merger Agreement will be waived or modified.

Subject to the assumptions, exceptions, qualifications and limitations stated herein and in the Registration Statement, we **are of the opinion that** the conclusions of law with respect to United States federal income tax matters set forth in the Registration Statement under the subheading "Tax Consequences to PMC Commercial Shareholders of the Special Dividend" (which is a subsection of the discussion under the heading "Material U.S. Federal Income Tax Consequences") are accurate and complete in all material respects.

We express no opinion as to any matter not discussed in the Registration Statement under the subheading "Tax Consequences to PMC Commercial Shareholders of the Special Dividend." Our opinion is limited to the federal income tax laws of the United States and does not purport to discuss the consequences or treatment of the Special Dividend under any other laws.

Our opinion is rendered to you as of the effective date of the Registration Statement, and we undertake no obligation to update our opinion subsequent to the date hereof. Our opinion is based upon current provisions of the Internal Revenue Code of 1986, as amended, existing Treasury regulations thereunder, current administrative rulings of the Internal Revenue Service (the "IRS"), and court decisions, all of which are subject to change at any time possibly with retroactive effect. Any change in applicable law or facts and circumstances surrounding the Special Dividend, or any inaccuracy or incompleteness in the statements, facts, information, assumptions, representations, warranties or covenants on which our opinion is based could affect our conclusions. Our opinion is not binding on the IRS or the courts, and no ruling has been, or will be, obtained from the IRS as to any federal income tax consequences of the Special Dividend.

We hereby consent to the filing of this opinion as an exhibit to the Registration Statement and to the use of our name in the Registration Statement. This consent does not constitute an admission that we are "experts" within the meaning of such term as used in the Securities Act of 1933, as amended, or the rules and regulations of the Securities and Exchange Commission issued thereunder.

Very truly yours,

DRAFT

LOCKE LORD LLP

DLA Piper LLP (US)
203 North LaSalle Street, Suite 1900
Chicago, Illinois 60601-1293
T 312.368.4000
F 312.236.7516
W www.dlapiper.com

~~October 11~~November , 2013

PMC Commercial Trust
17950 Preston Road, Suite 600
Dallas, Texas 75252

CIM Urban REIT, LLC
6922 Hollywood Blvd.
Ninth Floor
Los Angeles, CA 90028

Ladies and Gentlemen:

We have acted as counsel to CIM Urban REIT, LLC, a Delaware limited liability company ("CIM REIT"), in connection with the Merger (defined below) as described in a Registration Statement on Form S–4, File No. 333-190934, and the related joint proxy statement/prospectus filed by PMC Commercial (as defined below), PMC Merger Sub (as defined below), CIM REIT and CIM Merger Sub (as defined below) with the U.S. Securities and Exchange Commission (the "SEC") on ~~October 11~~November 15, 2013 (the "Registration Statement"). This opinion letter is furnished to you at your request to enable PMC Commercial to fulfill the requirements of Item 601(b)(8) of Regulation S-K, 17 C.F.R. § 229.601(b)(8), in connection with the Registration Statement.

CIM REIT, CIM Merger Sub, LLC, a Delaware limited liability company and a subsidiary of CIM REIT ("CIM Merger Sub"), PMC Commercial Trust, a Texas real estate investment trust ("PMC Commercial"), and Southfork Merger Sub, LLC, a Delaware limited liability company and wholly owned subsidiary of PMC Commercial ("PMC Merger Sub"), are parties to the Agreement and Plan of Merger, dated July 8, 2013 (as it may be amended from time to time, the "Merger Agreement").

Pursuant to the Merger Agreement, CIM Merger Sub will merge with and into PMC Merger Sub (the "Merger"), with PMC Merger Sub surviving the Merger as a direct, wholly owned subsidiary of PMC Commercial. CIM REIT and PMC Commercial have requested our opinion with respect to the matters set forth below.

In connection with rendering the opinion expressed below, we have examined originals (or copies identified to our satisfaction as true copies of the originals) of the following documents (collectively, the "Reviewed Documents"):

(1) The Registration Statement;

(2) CIM REIT's limited liability company agreement;

(3) The Merger Agreement; and

(4) Such other documents as may have been presented to us by CIM REIT from time to time.

In addition, we have relied upon the factual representations contained in the certificate issued by PMC Commercial, dated as of the date thereof, executed by a duly appointed officer of PMC Commercial, setting forth certain representations relating to the organization and proposed operation of PMC Commercial and its subsidiaries.

For purposes of our opinion, we have not made an independent investigation of the facts set forth in the documents we reviewed. We consequently have assumed that the information presented in such documents or otherwise furnished to us accurately and completely describes all material facts relevant to our opinion. No facts have come to our attention, however, that would cause us to question the accuracy and completeness of such facts or documents in a material way. Any representation or statement in any document upon which we rely that is made "to the best of our knowledge" or otherwise similarly qualified is assumed to be correct. Any alteration of such facts may adversely affect our opinion.

In our review, we have assumed, with your consent, that all of the representations and statements of a factual nature set forth in the documents we reviewed are true and correct, and all of the obligations imposed by any such documents on the parties thereto have been and will be performed or satisfied in accordance with their terms. We have also assumed the genuineness of all signatures, the proper execution of all documents, the authenticity of all documents submitted to us as originals, the conformity to originals of documents submitted to us as copies, and the authenticity of the originals from which any copies were made.

The opinion set forth in this Letter is based on relevant provisions of the Code, the regulations promulgated thereunder by the United States Department of the Treasury ("Regulations") (including proposed and temporary Regulations), and interpretations of the foregoing as expressed in court decisions, the legislative history, and existing administrative rulings and practices of the Internal Revenue Service ("IRS"), including its practices and policies in issuing private letter rulings, which are not binding on the IRS except with respect to a taxpayer that receives such a ruling, all as of the date hereof.

In rendering this opinion, we have assumed that the transactions contemplated by the Reviewed Documents have been or will be consummated in accordance with the terms and provisions of such documents, and that such documents accurately reflect the material facts of such transactions. In addition, the opinion is based on the assumption that PMC Commercial and its subsidiaries (if any) will each be operated in the manner described in the Declaration of Trust of PMC Commercial and the other organizational documents of each such entity and their subsidiaries, as the case may be, and all terms and provisions of such agreements and documents will be complied with by all parties thereto.

It should be noted that statutes, regulations, judicial decisions, and administrative interpretations are subject to change at any time and, in some circumstances, with retroactive effect. A material change that is made after the date hereof in any of the foregoing bases for our opinion could affect our conclusions. Furthermore, if the facts vary from those relied upon (including any representations, warranties, covenants or assumptions upon which we have relied are inaccurate, incomplete, breached or ineffective), our opinion contained herein could be inapplicable. Moreover, the qualification and taxation of PMC Commercial as REIT depends upon its ability to meet, through actual annual operating results, distribution levels and diversity of share ownership and the various qualification tests imposed under the Code, the results of which will not be reviewed by the undersigned. Accordingly, no assurance can be given that the actual results of the operations of PMC Commercial for any one taxable year will satisfy such requirements.

Based upon and subject to the foregoing, we are of the opinion that the conclusions of law with respect to the United States federal income tax matters set forth in the Registration Statement under the heading “Material U.S. Federal Income Tax Consequences,” excluding the matters set forth under the subheading “Tax Consequences to PMC Commercial Shareholders of the Special Dividend” (for which Locke Lord LLP, counsel to PMC Commercial, shall render an opinion) are accurate and complete in all material respects.

The foregoing opinion is limited to the matters specifically discussed herein, which are the only matters to which you have requested our opinion. Other than as expressly stated above, we express no opinion on any issue relating to the Company or to any investment therein.

We assume no obligation to advise you of any changes in the foregoing subsequent to the date of this Letter, and we are not undertaking to update this Letter from time to time. You should be aware that an opinion of counsel represents only counsel’s best legal judgment, and has no binding effect or official status of any kind, and that no assurance can be given that contrary positions may not be taken by the IRS or that a court considering the issues would not hold otherwise.

~~This opinion is rendered only to you and may not be quoted in whole or in part or otherwise referred to, nor be filed with, or furnished to, any other person or entity in connection with the Registration Statements, except as follows.~~ We hereby consent to the filing of this opinion as an exhibit to the Registration Statement under the Securities Act of 1933, as amended, pursuant to Item 601(b)(8) of Regulation S-K, 17 C.F.R § 229.601(b)(8), and the reference to DLA Piper LLP (US) contained under the heading “Material U.S. Federal Income Tax Consequences” in the Registration Statement. In giving this consent, we do not admit that we are included in the category of persons whose consent is required under Section 7 of the Securities Act of 1933, as amended, or the rules and regulations of the Securities and Exchange Commission thereunder.

Very truly yours,

DRAFT

DLA Piper LLP (US)

2200 Ross Avenue, Suite 2200
Dallas, Texas 75201
Telephone: 214-740-8000
Fax: 214-740-8800
www.lockelord.com

John B. McKnight
Direct Telephone: 214-740-8675
Direct Fax: 214-756-8675
jmcknight@lockelord.com

December 17, 2013

VIA EDGAR AND FEDEX

Jessica Barberich
Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, D.C. 20549

Re: PMC Commercial Trust
Registration Statement on Form S-4
Initially filed August 30, 2013
File No. 333-190934

Dear Ms. Barberich:

Set forth below are the responses of PMC Commercial Trust ("**PMC Commercial**") to the Staff's comment letter dated December 13, 2013 (the "**Comment Letter**") regarding Amendment No. 2 to the referenced Registration Statement on Form S-4, which was filed on November 20, 2013 ("**Amendment No. 2**").

For your convenience, we have set forth below the Staff's comments followed by PMC Commercial's responses thereto in bold typeface. The numbered paragraphs and headings below correspond to the numbered paragraphs and headings contained in the Comment Letter. The page numbers referenced below refer to the page numbers of Amendment No. 3 to the referenced Registration Statement on Form S-4 (the "**Registration Statement**"), which is filed herewith. Capitalized terms used but not defined herein have the meanings given to such terms in the Registration Statement.

To expedite your review, we are sending to you and Jennifer Gowetski via FedEx a copy of this letter, together with clean and marked copies of the Registration Statement showing changes made to Amendment No. 2.

General

1. We note your response to comment 2 of our letter dated November 1, 2013, including your reference to your Declaration of Trust. Please file a copy of your Declaration of Trust.

   We have filed the Declaration of Trust and the amendments thereto as Exhibit 3.1 to the Registration Statement in lieu of incorporating those documents by reference.

2. Please tell us whether CIM shareholders have approved this transaction, and, if applicable, how such approval was obtained. We may have further comment.

In accordance with the Delaware Limited Liability Company Act (the "DLLCA") and as discussed below, the only shareholder approval required by the CIM Group is the approval by Urban II as the sole member of CIM Merger Sub. This matter will be presented to Urban II for its approval after the Registration Statement is declared effective by the Staff.

The transaction set forth in the Registration Statement involves the issuance of the common shares and preferred shares of PMC Commercial in connection with the merger of CIM Merger Sub with and into PMC Merger Sub, with PMC Merger Sub being the surviving entity. Each of CIM Merger Sub and PMC Merger Sub are Delaware limited liability companies, so the provisions of the DLLCA govern the Merger.

Section 18-209(b) of the DLLCA provides as follows:

> **(b) Pursuant to an agreement of merger or consolidation, 1 or more domestic limited liability companies may merge or consolidate with or into 1 or more domestic limited liability companies or 1 or more other business entities formed or organized under the laws of the State of Delaware or any other state or the United States or any foreign country or other foreign jurisdiction, or any combination thereof, with such domestic limited liability company or other business entity as the agreement shall provide being the surviving or resulting domestic limited liability company or other business entity. Unless otherwise provided in the limited liability company agreement, a merger or consolidation shall be approved by each domestic limited liability company which is to merge or consolidate by the members or, if there is more than one class or group of members, then by each class or group of members, in either case, by members who own more than 50 percent of the then current percentage or other interest in the profits of the domestic limited liability company owned by all of the members or by the members in each class or group, as appropriate.**

In accordance with Section 18-209(b) of the DLLCA and given the absence of a merger voting provision in CIM Merger Sub's limited liability company agreement, the approval of Urban II as the sole member of CIM Merger Sub is required to approve consummation of the Merger. None of the governing documents of CIM REIT, CIM Urban or any other entity within CIM Group require shareholder approval of the Merger, so Urban II's approval is the sole shareholder approval required by the entities comprising CIM Group to consummate the Merger. The approval of the Merger is contemplated by the second sentence of CIM REIT's representation and warranty in Section 5.4 of the Merger Agreement, which provides that: "The execution and delivery of this Agreement by each of CIM [REIT] and CIM Merger Sub and the consummation by each of CIM [REIT], CIM Merger Sub and each CIM Subsidiary of the Transactions to which it is a party have been duly authorized by all necessary limited liability company or other action on the part of CIM [REIT], CIM Merger Sub and each such CIM Subsidiary, subject to approval of this Agreement by CIM [REIT] in its capacity as sole member of CIM Merger Sub." As set forth in the Consent and Waiver entered into as of November 20, 2013, Urban II is replacing CIM REIT as the sole member of CIM Merger Sub. Accordingly, Urban II will be presented with the decision to approve the Merger, as contemplated by the DLLCA and the Merger Agreement, after the Registration Statement has been declared effective.

Estimated Transaction Fees, page 19

3. We note footnote (1) on page 19. Please revise to briefly explain what you mean by "non-fee transaction costs."

We have revised the disclosure on pages 19-20 to clarify the nature of the "non-professional fee transaction costs."

Markets Overview, page 143

4. We note your revised disclosure stating that you cannot assure the accuracy or completeness of the data prepared by REIS and STR or other sources. This statement appears to disclaim the issuer's responsibility for information in the registration statement. As this is not consistent with the liability provisions of the Securities Act, please revise the disclosure to remove this disclaimer. We would not object to a statement, if accurate, that you have not verified the accuracy or completeness of this third-party data.

The sentence on page 144 has been deleted and replaced with the following sentence: "Neither PMC Commercial nor the CIM Group has verified the accuracy or completeness of the information provided by these sources."

Note 10: Commitments and Contingencies, page F-38

5. Please revise your disclosure related to the class action lawsuit to provide an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made. Please see ASC 450-20-50 for reference.

The last sentence of the Litigation paragraph on page F-38 has been updated to read as follows: "However, no assurance can be given as to the outcome of this lawsuit and the Partnership cannot estimate the possible loss or range of loss arising from the lawsuit."

If you have any questions regarding the above responses, please do not hesitate to contact the undersigned by phone at 214-740-8675 or by email at jmcknight@lockelord.com, or Mr. Jan Salit by phone at 972-349-3200, or by email at j.salit@pmctrust.com. We look forward to working with you to complete the Registration Statement. Thank you.

Very truly yours,

/s/ John B. McKnight

cc: Jan F. Salit

GOODWIN | PROCTER

Goodwin Procter LLP
Counsellors at Law
The New York Times Building
620 Eighth Avenue
New York, NY 10018

T: 212.813.8800
F: 212.523.3333
goodwinprocter.com

August 9, 2013

VIA EDGAR TRANSMISSION

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, NE
Washington, D.C. 20549

Attention: Tom Kluck, Branch Chief
Angela McHale

Re: Mid-America Apartment Communities, Inc.
Registration Statement on Form S-4
Filed July 19, 2013
File No. 333-190027

Mid-America Apartments, L.P.
Registration Statement on Form S-4
Filed July 19, 2013
File No. 333-190028

Ladies and Gentlemen:

This letter is submitted on behalf of Mid-America Apartment Communities, Inc. ("MAA") and Mid-America Apartments, L.P. ("MAA LP") in response to the comments of the staff of the Division of Corporation Finance of the Securities and Exchange Commission (the "Staff") as set forth in your letter to H. Eric Bolton, Jr., dated August 8, 2013, with respect to MAA's and MAA LP's registration statements on Form S-4 filed on July 19, 2013 (the "Registration Statements").

For reference purposes, the text of the Staff's comment has been reproduced herein with our response below.

1. *We note that part of the business combinations involves Colonial Realty Limited Partnership merging with Mid America Apartments L.P. (the "Partnership Merger"), whereby each limited partner interest in Colonial LP will be cancelled and converted into Class A Common Units in MAA LP. We note that this Partnership Merger is separate from the parent REIT merger. It appears that the Partnership Merger may constitute a roll-up transaction that would be subject to Subpart 900 of Regulation S-K. Please provide all the disclosure and other relevant information required by Subpart 900 or provide us with a supplemental analysis as to why you do not believe that this transaction constitutes a roll-up transaction.*

Response to Comment No. 1

As an initial matter, we respectfully advise the Staff that we do not believe that either MAA LP or Colonial Realty Limited Partnership ("Colonial LP") are "partnerships" as defined in Item 901(b) of Regulation S-K and the roll-up rules thus do not apply to the Partnership Merger. Moreover, even if it were determined that either or both MAA LP and/or Colonial LP are "partnerships" as defined in Item 901(b), we believe that at least three of the exemptions provided in Item 901(c)(2) would be applicable to exempt the Partnership Merger from applicability of the roll-up rules.

A. Definition of "Partnership". For the purposes of the 900 Series of Regulation S-K, a "partnership" is defined in Item 901(b)(2)(i) as a "finite life limited partnership", further defined as an entity that:

(A) "operates as a conduit vehicle for investors to participate in the ownership of assets for a limited period of time;" and

(B) "has a policy or purpose of distributing to investors proceeds from the sale, financing or refinancing of assets or cash from operations, rather than reinvesting such proceeds or cash in the business."

With respect to the "finite life" requirement, MAA LP's Second Amended and Restated Agreement of Limited Partnership (the "MAA LP Partnership Agreement") provides that the term of MAALP will continue until December 31, 2053, unless it is sooner dissolved by reason of other provisions of the partnership agreement. Similarly, Colonial LP's Fourth Amended and Restated Agreement of Limited Partnership (the "Colonial LP Partnership Agreement") provides for an even longer term, ending December 31, 2092. While both MAA LP and Colonial LP are thus nominally "finite life" entities, they are not practically the type of entity the 900 Series rules were intended to cover, inasmuch as the life of both partnerships effectively only terminate upon the sale of all or substantially all of the applicable partnership's assets and limited partners would not view the remaining terms of 40 to 80 years as a "limited period of time."

Even if MAALP or Colonial LP were deemed to have a "finite life," neither MAA LP nor Colonial LP has as a policy or purpose distributing to investors proceeds from the sale, financing or refinancing of assets or cash from operations. Each of these entities is the operating partnership in an UPREIT structure and, as such, makes quarterly distributions to enable its principal limited partner, the public REIT, to distribute its REIT-taxable income each year as required by applicable tax laws. Item 901(b)(2)(ii) of Regulation S-K specifically acknowledges that the requirement that a REIT distribute its net income does not mean that a REIT will be deemed to be a "partnership," so long as it does not have a policy of distributing the proceeds of sales, financings, or refinancing of assets. This principle applies equally to the operating partnership through which a REIT owns and operates its assets. Moreover, pursuant to the MAA LP Partnership Agreement and Colonial LP Partnership Agreement, respectively, each of Colonial LP and MAA LP may reinvest such proceeds or operating cash flow in the business for the following:

- investments in any entity (including loans);

- certain cash expenditures, including capital expenditures; and
- increases in reserves which the general partner of MAA LP or the general partner of Colonial LP, as applicable, determines, in its sole discretion, is necessary or appropriate.

Accordingly, neither the Colonial LP Partnership Agreement nor the MAA LP Partnership Agreement can be said to have a policy or the purpose of distributing sales and financing proceeds or operating cash flow to investors within the meaning of Item 901(b). Rather, under the terms of their respective partnership agreements, subject to the policy of making distributions sufficient to enable their REIT partners to distribute their net income, MAA LP and Colonial LP have the ability and the policy of investing proceeds from financings and sales and operating cash flow in their respective businesses.

B. Item 901(c)(2) Exemptions. Even if it were to be determined that either MAA LP or Colonial LP falls within the definition of a "partnership" under Item 901(b), we believe that each of the exemptions to the roll-up rules provided by Items 901(c)(2)(iii), 901 (c)(2)(iv) and 901(c)(2)(vii) would be applicable to the Partnership Merger.

Item 901(c)(2)(iii). Item 901(c)(2)(iii) exempts transactions that involve "only issuers that are not required to register or report under Section 12 of the Securities Exchange Act of 1934, both before and after the transaction". In the context of the Partnership Merger, MAA LP is not, nor will be, required to report under Section 12, either before or after the Partnership Merger.

Item 901(c)(2)(iv). Item 901(c)(2)(iv) exempts transactions where a non-affiliated party succeeds to the interests of a general partner or sponsor, if:

(A) such action is approved by not less than 66-2/3% of the outstanding units of each of the participating partnerships; and

(B) as a result of the transaction, the existing general partners will receive only compensation to which they are entitled as expressly provided for in the preexisting partnership agreements.

In the context of the Partnership Merger, Colonial LP will become a wholly-owned subsidiary of MAA LP and MAA LP, an unaffiliated party, will succeed to the interests of Colonial Properties Trust, as general partner. In addition, (A) pursuant to the terms of the merger agreement as described in the Registration Statements, the Partnership Merger will only be consummated if approved by at least 66 2/3% of the outstanding units of each of MAA LP and Colonial LP, and (B) MAA and Colonial, as general partners of MAA LP and Colonial LP, respectively, will receive only the compensation to which they are entitled to under the terms of the of the preexisting MAA LP Partnership Agreement and the Colonial LP Partnership Agreement.

Item 901(c)(2)(vii). Item 901(c)(2)(vii) exempts transactions in which the investors are not subject to a significant adverse change with respect to voting rights, the terms of existence of the entity, management compensation or investment objectives. Under the terms of the merger agreement as described in the Registration Statements, in the Partnership Merger neither MAA LP unitholders nor Colonial LP unitholders will be subject to a significant adverse change with respect to voting rights, the terms of existence of the entity, management compensation or investment objectives as a result of the Partnership Merger. Specifically, each MAA LP unit held by MAA LP unitholders immediately prior to the Partnership Merger will continue to represent one MAA LP unit after the Partnership Merger. Immediately prior to the Partnership Merger, MAA LP's limited partnership agreement will also be amended and restated on terms that are substantially similar to those contained in Colonial LP's current partnership agreement. As a result, the rights of Colonial LP unitholders upon the closing of the partnership merger will be substantially similar to the current rights of Colonial LP unitholders. In addition, the differences between the existing MAA LP limited partnership agreement and the form of partnership agreement which will be in effect following consummation of the Partnership Merger, as described in the Registration Statements, are not sufficiently material in the sense that they could be said to subject MAA LP unitholders to a significant adverse change with respect to voting rights, the term of existence of the entity, management compensation or investment objectives.

If you should have any questions concerning the enclosed matters, please contact the undersigned at (212) 813-8831.

Very truly yours,

/s/ Yoel Kranz

Yoel Kranz

Cc: H. Eric Bolton
Albert M. Campbell, III
Mid-America Apartment Communities, Inc.
Mid-America Apartments, L.P.
Gilbert G. Menna
Mark S. Opper
Goodwin Procter LLP

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP
500 BOYLSTON STREET
BOSTON, MASSACHUSETTS 02116-3727

TEL: (617) 573-4800
FAX: (617) 573-4822
www.skadden.com

DIRECT DIAL
(617) 573-4859
DIRECT FAX
(617) 305-4859
EMAIL ADDRESS
margaret.cohen@skadden.com

November 24, 2014

VIA EDGAR AND OVERNIGHT COURIER

United States Securities and Exchange Commission
Division of Corporate Finance
100 F Street, N.E.
Washington, D.C. 20549

Attention: Jennifer Gowetski, Special Counsel

Re: Select Income REIT
Registration Statement on Form S-4
Filed October 17, 2014
File No. 333-199445

Dear Ms. Gowetski:

On behalf of Select Income REIT ("SIR"), we are hereby responding to comments of the staff (the "Staff") of the United States Securities and Exchange Commission (the "Commission") contained in your letter dated November 14, 2014 in connection with the above-captioned registration statement (the "Registration Statement"). Amendment No. 1 to the Registration Statement is being filed simultaneously with this response (the "Amended Registration Statement"). For the convenience of the Staff, we are also enclosing clean and marked copies of the Amended Registration Statement.

Your numbered comments with respect to the Registration Statement have been reproduced below in italicized text. SIR's responses thereto are set forth immediately following the reproduced comment to which they relate. Information below regarding Cole Corporate Income Trust, Inc. ("CCIT") and its affiliates has been provided to SIR by CCIT.

General

1. *Please provide us with copies of any non-public information, including board books, financial forecasts, and projections, presented to the board and/or the independent directors or trustees of Select Income REIT or Cole Corporate Income Trust, Inc. by their respective management and financial advisors in connection with the proposed transaction.*

Response: In response to the Staff's comment, on behalf of SIR, counsel to UBS Securities LLC ("UBS") is providing to the Staff, under separate cover and on a confidential and supplemental basis pursuant to Rule 418 under the Securities Act of 1933, as amended (the "Securities Act") and Rule 12b-4 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), copies of the written materials presented by UBS in connection with its opinions, each dated August 30, 2014, to the SIR board of trustees. In response to the Staff's comment, on behalf of CCIT, counsel to each of Wells Fargo Securities, LLC ("Wells Fargo Securities") and Hentschel & Company, LLC ("Hentschel & Company") is providing to the Staff, under separate cover and on a confidential and supplemental basis pursuant to Rule 418 under the Securities Act and Rule 12b-4 under the Exchange Act, copies of the written materials presented by Wells Fargo Securities and Hentschel & Company in connection with their respective opinions, each dated August 30, 2014, to the CCIT board of directors. Also pursuant to such rules, the respective counsel for each of UBS, Wells Fargo Securities and Hentschel & Company has requested that these materials be returned promptly following completion of the Staff's review thereof. By separate letters, the respective counsel for each of UBS, Wells Fargo Securities and Hentschel & Company also has requested confidential treatment of this information in accordance with Rule 83 of the Commission's Rules on Information and Requests, 17 C.F.R. § 200.83.

Summary, page 12

2. *Refer to the Schedule TO filed by CMG Partners, LLC and affiliates on November 4, 2014, as amended. Please revise your disclosure to address the offer. Ensure that disclosure included in the proxy statement/prospectus is consistent with disclosure that will be included in Cole Corporate Income Trust, Inc.'s recommendation statement on Schedule 14d-9.*

Response: In response to the Staff's comment, the following section has been added to the Summary of the Amended Registration Statement on page 28: "Summary — The CCIT Board of Directors Recommends that CCIT Stockholders Reject the Unsolicited Tender Offer by CMG Partners, LLC."

3. *Please include a description of the material transaction fees that have been and will be incurred in connection with this transaction. Please clarify which fees are contingent on approval and consummation of the merger.*

Response: In response to the Staff's comment, the following section has been added to the Summary of the Amended Registration Statement on page 27: "Summary — Estimated Transaction Fees."

4. *Please include a discussion as the tax consequences of the healthcare properties purchase and sale, or tell us why you believe such disclosure is not material. Please provide similar disclosure in the "Material United States Federal Income Tax Considerations" section starting on page 155.*

Response: In response to the Staff's comment, the disclosure on pages 27-28 and 171-172 has been revised in the Amended Registration Statement. Additionally, SIR respectfully directs the Staff's attention to the existing disclosure regarding the Healthcare Properties Sale under the headings "Material United States Federal Income Tax Considerations — Material United States Federal Income Tax Consequences of the Merger — Material United States Federal Income Tax Consequences of the Merger to CCIT and SIR" beginning on page 162, and "Material United States Federal Income Tax Considerations — Material United States Federal Income Tax Considerations Related to SIR Common Shares — REIT Qualification Requirements — Income Tests" beginning on page 169, of the Amended Registration Statement.

Recent Developments, page 27

5. *Please update your disclosure under this heading to reference the pending tender offer by CMG Partners, LLC and affiliates for up to 2,000,000 shares of CCIT.*

Response: Please see the response to Comment 2 above.

Unaudited Pro Forma Condensed Consolidated Financial Information, page 31

Notes to Unaudited Pro Forma Condensed Consolidated Financial Information, page 35

(2) The Merger and Related Transactions, page 35

6. *Please revise your disclosure to discuss how you determined fair value of the assets acquired and liabilities assumed. Additionally, please revise your disclosure to clarify if you considered bargain renewal options periods in your valuation of below market lease liabilities.*

Response: In response to the Staff's comment, the disclosure on pages 38-39 has been revised in the Amended Registration Statement. Additionally, SIR respectfully advises the Staff that SIR did not identify any bargain renewal options in the CCIT portfolio.

(3) Notes to Unaudited Pro Forma Condensed Consolidated Balance Sheet Adjustments, page 37

7. *We note your adjustments (A) and (B), please narratively clarify that the aggregate of these two columns is consistent with the net purchase price allocation provided in note (2).*

Response: In response to the Staff's comment, the disclosure on page 41 has been revised in the Amended Registration Statement.

8. *Please revise your description of your adjustment (C) to explain the $7.9 million adjustment to deferred financing costs.*

Response: In response to the Staff's comment, the disclosure on page 41 has been revised in the Amended Registration Statement.

(4) Notes to Unaudited Pro Forma Condensed Consolidated Statements of Income, page 40

9. *We note your adjustment for interest expense in column (E). Please clarify for us and in your filing the nature of the $4.6 million increase in mortgage interest.*

Response: As disclosed in the Registration Statement, SIR expects to assume approximately $297.7 million of CCIT's secured mortgage debt in the transaction. The $4.6 million increase in mortgage interest relates to this mortgage debt. Additionally, the disclosure under the heading "Summary — Unaudited Pro Forma Condensed Consolidated Financial Information — Notes to Unaudited Pro Forma Condensed Consolidated Financial Information — (4) Notes to Unaudited Pro Forma Condensed Consolidated Statements of Income" on page 42 has been revised in the Amended Registration Statement to include this clarification.

10. *We note your adjustment for interest expense in column (E). Please revise your disclosure to also disclose the applicable amounts for the six months ended June 30, 2014.*

Response: In response to the Staff's comment, the disclosure on page 42 has been revised in the Amended Registration Statement. Please note that the pro forma financial information has been updated to reflect September 30, 2014 interim financial information.

11. We note your footnote (2) to adjustment (G). Please revise to disclose the amount of these fees.

Response: In response to the Staff's comment, the disclosure on page 43 has been revised in the Amended Registration Statement.

Property Portfolio Information, page 70

Combined Company, page 70

12. We refer to footnote 3 to the series of tables beginning on page 70. Please revise to clarify whether tenant concessions are reflected in annualized rental revenue and explain briefly how you estimated recurring expense reimbursements. To the extent tenant concessions are not reflected in annualized rental revenue, please revise to include footnote disclosure quantifying such concessions.

Response: In response to the Staff's comment, the footnote on page 77 has been revised in the Amended Registration Statement.

The SIR Special Meeting, page 82

13. Please confirm that shareholder approval is not required for the Healthcare Properties Sale or advise.

Response: In response to the Staff's comment, SIR confirms that shareholder approval is not required for the Healthcare Properties Sale.

The Merger, page 91

Background of the Merger and the Related Transactions, page 91

14. We refer to the April 15, 2014 meeting at which representatives from Wells Fargo Securities discussed with CCIT's board of director potential strategic options for CCIT. We note that the CCIT board determined to move forward with a targeted third party solicitation process. Please discuss in greater detail why the other strategic options presented by Wells Fargo Securities were not pursued, and why the board felt that a third party solicitation process was in the best interests of CCIT shareholders at that time.

Response: In response to the Staff's comment, the disclosure on page 94 has been revised in the Amended Registration Statement.

15. We note the disclosure on page 100 regarding discussions concerning the sale of the Healthcare Properties. Please revise to describe any discussions proposing such sale and relating to SIR's decision not to absorb those properties in the merger.

Response: In response to the Staff's comment, the disclosure on page 102 has been revised in the Amended Registration Statement.

16. Please discuss whether each respective board believes that the transaction or consideration is fair form a financial point of view.

Response: As disclosed in the Registration Statement, the decision of the SIR board of trustees on August 30, 2014 to approve, adopt, declare advisable and enter into the Merger Agreement was the result of the review and careful consideration of many factors, including the opinion of UBS, dated August 30, 2014, to the effect that, as of that date and based on and subject to the matters described therein, the per share consideration to be paid by SIR in the Merger was fair, from a financial point of view, to SIR. Implicit in such determination of the SIR board of trustees is the SIR board of trustees' view that the per share consideration to be paid by SIR in the Merger was fair, from a financial point of view, to SIR.

As disclosed in the Registration Statement, the decision of the CCIT board of directors on August 30, 2014 to approve, adopt, declare advisable and enter into the Merger Agreement was the result of the review and careful consideration of many factors, including the opinions of Wells Fargo Securities and Hentschel & Company, each dated August 30, 2014, to the effect that, as of that date and based on and subject to the matters described therein, the consideration to be received by CCIT stockholders in the Merger was fair, from a financial point of view, to such holders. Implicit in such determination of the CCIT board of directors is the CCIT board of directors' view that the consideration to be received by CCIT stockholders in the Merger was fair, from a financial point of view, to CCIT stockholders.

Opinion of SIR's Financial Advisor Regarding the Merger, page 113

17. We note that UBS's opinions were delivered on August 30, 2014. Please disclose whether any material changes in Select Income REIT's or Cole Corporate Income Trust, Inc.'s operations, performance, or in any of the projections or assumptions upon which UBS based its opinions have occurred since the delivery of the opinion or that are anticipated to occur before the Select Income REIT shareholder meeting.

Response: In response to the Staff's comment, the disclosure on pages 108 and 113 has been revised in the Amended Registration Statement.

Select Public Companies Analysis, Page 116

18. *Please disclose in more detail the criteria used to select the public companies used. If any company met the criteria but was excluded from the analysis, please identify the company and explain why it was excluded. Please provide similar disclosure in the "Selected Precedent Transactions Analysis" section on page 117, the "Selected Public Companies Analysis" section on page 123, and the "Selected Precedent Transactions Analysis" on page 124.*

Response: In response to the Staff's comment, the disclosure on pages 117-119 and 124-126 has been revised in the Amended Registration Statement.

19. *Please revise your disclosure to clarify how estimated FFO and AFFO values of comparable companies were calculated, including whether the FFO values were all calculated in accordance with the NAREIT FFO definition. Please include similar disclosure in the "Selected Public Companies Analysis" section starting on page 123 as well as throughout the registration statement when providing comparable company analysis.*

Response: In response to the Staff's comment, the disclosure on pages 117 and 122-124 has been revised in the Amended Registration Statement.

Discounted Cash Flow Analysis — CCIT Standalone, including Potential Net Synergies, page 118

20. *Please discuss in greater detail the assumptions used in this discounted cash flow analysis. Please provide similar disclosure in the "Discounted Cash Flow Analysis — SIR Standalone" section on page 118.*

Response: In response to the Staff's comment, the disclosure on pages 119-120 has been revised in the Amended Registration Statement.

Opinion of SIR's Financial Advisor Regarding the Healthcare Properties Sale — Miscellaneous, page 125

21. *Please disclose the amount of compensation UBS has received from Select Income REIT, Cole Corporate Income Trust, Inc., and their respective affiliates in the last two years for the services disclosed in this section or advise.*

Response: In response to the Staff's comment, the disclosure on page 128 has been revised in the Amended Registration Statement.

Opinion of CCIT's Financial Advisors — Wells Fargo Securities, LLC, page 129

22. *We note that Wells Fargo's opinion was delivered on August 30, 2014. Please disclose whether any material changes in Select Income REIT's or Cole Corporate Income Trust, Inc.'s operations, performance, or in any of the projections or assumptions upon which Wells Fargo based its opinion have occurred since the delivery of the opinion or that are anticipated to occur before the Cole Corporate Income Trust, Inc. stockholder meeting.*

Response: In response to the Staff's comment, the disclosure on pages 108 and 113 has been revised in the Amended Registration Statement.

CCIT Financial Analyses, Page 133

23. *We note your disclosure that the term "'implied per share Merger Consideration' refers to $10.50 per share based on the cash portion of the Merger Consideration, taking into account both the Minimum Cash Consideration Number and the Maximum Cash Consideration Number, and the implied value of the Share Consideration utilizing the 0.360x exchange ratio and the closing price of SIR Common Shares of $27.90 per share on August 29, 2014." Please clarify how this number takes into account the implied value of the Share Consideration.*

Response: In response to the Staff's comment, the disclosure on page 135 has been revised in the Amended Registration Statement.

Selected Publicly Traded Companies Analysis, page 134

24. *Please disclose in more detail the criteria used to select the public companies used. If any company met the criteria but was excluded from the analysis, please identify the company and explain why it was excluded. Please provide similar disclosure in the "Selected Precedent Transactions Analysis" section on page 134, and the "Selected Publicly Traded Companies Analysis" section on page 136.*

Response: In response to the Staff's comment, the disclosure on pages 135-138 has been revised in the Amended Registration Statement.

General, Page 137

25. *Please disclose the amount of compensation Wells Fargo has received from Cole Corporate Income Trust, Inc., Select Income REIT, and their respective affiliates in the last two years for the services disclosed in this section or advise.*

Response: In response to the Staff's comment, the disclosure on page 140 has been revised in the Amended Registration Statement.

Opinions of CCIT's Financial Advisors — Hentschel & Company, LLC, page 138

26. *We note that Hentschel & Company's opinion was delivered on August 30, 2014. Please disclose whether any material changes in Select Income REIT's or Cole Corporate Income Trust, Inc.'s operations, performance, or in any of the projections or assumptions upon which Hentschel & Company based its opinion have occurred since the delivery of the opinion or that are anticipated to occur before the Cole Corporate Income Trust, Inc. stockholder meeting.*

Response: In response to the Staff's comment, the disclosure on pages 108 and 113 has been revised in the Amended Registration Statement.

Comparable Company Analysis, page 141

27. *Please disclose in more detail the criteria used to select the public companies used. If any company met the criteria but was excluded from the analysis, please identify the company and explain why it was excluded. Please provide similar disclosure in the "Precedent Transactions Analysis" section on page 143, and the "Comparable Company Analysis" section on page 145.*

Response: In response to the Staff's comment, the disclosure on pages 143-145 and 147-148 has been revised in the Amended Registration Statement.

Discounted Cash Flow Analysis, page 144

28. *Please discuss in greater detail the assumptions used in this discounted cash flow analysis. Please provide similar disclosure in the "Discounted Cash Flow Analysis" section on page 146.*

Response: In response to the Staff's comment, the disclosure on pages 146-147 and 148-149 has been revised in the Amended Registration Statement.

Material United States Federal Income Tax Consideration, page 155

29. *Please confirm for us that you will file all tax opinions prior to the registration statement being declared effective. If you are not in a position to file the tax opinions with your next amendment, please file drafts of such opinions so that we may review them.*

Response: In response to the Staff's comment, SIR is supplementally furnishing to the Staff drafts of the tax opinions. SIR hereby confirms that final opinions will be filed as exhibits to a later amendment of the Registration Statement prior to it being declared effective.

The Merger Agreement — Consideration to be Received in the Merger, page 181

30. *Please include disclosure as to the aggregate minimum and maximum cash consideration and stock consideration payable by you in connection with the merger. Please also provide examples of the consideration a Cole Corporate Income Trust shareholder will receive for one share of CCIT should no CCIT shareholders elect to receive the cash consideration and should all CCIT shareholders elect to receive cash consideration.*

Response: In response to the Staff's comment, the disclosure on pages 185-186 has been revised in the Amended Registration Statement.

Funding of the Transaction, page 183

31. *Please state, if true, that the merger will not cause a default under your existing credit facility.*

Response: In response to the Staff's comment, the disclosure on page 187 has been revised in the Amended Registration Statement.

Signatures

32. *Please identify your principal executive officer with your next filing.*

Response: In response to the Staff's comment, SIR has revised the signature page of the Amended Registration Statement.

If you have any questions regarding the responses to the comments of the Staff, or require additional information, please call me at (617) 573-4859.

Very truly yours,

/s/ Margaret R. Cohen

Margaret R. Cohen

cc: Sara von Althann, Attorney-Advisor
United States Securities and Exchange Commission

John C. Popeo, Treasurer and Chief Financial Officer
Select Income REIT

Enclosures

Select Income REIT

Two Newton Place, 255 Washington Street, Newton, MA 02458-1634
(617) 796-8303 tel (617) 796-8335 fax www.sirreit.com

November 24, 2014

VIA EDGAR AND OVERNIGHT COURIER

United States Securities and Exchange Commission
Division of Corporation Finance
100 F Street, NE
Washington, D.C. 20549

Attention: Jennifer Gowetski, Special Counsel

RE: Select Income REIT
Registration Statement on Form S-4
Filed October 17, 2014
File No. 333-199445

Dear Ms. Gowetski:

In response to the request of the staff (the "Staff") of the United States Securities and Exchange Commission (the "Commission") contained in your letter dated November 14, 2014, in connection with the above-captioned registration statement of Select Income REIT (the "Company"), the Company hereby acknowledges that, in the event the Company requests acceleration of the effective date of such registration statement:

- should the Commission or the Staff, acting pursuant to delegated authority, declare the filing effective, it does not foreclose the Commission from taking any action with respect to the filing;

- the action of the Commission or the Staff, acting pursuant to delegated authority, in declaring the filing effective, does not relieve the Company from its full responsibility for the adequacy and accuracy of the disclosure in the filing; and

- the Company may not assert Staff comments and the declaration of effectiveness as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

If you have any questions regarding the responses to the comments of the Staff, or require additional information, please contact our counsel, Margaret R. Cohen, Skadden, Arps, Slate, Meagher & Flom LLP, at (617) 573-4859.

Very truly yours,

/s/ John C. Popeo

John C. Popeo

cc: Margaret R. Cohen
Skadden, Arps, Slate, Meagher & Flom LLP

General Session: State of Capital Markets Meeting

Wednesday, April 1st
8am – 9:30am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Mark Decker, Jr., Managing Director & Head-US Real Estate, Lodging & Leisure Group

Panelists:
Joel Beam, VP & Portfolio Manager, Forward Management
Daniel Heberle, Principal, KeyBank
Sheila McGrath, Managing Director, Evercore ISI
Christopher Volk, President & CEO, STORE Capital Corporation

REIT Wise®

March 31- April 2
2015

NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

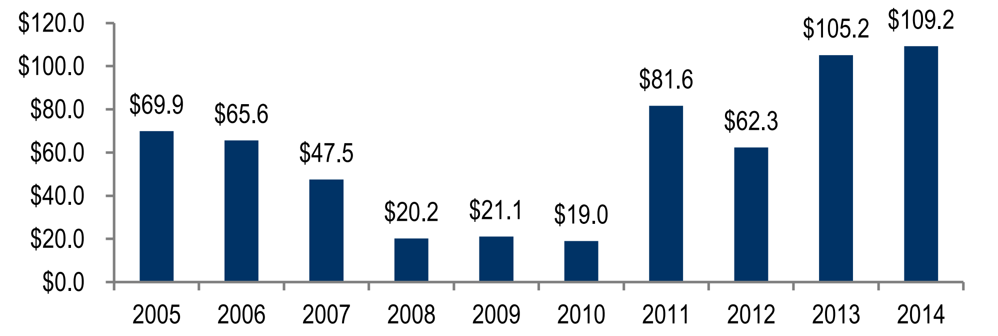
Capital Markets Panel

March 31-April 2, 2015

Bank Debt Market

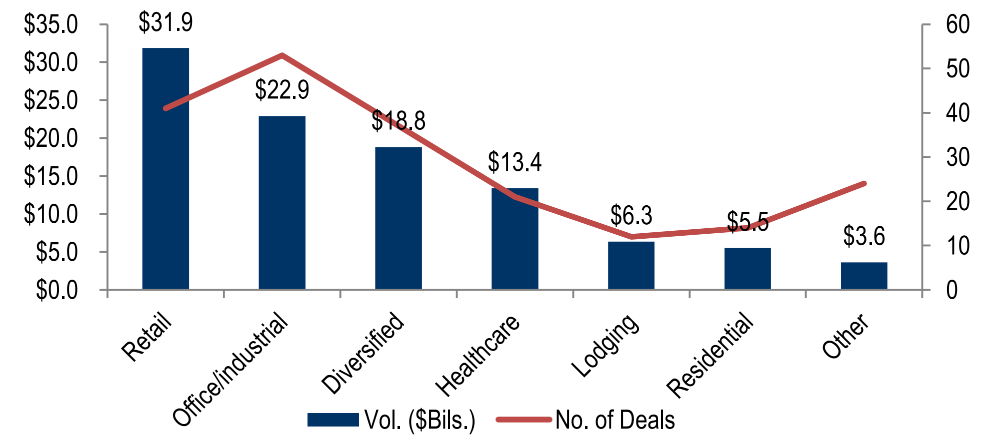
- 2014 U.S. REIT Bank Debt Volume of $109.2 billion was an all-time high
- Demand remains robust and is coming from lenders historically active in the space and from a steady flow of new entrants

U.S. REIT Bank Debt Volume 2005 – 2014 ($Bn)



- Volume in the U.S. REIT bank market remained diversified across sectors
- Market participants include investment banks, money center banks, U.S. super regional and regional banks as well as some European banks

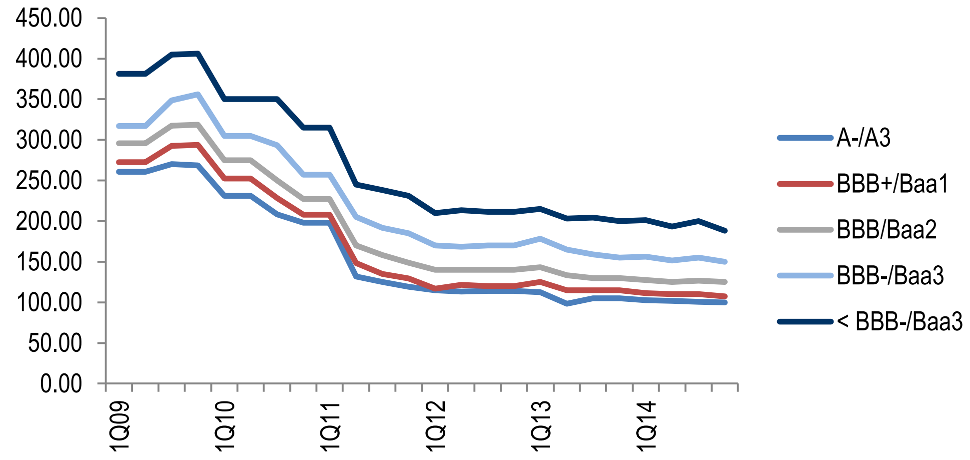
U.S. REIT Bank Debt Volume by Sector – 2014 ($Bn)



Bank Debt Market (cont'd)

- Consistent with the last 3 years, spread compression remained moderate in 2014
- Credit spreads in 2014 are approaching all-time lows in the face of record volume

U.S. REIT Spreads – 2010-2014 (bps)



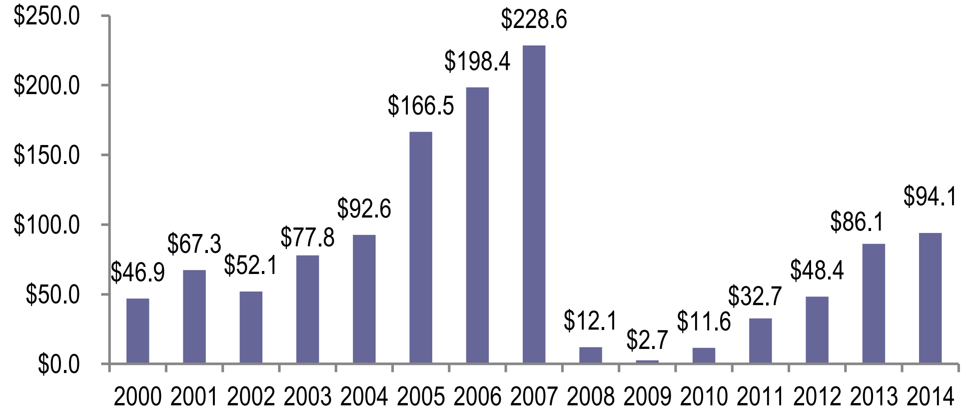
Market Observations

	Recent Trends
Market Attitude	Superior credit risk is rewarded by lower pricing and more flexible structure Debt markets open for clients providing additional business opportunities Preference for existing clients / publicly traded entities
Term	4-year terms are the norm for revolvers 5-year terms are available for term loans and for clients representing the best credit risk
Bank Group	Banks have large selection of transactions, leaning towards existing relationships and investment grade rated issuers Demand for quality paper has pushed terms, including pricing, structure and tenor Increasing need for ancillary business in order to meet return hurdles
Pricing	LIBOR spread discount are for investment grade borrowers and clients offering ancillary business LIBOR floor requirements are gone

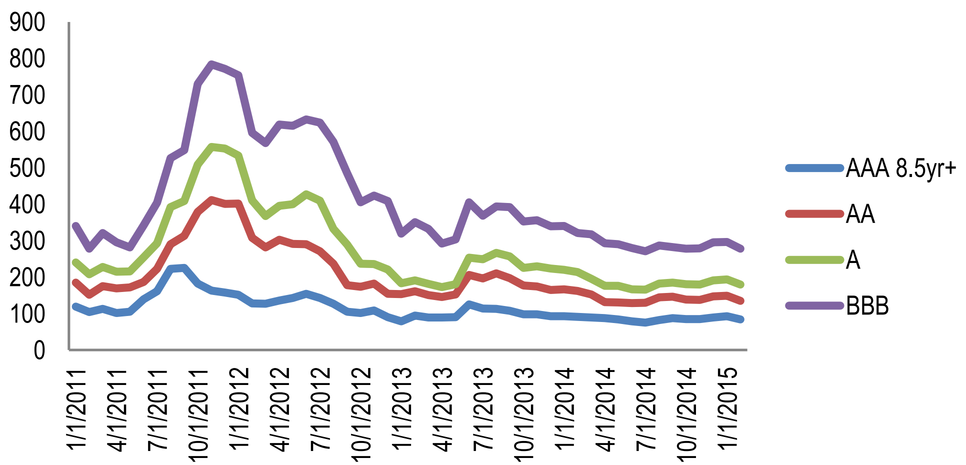
Commercial Mortgage Market

- 2014 U.S. CMBS volumes of $94 billion, the most since 2007
- Demand remains robust, largely from investors hunting for yield
- Growing demand from investors increased the number of active lenders to 35 in 2014 compared to just 18 in 2011
- According to Commercial Mortgage Alert, CMBS volume for 2015 is predicted to average $124 billion
- Commercial real estate loan interest rates for CMBS originations have been steadily declining since the end of 2011
- Spreads remained relatively stable in 2014 compared to the larger movements witnessed in 2013

U.S. CMBS Issuance 2000 – 2014 ($Bn)



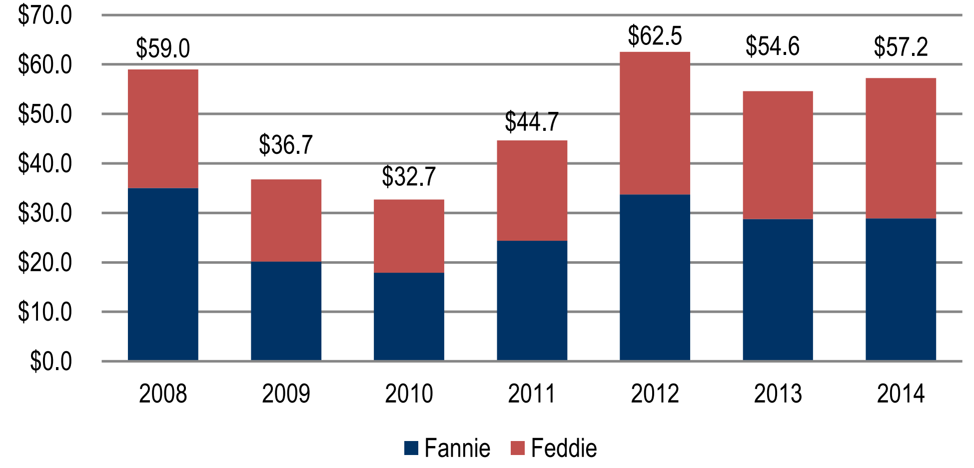
CMBS Spreads to Treasuries 2011- YTD 2015 ($Bn)



Commercial Mortgage Market (cont'd)

- Agencies purchased $57.2 billion of loans in 2014. Up from $54.4 billion in 2013, but down from the record $62.6 billion in 2012
- Fannie purchased $28.9 billion of multi-family loans last year, within 5% of the $30.4 billion cap imposed by the Federal Housing Finance Agency. Freddie reached its $25.9 billion limit.
- Fannie's origination volume in 2014 was static with 2013. Freddie's volume was up 9% from 2013.
- Fannie and Freddie acquired a combined $10.5 billion of multi-family loans from agency lenders in December, the highest monthly total of the year.
- From January to June, purchases totaled only $8.2 billion for Fannie and $7.1 billion for Freddie, as the agencies faced strong competition from banks, insurers and commercial MBS programs.

U.S. Agency Purchase 2008-2014 ($Bn)



REIT Equity Market Update

Pre-Crisis

- **2000-2007:** Investors shifted into REITs, seeking yield and diversification after the tech bubble and recession years of 2000-2001

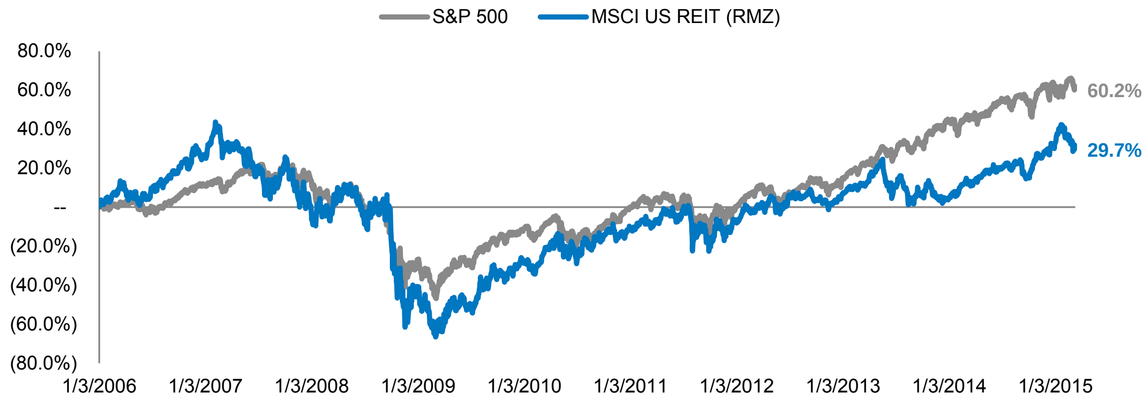
Financial Crisis

- **2007-2009:** REIT stocks plummeted 76%to a trough in March 2009 as a result of asset value declines, dry credit markets, and the troubles of the overall economy

Recovery

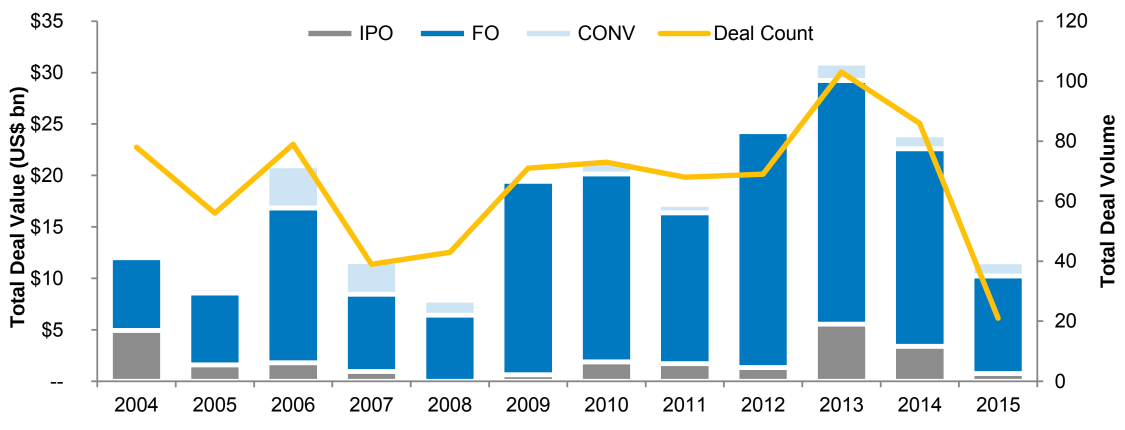
- **2010-2015:** REITs continue to raise equity to fund accretive acquisition opportunities; 2013 was a record year for equity issuance, while 2014 was down slightly overall volume was still high relative to previous years

Price Return Since 2006



Historical REIT ECM Activity

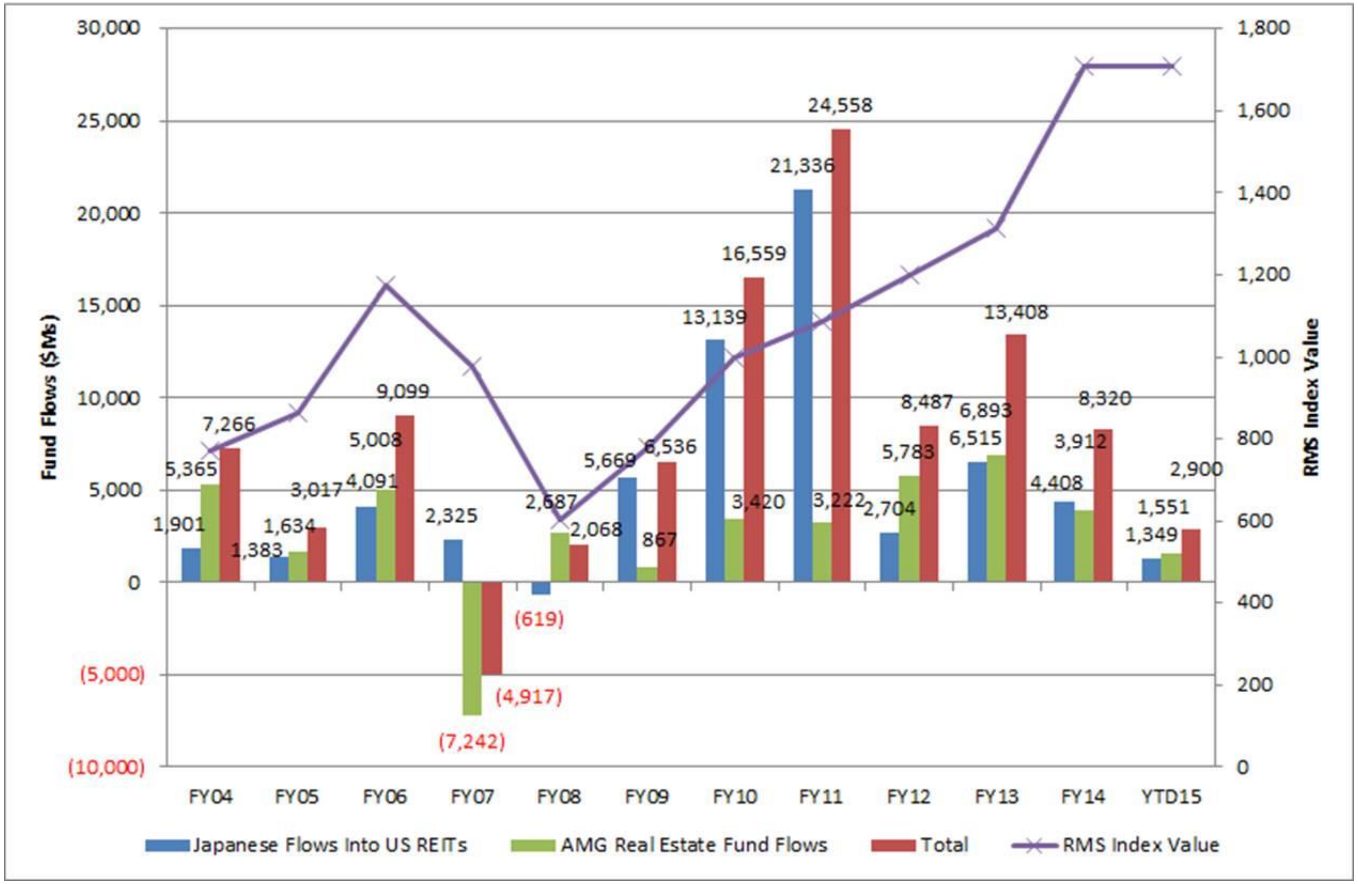
(US$ in billions)



Source: Dealogic, SNL Financial

Historical Real Estate Fund Flows

North America, Japan, and Aggregate Flows to REIT Mutual Funds



Flows to REIT mutual funds moderating last few years

Source: Lipper, Bloomberg, Evercore ISI

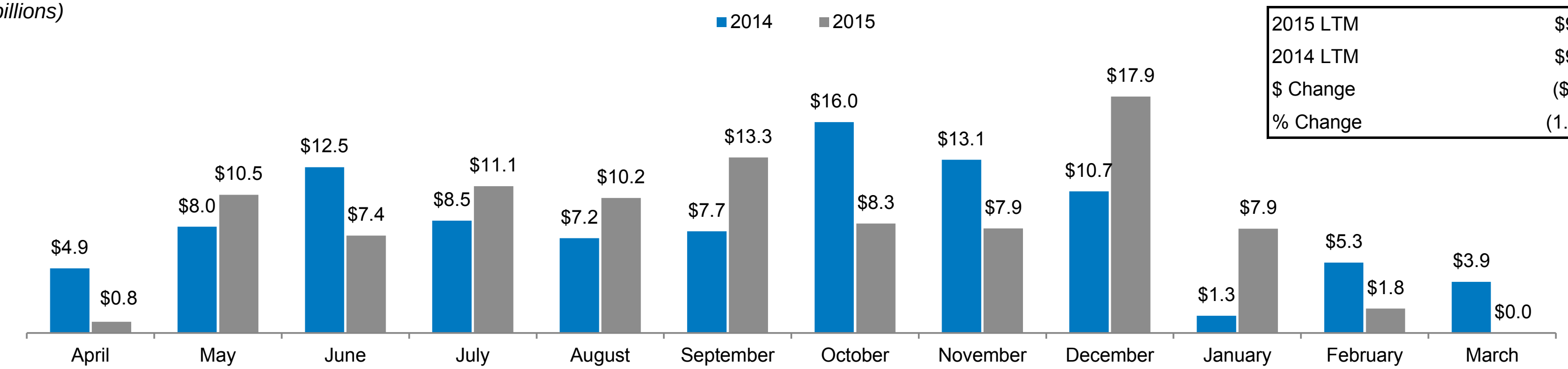
REIT M&A Market

Recent Notable Real Estate Transactions

Buyer	Target	Sector	Announcement Date	Announced Deal Value ($BN)	Price / Unit-Bed-Room-SF-Site	Cap Rate	Premium / (Discount) to NAV	Consideration	Premium to Pre-Announcement Price
Blackstone	Praedium Group (apartment portfolio)	Multifamily	Jan-15	$1.70	$154,545	*n.a.*	*n.a.*	Cash	*n.a.*
Senior Housing Properties Trust	CNL Lifestyle Properties (senior housing portfolio)	Healthcare	Dec-14	0.79	227,928	*~7.0%*	*n.a.*	Cash	*n.a.*
GIC	IndCor Properties (Blackstone)	Industrial	Dec-14	8.10	476	*n.a.*	*n.a.*	Cash	*n.a.*
Griffin Capital Essential Asset REIT	Signature Office REIT	Office	Nov-14	~0.43	165	*n.a.*	*n.a.*	Stock	*n.a.*
EDENS	AmREIT	Shopping Center	Oct-14	0.76	449	*n.a.*	*n.a.*	Cash	*6.8%* [1]
Omega Healthcare REIT	Aviv REIT	Healthcare	Oct-14	2.15	81,109	*6.5%*	*57.0%*	Stock	*16.2%*
NorthStar / Chatham Lodging	Inland American (hotel portfolio)	Lodging	Sep-14	1.10	151,000	*n.a.*	*n.a.*	Cash, stock	*n.a.*
Washington Prime Group	Glimcher Realty Trust	Mall	Sep-14	2.11	117	*6.5%*	*(9.2%)*	Cash, stock	*32.9%*
Select Income REIT	Cole Corporate Income Trust	Diversified	Sep-14	3.40	212	*6.4%*	*n.a.*	Cash, stock	*3.2%*
Square Mile Capital / USAA Real Estate	EVOQ Properties	Diversified	Aug-14	0.24	119	*n.a.*	*n.a.*	Cash	*51.9%*
Health Care REIT	Healthlease Properties	Healthcare	Aug-14	0.95	178,203	*7.0%*	*n.a.*	Cash	*31.1%*
NorthStar Realty Finance	Griffin-American Healthcare REIT II	Healthcare	Aug-14	3.40	n.a.	*6.4%*	*n.a.*	Cash, stock	*12.5%*
Sun Communities	Green Courte Partners (portfolio)	Manufactured Housing	Jul-14	1.32	69,474	*6.0%*	*n.a.*	Cash, stock	*n.a.*
ARC Hospitality Trust	Equity Inns (Whitehall)	Lodging	Jun-14	1.90	138,242	*n.a.*	*n.a.*	Cash	*n.a.*
Mean				**$2.06**		***6.4%***	***23.9%***		***21.0%***
Median				**$1.51**		***6.5%***	***23.9%***		***14.8%***

LTM Momentum (Announced Basis) vs. Prior Period[2]

($ in billions)



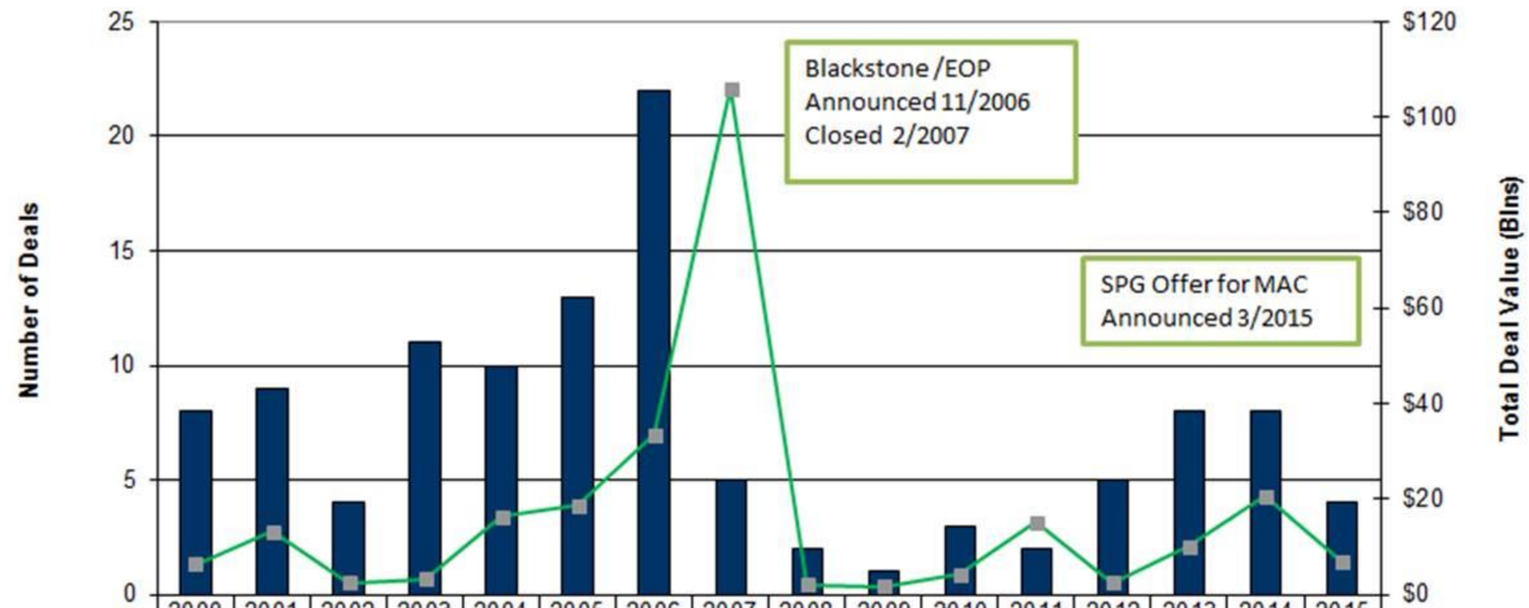
2015 LTM	$97.1
2014 LTM	$98.1
$ Change	($1.0)
% Change	(1.0%)

Source: Dealogic, SNL Finacial, street research

1. Premium of nearly 40% over AmREIT's closing stock price on July 9, 2014, the last trading prior to disclosure of an unsolicited proposal from Regency Centers.
2. Includes U.S. corporate and property-level transactions with disclosed values greater than $200 million. LTM as of March 6, 2015.

REIT M&A Market (cont'd)

Historical REIT M&A Volume



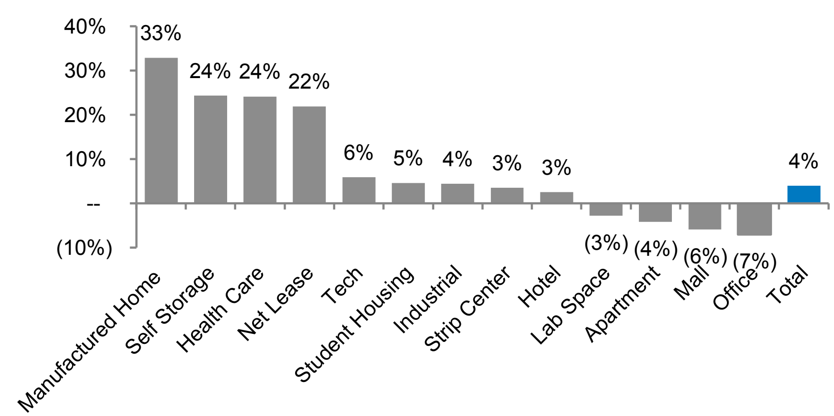
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
# of Deals	8	9	4	11	10	13	22	5	2	1	3	2	5	8	8	4
Volume	$6.4	$13.1	$2.4	$3.2	$16.3	$18.7	$33.4	$106.	$2.1	$1.8	$4.2	$15.3	$2.5	$10.2	$20.5	$6.7

Still waiting for a meaningful pick up in M&A activity

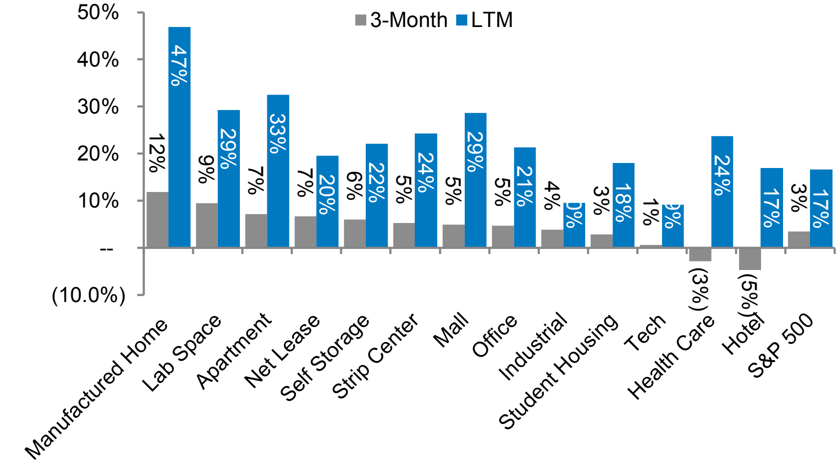
Source: SNL Financial, Evercore ISI

Valuations Across Property Types

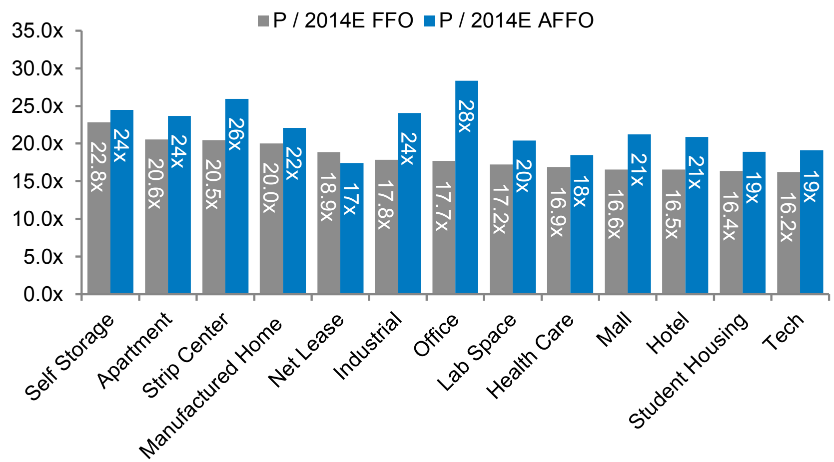
Premium / (Discount) to NAV



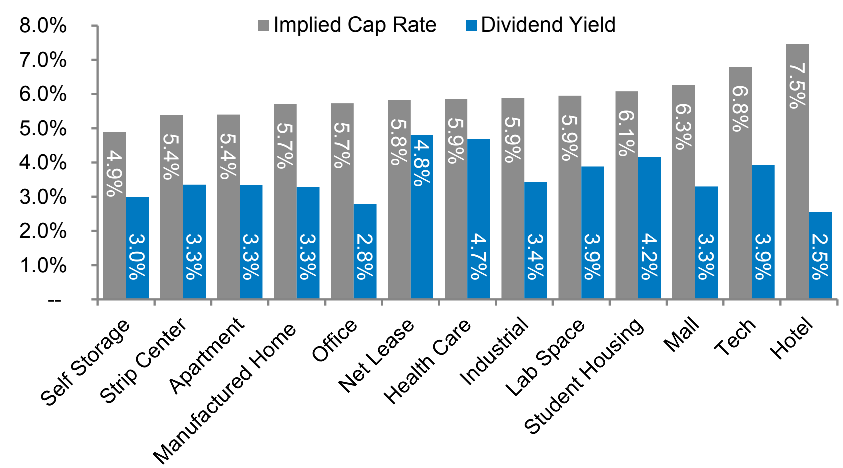
Total Return



FFO / AFFO Multiples



Implied Cap Rate / Dividend Yield



Source: Green Street Advisors, FactSet, SNL Financial
Note: Reflects all U.S. REITs covered by Green Street Advisors.

REIT Valuations

REIT Metrics Now vs. Last '07 Peak

	Current	Q1 2007	Average 1 Year	3 Year	5 Year	10 Year
REIT Dividend Yield	3.6%	3.5%	3.6%	3.5%	3.6%	4.2%
Spread Vs Ten-Year Treasury	135	(114)	119	130	110	90
Spread Vs Baa Corporate Bonds	(114)	(276)	(116)	(140)	(172)	(183)
10YR Rate	2.2%	4.6%	2.4%	2.2%	2.5%	3.3%
Baa Rate	4.7%	6.4%	4.7%	4.9%	5.3%	6.0%
S&P Yield	2.0%	2.0%				
P/FFO Multiples (1)						
Straight Average	15.8	16.9	15.8	15.4	15.1	14.0
Weighted Average	18.1	18.6	17.9	17.8	17.0	15.3
S&P Average	17.0	15.3	15.8	14.2	13.6	14.2
Premium/Discount to S&P	6%	22%	13%	26%	25%	7%
Current REIT Multiple vs. Its Historical Average			1%	1%	6%	18%
Wtd Multiple/Near term Growth Rate (REITs)	2.0x	2.7x				
Snapshot PEG Ratio (2)	2.0	2.7	NM	NM	NM	
Annual FFO/Share Growth (2)	9.1%	6.9%				
NAV Prem./Disc.	1.2%	8.8%	-0.1%	4.3%	8.1%	3.8%

(1) Current = NTM Multiples

(2) 2015/2016 Earnings Growth

Source: SNL Financial, FactSet, Evercore ISI

Historical Offerings of Securities

February 27, 2015

Period	Total Number	Total Capital Raised[1]	Initial Public Offerings Number	Initial Public Offerings Capital Raised[1]	Secondary Equity Common Shares Number	Secondary Equity Common Shares Capital Raised[1]	Secondary Equity Preferred Shares Number	Secondary Equity Preferred Shares Capital Raised[1]	Secondary Debt Unsecured Number	Secondary Debt Unsecured Capital Raised[1]
Annual Totals (including current year to date)										
2007	129	36,031	4	1,820	56	11,854	26	4,202	43	18,155
2008	82	17,991	2	491	60	11,132	9	1,195	11	5,173
2009	130	34,656	9	2,990	87	21,244	0	0	34	10,422
2010	173	47,450	9	1,975	91	23,629	17	2,617	56	19,230
2011	164	51,280	8	2,307	92	31,075	31	4,108	33	13,790
2012	254	73,326	8	1,822	106	35,143	71	10,631	69	25,730
2013	254	76,958	19	5,707	121	35,756	28	4,755	86	30,739
2014	218	63,642	5	3,984	102	24,106	24	4,618	87	30,934
2015	35	15,763	3	817	17	8,304	3	1,441	12	5,200
Quarterly Totals										
2013: Q4	61	16,396	5	2,626	26	5,164	4	362	26	8,243
2014: Q1	41	11,158	2	701	20	3,383	3	630	16	6,444
Q2	78	23,965	1	61	31	9,565	13	2,093	33	12,245
Q3	57	16,056	0	0	28	7,284	4	306	25	8,466
Q4	42	12,463	2	3,221	23	3,874	4	1,589	13	3,779
2015: Q1	35	15,763	3	817	17	8,304	3	1,441	12	5,200
Monthly Totals										
2013: May	34	11,344	3	698	16	7,249	2	207	13	3,190
Jun	14	5,029	0	0	8	2,464	1	690	5	1,875
Jul	13	3,750	3	1,207	7	1,290	0	0	3	1,252
Aug	13	4,709	1	39	7	2,020	0	0	5	2,650
Sep	19	6,591	0	0	7	1,681	0	0	12	4,910
Oct	26	7,582	4	2,463	12	2,655	2	224	8	2,240
Nov	23	5,767	0	0	12	1,730	0	0	11	4,038
Dec	12	3,046	1	163	2	780	2	138	7	1,965
2014: Jan	18	4,433	0	0	12	1,903	0	0	6	2,530
Feb	6	2,099	0	0	2	366	1	26	3	1,707
Mar	17	4,626	2	701	6	1,114	2	604	7	2,207
Apr	26	6,488	1	61	11	2,233	4	333	10	3,860
May	30	10,090	0	0	12	5,281	7	1,547	11	3,263
Jun	22	7,387	0	0	8	2,052	2	213	12	5,123
Jul	12	3,118	0	0	8	1,718	0	0	4	1,400
Aug	12	3,049	0	0	4	695	1	88	7	2,266
Sep	33	9,889	0	0	16	4,871	3	218	14	4,800
Oct	15	3,851	0	0	8	849	2	1,349	5	1,654
Nov	19	6,922	2	3,221	7	1,335	2	240	8	2,125
Dec	8	1,690	0	0	8	1,690	0	0	0	0
2015: Jan	26	8,518	1	529	11	2,723	2	66	12	5,200
Feb	9	7,245	2	288	6	5,581	1	1,375	0	0

Source: SNL Financial, NAREIT®.

Notes:
[1] Data presented in millions of dollars.

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US REIT Industry Equity Market Cap

HISTORICAL REIT INDUSTRY MARKET CAPITALIZATION: 1972-2014

EQUITY MARKET CAPITALIZATION OUTSTANDING (MILLIONS OF DOLLARS AT YEAR END)

	All REITs		Equity		Mortgage		Hybrid	
End of Year	# of REITs	Market Capitalization	# of REITs	Market Capitalization	# of REITs	Market Capitalization	# of REITs	Market Capitalization
1971	34	1,494.3	12	332.0	12	570.8	10	591.6
1972	46	1,880.9	17	377.3	18	774.7	11	728.9
1973	53	1,393.5	20	336.0	22	517.3	11	540.2
1974	53	712.4	19	241.9	22	238.8	12	231.7
1975	46	899.7	12	275.7	22	312.0	12	312.0
1976	62	1,308.0	27	409.6	22	415.6	13	482.8
1977	69	1,528.1	32	538.1	19	398.3	18	591.6
1978	71	1,412.4	33	575.7	19	340.3	19	496.4
1979	71	1,754.0	32	743.6	19	377.1	20	633.3
1980	75	2,298.6	35	942.2	21	509.5	19	846.8
1981	76	2,438.9	36	977.5	21	541.3	19	920.1
1982	66	3,298.6	30	1,071.4	20	1,133.4	16	1,093.8
1983	59	4,257.2	26	1,468.6	19	1,460.0	14	1,328.7

1984	59	5,085.3	25	1,794.5	20	1,801.3	14	1,489.4
1985	82	7,674.0	37	3,270.3	32	3,162.4	13	1,241.2
1986	96	9,923.6	45	4,336.1	35	3,625.8	16	1,961.7
1987	110	9,702.4	53	4,758.5	38	3,161.4	19	1,782.4
1988	117	11,435.2	56	6,141.7	40	3,620.8	21	1,672.6
1989	120	11,662.2	56	6,769.6	43	3,536.3	21	1,356.3
1990	119	8,737.1	58	5,551.6	43	2,549.2	18	636.3
1991	138	12,968.2	86	8,785.5	28	2,586.3	24	1,596.4
1992	142	15,912.0	89	11,171.1	30	2,772.8	23	1,968.1
1993	189	32,158.7	135	26,081.9	32	3,398.5	22	2,678.2
1994	226	44,306.0	175	38,812.0	29	2,502.7	22	2,991.3
1995	219	57,541.3	178	49,913.0	24	3,395.4	17	4,232.9
1996	199	88,776.3	166	78,302.0	20	4,778.6	13	5,695.8
1997	211	140,533.8	176	127,825.3	26	7,370.3	9	5,338.2
1998	210	138,301.4	173	126,904.5	28	6,480.7	9	4,916.2
1999	203	124,261.9	167	118,232.7	26	4,441.7	10	1,587.5
2000	189	138,715.4	158	134,431.0	22	1,632.0	9	2,652.4
2001	182	154,898.6	151	147,092.1	22	3,990.5	9	3,816.0
2002	176	161,937.3	149	151,271.5	20	7,146.4	7	3,519.4
2003	171	224,211.9	144	204,800.4	20	14,186.5	7	5,225.0
2004	193	307,894.7	153	275,291.0	33	25,964.3	7	6,639.4
2005	197	330,691.3	152	301,491.0	37	23,393.7	8	5,806.6
2006	183	438,071.1	138	400,741.4	38	29,195.3	7	8,134.3
2007	152	312,009.0	118	288,694.6	29	19,054.1	5	4,260.3
2008	136	191,651.0	113	176,237.7	20	14,280.5	3	1,132.9
2009	142	271,199.2	115	248,355.2	23	22,103.2	4	740.8
2010	153	389,295.4	126	358,908.2	27	30,387.2	--	--
2011	160	450,500.6	130	407,528.9	30	42,971.7	--	--

2012	172	603,415.3	139	544,414.9	33	59,000.3	--	--
2013	202	670,334.1	161	608,276.6	41	62,057.4	--	--
2014	216	907,425.5	177	846,410.3	39	61,017.2	--	--

Note: The FTSE NAREIT Hybrid REIT Index was discontinued on December 17, 2010.

Still More REIT Tax Issues Meeting

Wednesday, April 1st
11:15am – 12:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Adam Cohen, Executive Director-Tax, W.P. Carey, Inc.

Panelists:
Lynn Kawaminami, Partner-Tax, Deloitte LLP
Courtney Sargent, Sr. Manager, PwC
Steven Szymanski, SVP-Tax, American Tower Corporation
Roger Laty, VP-Tax, UDR, Inc.

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March 31- April 2 2015

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Still More REIT Tax Issues

April 1, 2015

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Moderator:

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Steven Szymanski, SVP-Tax, American Tower Corporation

Agenda

I. Tax Due Diligence Leading Practices

II. Managing Built-in Gains

III. Internal Controls in the Tax Function

Tax Due Diligence Leading Practices

Key Items

- Seat at the Table
  - Tax should be involved up front and in the strategy sessions
  - Meet with key executives to understand strategy (both short and long term)

- Investment Committee
  - Tax should attend and participate in IC meetings and review summaries and presentations <u>before</u> they are submitted to the full IC

- Communicate Early and Often with Deal Teams
  - Understand the pipeline (acquisition and sell side – including whether any assets to be acquired will be sold shortly after)
  - Voice concerns <u>and</u> solutions

Tax Due Diligence Leading Practices

Acquisition Side

- What are we purchasing?
    - Entities
    - Assets
- Use a checklist (see sample checklist in Appendix)
- Consider how technology can help – so you can focus on the issues
- Three primary work streams – each impacts the others
    - Due diligence
    - Structuring
    - Documents

Tax Due Diligence Leading Practices

Entity Acquisitions – Key Items to Review

- Leases
- Property services questionnaires
- Organizational chart / entity tax elections
- Tax audits
- Uncertain tax positions (federal, foreign, state, and local)
- Tax attributes / limitations
- Pro forma impact to REIT asset, income and distribution tests
- E&P
- Potential step-up or down in tax basis and allocation of purchase price
- Transaction taxes (transfer taxes, property taxes)
- Funding structure
- Non-income taxes (sales and use taxes, payroll taxes)
- Potential 280G implications
- If target is a JV interest – partnership agreements and ability to be REIT-friendly
- If target is a REIT – REIT tests!!!

Tax Due Diligence Leading Practices

Asset Acquisitions – Key Items to Review

- Leases
- Property services questionnaires
- Pro forma impact to REIT asset, income and distribution tests
- Potential step-up or down in tax basis and allocation of purchase price
- Transaction taxes (transfer taxes, property taxes)
- Funding structure

Tax Due Diligence Leading Practices

Disposition Side

- What are we selling?
    - Entities
    - Assets
- Be “diligence-ready” and understand tax implications
- Three primary work streams – each impacts the others
    - Due diligence
    - Structuring
    - Documents

Managing Built-in Gains

C-Corporation Built-in Gains

- Retain Assets for Built-in Gain Time Frame
  - Maintain a schedule of Built-in Gain by asset
  - Monitor and communicate the changing time frames
- Use C-Corporation NOLs to Offset
- Structure to Defer the Gain – i.e., Section 1031
- Other Non-recognition Structures
  - Joint venture structure
  - Deferred finance lease

Managing Built-in Gains

General Built-in Gains

- Structure to Defer the Gain
  - Section 1031
  - Installment sale
- Other Non-recognition Structures
  - Joint venture structure
  - Deferred finance lease
- Manage through Taxable Income
  - Structure to “fill the bucket”
  - Tangible property regulations
  - Cost segregation studies
  - Depreciation methods

Managing Built-in Gains

General Built-in Gains (continued)

- Manage through Distributions
  - Elective stock dividends in lieu of cash
  - Retain REIT taxable income
    - Pay tax on the 10%
  - Retain capital gains
    - Pay tax at 35%
    - Pass the gain and credit for tax to shareholders
  - Throw back dividends under section 858
    - Monitor potential 4% excise tax

Internal Controls in the Tax Function

REIT Status – Key Controls

- Review Processes / Flowcharts / Memos at beginning of the year
- Communication policy with Property Management and Senior Management
  - They know who you are (senior members of tax team)
  - They know when to call you (executive training)
- REIT Governance Committee
  - Tax Department discusses the test results with Executive Team

Documentation and Procedures

- Internal audit -- active and engaged throughout the year
- Consider technology solutions to facilitate effective and efficient review
- Advisors review REIT tests quarterly and annually
- Documentation requirements, scope, and level of evidence required
  - Proof of internal review, including review notes and sign-off
  - Memoranda (e.g., tax impact of transactions, REIT diligence procedures and conclusions)

Internal Controls in the Tax Function

REIT Status Controls (continued)

- Completion of REIT tests and documentation
  - Separate internal preparation and review roles required
    - Challenges
  - Asset tests
    - Reconciliation of US GAAP amounts to asset values used in the asset test
  - Income tests
    - Review new leases (if not standard) and property surveys
    - Quarterly review of revenue accounts
    - Reconciliation of US GAAP amounts to gross income used in income test
  - Distribution test
    - Quarterly review of current and projected REIT taxable income

Internal Controls in the Tax Function

Tax Provision Key Controls

- Review tax rate reconciliation; compare to previous year and to expectations for the current year
- Review tax account roll-forward schedule and reconcile tax payments, tax accruals, and return to provision adjustments
- Review balance sheet accounts for new accounts or unusual changes for potential new temporary differences

Documentation and Procedures

- Internal Audit – active and engaged throughout the year
- Consider technology solutions to facilitate effective and efficient review
- Documentation requirements, scope, and level of evidence required
  - Proof of internal review, including review notes and sign-off
  - Memoranda (e.g., valuation allowances, purchase accounting, tax impact of transactions, diligence procedures and conclusions)

Internal Controls in the Tax Function

Other Audit-Related Topics

- Entity and/or country level forecasts
- Forecast effective tax rate for current year and long term
- Foreign countries – can add significant effort and challenges
  - Outsource versus internal resources
  - Controls and reliance on external resources
  - Monitoring multiple country tax law changes
- Footnote disclosures
  - Procedures and controls for documentation
  - Recent developments

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Note: This sample data request is for illustration only and reflects an entity acquisition of a target REIT with foreign operations. The due diligence request list would typically be tailored for the specific asset class, target structure, and other transaction-specific facts, and follow-on requests to provide further detail would generally be issued as the diligence progresses.

Tax Data Request

The following is a preliminary list of documents and information needed to perform our tax due diligence procedures. Unless otherwise noted, all information is requested for all open tax years and for the most recent interim period. In addition to the items included on this list, please provide us with any information that you believe would enhance our understanding of the tax position of the company. Please note that we may require additional information as our tax due diligence progresses.

General

1. Access to tax personnel and/or tax advisors to discuss US federal, state, local and non-US income and non-income tax matters.

2. Current legal organizational structure of the entities being acquired, including all domestic and foreign holdings. Chart should indicate the legal and tax (e.g., check-the-box) form of each entity.

3. Copies of US federal, state, local and non-US income tax returns filed, including but not limited to Forms 1118, 5471, 5472, 8858 and 8865 for all open tax years and access to workpapers prepared in connection with such returns. Additionally, please provide copies of the payroll, excise, sales & use, VAT, and GST tax returns filed for the most recent year.

4. Analysis of all tax attributes (e.g., net operating losses, capital losses, built-in losses, R&D credits, etc.) including expiration dates of such attributes and any applicable limitations on the utilization of such carryovers by legal entity by jurisdiction.

5. List of all significant US federal, state, local and non-US tax elections, including any check-the-box and TRS elections.

6. A schedule reflecting the rollout of amortization and depreciation for current tangible and intangible assets.

7. Please provide information regarding participation in any listed or reportable transactions, if any.

8. Copies of the ASC 740 calculation and related workpapers for the past 2 years and for the 2 most recent quarters.

9. Details of any positions taken on prior US federal, state, local and non-US tax returns (including, but not limited to, income, payroll, excise, sales, VAT, and GST taxes) for which there is potential exposure. Additionally please provide a summary schedule of any uncertain income and non-income tax reserves (f/k/a: FAS 5, FIN 48) including an explanation of each reserve along with any relevant opinions, correspondence and/or memoranda prepared regarding such tax exposure.

10. Summary of closed, ongoing and pending US federal, state, local and non-US tax audits (including, but not limited to income, payroll, excise, sales, VAT, and GST taxes) for the past five years. For any closed audits, please provide a copy of the revenue agent report issued, including detailed explanations of all audit adjustments. For any closed or ongoing audits, please provide copies of all issued information document requests ("IDR") along with the Company's response to each IDR for the past five years. Also please indicate whether any waivers to extend the statute of limitations have been executed.

11. Copies of tax rulings (or ruling requests), requests for changes in accounting methods or closing agreements entered into by the Company and/or subsidiaries during the past five years (or longer, if there is prospective application).

12. Details regarding the Company's revenue recognition policies for tax purposes with respect to each type of revenue realized.

13. Details of any restructuring history, including corporate merger, acquisition, divestiture, bankruptcy and joint venture occurring within the last five years. For any transaction, please include the date and type of transactions, copies of agreements and tax rulings or legal opinion/memorandum regarding taxability of such transaction and the tax treatment of contingent consideration. Also please include any tax due diligence report or similar document compiled with respect to any such acquisition.

14. Copies of any contract, agreement or arrangement under which the Company and/or any subsidiary has, or at any time in the future may have, an obligation to contribute (whether directly, by indemnity or otherwise) to the payment of a portion of tax (or pay any amount calculated with reference to any portion of a tax) determined on a consolidated, combined or unitary basis.

15. Details related to all related party or inter-company transactions with affiliates, shareholders, and other related parties (e.g., sales, loans, interest, royalties, management fees, deferred inter-company transactions, etc.) including a copy of any agreements entered into with respect to such transactions and a copy of any transfer pricing reports or other documentation supporting the arm's length nature of transactions.

16. Copies of any tax allocation or tax sharing agreements.

17. List of all outstanding debt obligations setting forth key terms (i.e., principal, interest rates, conversion features) and any memoranda, opinion, ruling or similar analysis regarding the nature of such obligation as indebtedness for tax purposes or the deductibility of interest.

REIT

18. All quarterly asset tests and underlying trial balances since its REIT election.

19. All income tests and underling trial balances since its REIT election.

20. Schedule of distributions and distribution tests since its REIT election.

21. Schedule of any non-REIT year earnings and profits distributed to shareholders.

22. Articles of incorporation.

23. Shareholder list.

24. Schedule of “five or fewer” tests since its REIT election.

25. Copy of demand letters sent since its REIT election.

26. Analysis of any impermissible tenant service income.

27. Schedule of section 1374 built-in gains, if applicable.

28. Hedge identifications.

29. Copies of any “reasonable cause” memorandums or opinions.

30. Copies of all lease agreements.

Operating Partnership

31. Schedule of section 704(c) built-in gains.

32. Copies of any tax protection agreements.

State and Local

33. A list, such as a tax calendar, of all state and local tax returns (i.e., income, franchise, sales) filed by each entity.

34. Schedule detailing state apportionment factors (including property, payroll and sales numerators and denominators by state) of each entity.

35. Copies of any correspondence from state, local or foreign taxing authorities questioning the activities of each entity in any jurisdiction and copies of responses by the entity or its representatives, if any.

36. Details on sales, use and other non income tax policies and procedures.

Compensation and Payroll

37. All documentation (including "change in control" agreements, executive employment agreements and qualified plan documents) detailing change of control payment or benefit that results in non-deductible "excess parachute payments" and excise taxes pursuant to section 280G.

38. Details on the Company's use of independent contractors including policies for determining and monitoring contractor status, number of Forms 1099 issued and amounts reported.

International – US Multinational

39. Schedule of all foreign jurisdictions in which the Company or its subsidiaries: (a) files a tax return, (b) has employees, (c) owns assets or (d) has employees or agents that reside or make regular visits to and/or perform service or inspection type functions.

40. Schedule of EBITDA and cash taxes by country.

41. Summary schedule of earnings and profits (E&P) and tax pools by country.

42. Schedule of intercompany debt and related notes.

43. Copies of tax planning schedules, slides or memoranda.

44. Schedule of distributable reserves deficits or other trapped cash by country.

45. Details as to the Company's compliance with VAT and customs tax/reporting.

46. Copies of the most recent Form 1042 and the Form W8BEN utilized to reduce withholding taxes for the 5 largest payments.

47. Details regarding any agreements (e.g., APAs, etc.) entered into with tax authorities.

48. Schedule of all qualified business units (“QBUs”) and section 987/988 pools.

International – US subsidiary of foreign parent

49. Analysis of whether the target is a US Real Property Holding Company within the meaning of Section 897.

50. Earnings stripping calculations for all relevant years.

51. Details regarding any inbound financing arrangements.

52. Copies of the most recent Form 1042 and the Form W8BEN utilized to reduce withholding taxes for the 5 largest payments.

Customs and Global Trade

53. Please provide a list of countries to which the Company (or a related entity) imports goods. Information should include, but not be limited to, description of goods imported, whether the exporter and importer are related parties, as well as the total customs value and duty paid in the last year for each country.

54. Please provide a list of countries out of which the Company (or a related entity) exports goods. Information should include, but not be limited to, description of goods exported, what countries the goods are exported to, as well as total value of exports in the last year for each country.

55. Details of licenses required to import or export goods (if any).

56. Details with respect to any past or pending Customs or Export Authority audits, penalties or disputes (ongoing or resolved). Information should include, but not be limited to, correspondence with a Customs or Export Authority, issues raised, proposed resolutions and, if closed, the outcome.

57. Details of any Duty Deferral, Bonded Facilities or Free Trade Agreements utilized by the company.

Value Added Tax (VAT) and Goods and Services Tax (GST)

58. Please provide a list of countries in which the Company (or its subsidiaries) is registered for VAT/GST purposes as well as details on the periodical VAT/GST position (payment vs. refund) in those countries.

59. Please provide a list of countries where the Company is acting as "importer of record" and include details on the delivery terms/incoterms that are generally being used.

60. Please provide information as to whether the Company (i) accrued for VAT/GST, (ii) maintains VAT/GST receivables on the balance sheet, and/or (iii) is currently sitting on any VAT/GST refund that is not being reimbursed by the Tax Authorities.

61. Details on VAT/GST policies and procedures.

Tax Issues Arising from Inbound Investments into US REITs Meeting

Thursday, April 2nd
9:30am – 10:45am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
A. Cristina Arumi, Partner, Ernst & Young

Panelists:
James Croker, Partner, Alston & Bird LLP
Ameek Ponda, Partner & Director-Tax Department
Rohn Grazer, SVP & Director, Prologis, Inc.

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March 31- April 2 2015

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Tax Issues Arising From Inbound Investment Into US REITs

(a/k/a FIRPTA, FIRPTA, FIRPTA)

March 31-April 2, 2015

Cristina Arumi
Jim Croker
Rohn Grazer
Ameek Ponda

Overview of Topics

- Overview of US Taxation of Non-US Investors in US REITs
  - Legislative Proposals
- Domestically Controlled REITs
- REIT Joint Ventures
  - Preparing for the Exit Strategy
  - Understanding the Unique Tax Rules for Foreign Governments
- Capital Gain Dividends and other Section 897(h)(1) Distributions
  - Substantive Tax
  - Withholding Obligations
- Other FIRPTA/Inbound Issues
  - What is a USRPI?
  - Fund/Alternative Investment Vehicle ("AIV") Investments

Overview of US Taxation of Non-US Investors in US REITs

Taxation of Non-US Persons

- Is the US-source income effectively connected with a US trade or business (“ECI”)?
  - If Yes:
    - Subject to US tax at regular rates
      - Corporations taxed at a maximum of 35% under current law on ordinary income and capital gains
      - Individuals taxed at a maximum of 39.6% on ordinary income and 20% on capital gains (25% on depreciation recapture)
    - Additional 30% branch profits tax imposed on non-US corporations, subject to exemption or reduction under an applicable tax treaty
    - Tax return filing obligations
    - US tax may be creditable against foreign tax obligations

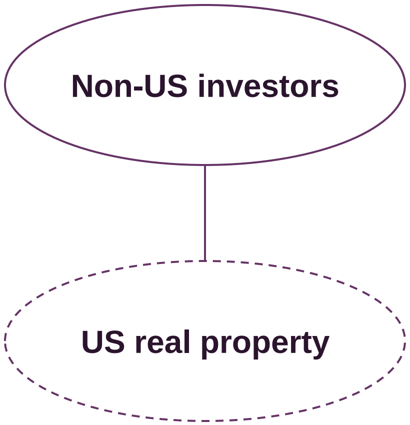
Taxation of Non-US Persons

- Is the US-source income effectively connected with a US trade or business?
  - If No:
    - US-source fixed or determinable annual or periodical income (i.e., dividends, interest, certain rents)
      - 30% US withholding tax on gross basis, but subject to exemption or reduction under applicable income tax treaties
    - Most capital gains
      - Generally not taxable
    - Generally no US tax return filing obligation

Taxation of Non-US Persons – US Real Estate

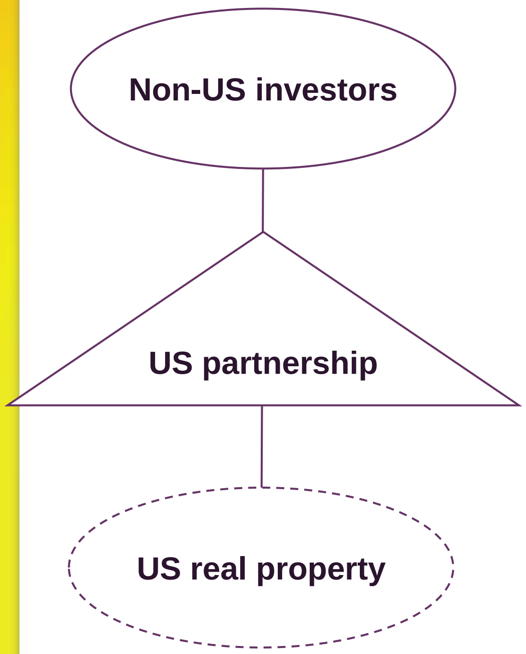
- Real estate rental income generally ECI (unless net lease)
- Gain from disposition of a US real property interest ("**USRPI**") is ECI and subject to withholding, US tax and tax return filing obligations under FIRPTA
  - USRPI includes US real estate and stock of a US corporation if the fair market value of such corporation's US real property interests is at least 50% of the value of most of its assets ("**USRPHC**")
    - Exception for sale of stock in domestically controlled REITs
    - Exception for sale of certain small interests in listed USRPHCs

Direct Investment



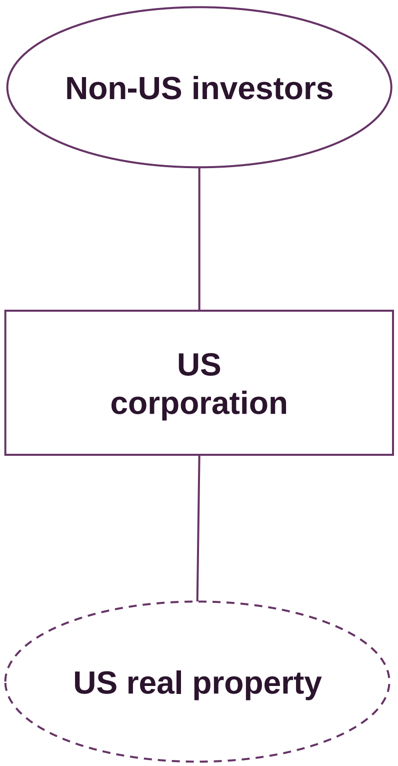
- ECI rules probably apply to all income (unless net lease property).
- Non-US investors must file US tax returns.
- Corporate foreign investors:
  - (a) Maximum 35% federal tax (under current law) on ordinary income and capital gains; state taxes also generally apply.
  - (b) Additional 30% US “branch profits tax” payment obligation for foreign corporate investors, which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%. May be reduced by applicable tax treaty and certain exceptions may apply.
- Individual foreign investors:
  - (a) Maximum 39.6% federal tax on ordinary income.
  - (b) Long-term capital gains eligible for 20%, or 25% in the case of unrecaptured section 1250 gain.
  - (c) US real property subject to US estate tax.

Investment Through Partnership



- Partnership income flows through to investors. Non-US investors will likely be treated as engaged in a US business as a result of directly investing in the US partnership, which engages in US business (unless net lease property). Thus, essentially same consequences as direct investment.
- Allocable shares of operating income and gains from the sale of real estate subject to US tax at regular rates.
- Non-US investors must file US tax returns. State taxes generally apply.
- The Partnership must withhold quarterly on net ECI allocable to non-US partners at highest applicable rates under section 1446 and the regulations thereunder.
- Additional 30% US "branch profits tax" payment obligation for foreign corporate investors (unless reduced by treaty or exceptions apply), which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%
- Potential US estate tax consequences.
- Sale of interest in the US partnership
  - Gain on sale (capital gain) likely treated as ECI and taxable to investors at regular individual or corporate rates, as applicable. See IRC § 897(g); Rev. Rul. 91-32.
  - Seller withholding obligations – see IRC § 1445(e)(5); Treas. Reg. § 1.1445-11T(b).

Investment Through US Corporation



- US corporation pays tax at regular rates on operating income and gains from sale.
- Dividends subject to 30% US withholding tax (subject to treaty reduction). No filing obligation on dividends.
- Return of capital distributions subject to 10% FIRPTA withholding in absence of applicable exception.
- Gain on sale of US corporation stock taxable under FIRPTA and subject to 10% withholding in absence of applicable exception.
- No branch profits tax for foreign corporate investor.
- Could capitalize US corporation with debt payable to shareholders in order to offset income with interest deductions. (Limitations under section 163(j) if debt-equity ratio exceeds 1.5-to-1. Also, limits in certain cases if rate is too high or interest is accruing but unpaid.)
- Interest payments may be exempt as “portfolio interest” if lending shareholders do not own more than 10% of stock. Otherwise, 30% US withholding tax applies to interest payments, subject to treaty reduction.
- US corporation stock subject to US estate tax, subject to treaty exemption.

U.S. Taxation of Non-U.S. Shareholders of U.S. REITs

	Listed (Equity) REIT	Nonlisted (Equity) REIT	Mortgage REIT
Ordinary Dividends	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate
C/G Dividends			
≤ 5% S/Hs	30% withholding, subject to applicable treaty rate	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
> 5% S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
Gain on Sale of Shares			
≤ 5% S/Hs	Exempt	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
> 5% S/Hs	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
Liquidating Distributions			
≤ 5% S/Hs	Exempt	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
> 5% S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI

Treaty Rates for Ordinary REIT Dividends

- US Model Treaty
  - 0% for pension funds that do not own more than 10% of the REIT
  - 15% for individuals who do not own more than 10% of the REIT
  - 15% for persons who do not own more than 5% of any class of the REIT's listed stock
  - 15% for $\leq$ 10% shareholders if the REIT is diversified, i.e., if no REIT property is worth more than 10% of the value of its total real property interests.
- Exemption for pension funds in certain (e.g., Canadian, Dutch, UK) treaties
  - Limitations, e.g., exemption inapplicable to dividends received by Canadian pension plan from "related" REIT or by Dutch pension plan that owns more than 80% of any class of the REIT's stock
- Idiosyncratic treaty rates – 10% dividend rate under US treaties with Japan and China

Taxation of Capital Gain Dividends

- Distributions that are attributable to gain from sale of USRPIs are treated as FIRPTA gain – subject to recharacterization rule for ≤ 5% shareholders (one-year look-back period) of publicly traded REITs. IRC §§ 897(h)(1) & 857(b)(3)(F).
- Treat as C/G dividends the maximum amount that could have been treated as a C/G dividend. Treas. Reg. § 1.1445-8(c)(2)(ii)(A).
- Retention of FIRPTA treatment for distributions through tiered REITs. IRC § 897(h)(1).
- Wash sale anti-abuse rule. IRC § 897(h)(5).
- 35% withholding. IRC § 1445(e)(6).
- Because "net capital gain" not determinable until end of year, can withhold in subsequent year. Treas. Reg. § 1.1445-8(c)(2)(ii)(C).

Legislative Proposals Affecting Taxation of Non-US Investors in US REITs

- Obama Budget Proposal
  - Would exempt foreign pension funds from FIRPTA.
- Senate Finance Committee Proposals
  - C/G dividends of publicly traded REITs would be recharacterized as ordinary dividends for ≤ 10% shareholders.
  - Gain on sale of shares of publicly traded REIT by ≤ 10% shareholders would not be taxable under FIRPTA.
  - FIRPTA would be inapplicable with respect to holdings in REITs (whether private or publicly traded) by certain listed Dutch beliggingsinstellings and listed Australian property trusts except with respect to investors therein that indirectly own more than 10% of the REIT’s stock.
  - 15% withholding rate on sales of USRPHC stock.
  - Cleansed USRPHC rule would be inapplicable to REITs and RICs.

Domestically Controlled REITs

Benefit of Domestically Controlled REIT

- Section 897(h)(2) provides that stock in a "domestically controlled qualified investment entity" is not a USRPI
  - Therefore, a foreign person can sell stock in a domestically controlled REIT without a FIRPTA tax liability or FIRPTA withholding
  - But domestically controlled REIT status *does not* confer any FIRPTA exemption on capital gain dividends or other distributions from a REIT that are captured by section 897(h)(1)

Definition of Domestically Controlled REIT

- Section 897(h)(4)(B)
  - The term “domestically controlled qualified investment entity” means any qualified investment entity [REIT] in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.
  - Generally, the testing period is the five-year period ending on the date of disposition or, if shorter, the period during which the REIT was in existence.
    - USRPHC that makes REIT election after first USRPHC year?
  - Charter restrictions to maintain domestically controlled REIT status will not violate transferable share requirement. See, e.g., PLR 9630016.

Domestically Controlled REIT Status

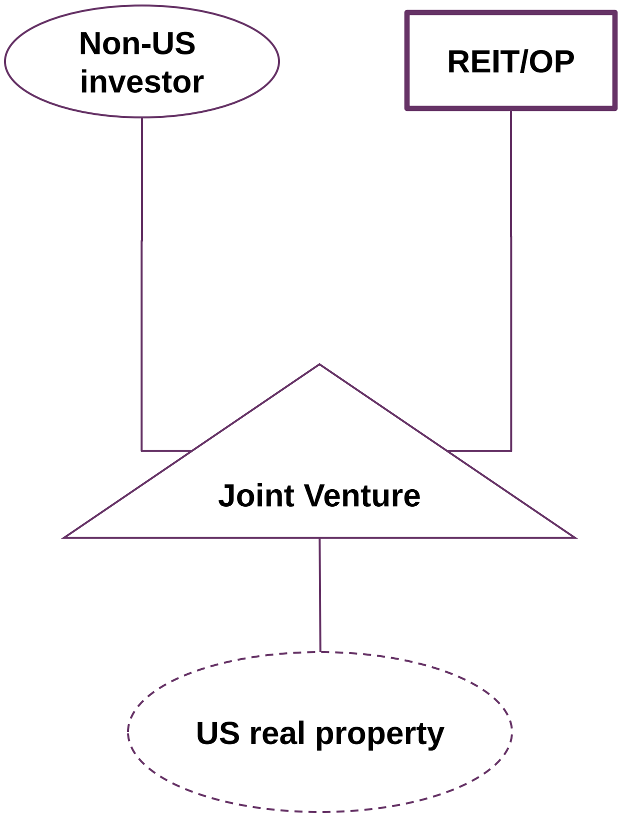
- What indirect ownership is/should be taken into account?
  - Actual owners of shares, i.e., persons required to include dividends in income to be taken into account. Treas. Reg. § 1.897-1(c)(2)(i).
  - No clear authority on whether to look through US partnerships, US C corporations, or US REITs, or whether base erosion could be relevant.
  - In PLR 200923001, the IRS concluded that it would not look through US C corporations, noting that they were not a REIT, RIC, hybrid entity, conduit, disregarded entity or other flow-through or look-through entity.
  - Publicly traded REIT disclosures regarding domestically controlled status versus practical impossibility to confirm domestically controlled status.
  - Process for establishing domestically controlled status for withholding agents uncertain. See Treas. Reg. §§ 1.897-2(g)(3) & (h)(3).

Legislative Proposals to Clarify Domestically Controlled Determination

- Senate Finance Proposals
  - Presumption that less than 5% shareholders of publicly traded REITs are US persons, absent actual knowledge to the contrary.
  - Stock held by a publicly traded REIT or an open-end RIC is treated as held by foreign persons unless the shareholder REIT or RIC is itself domestically controlled, in which case it would be treated as a US person. Look-through for other shareholder REITs and RICs.
  - Treated as not domestically controlled unless publicly disclose domestically controlled status.

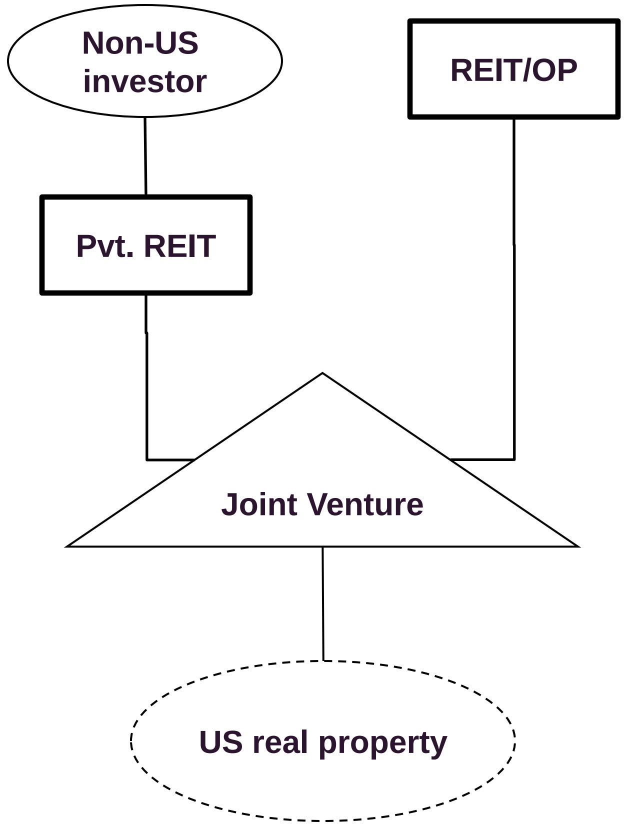
Structures for JV Between REIT and Non-US Investor

Simple JV with Non-US Investor



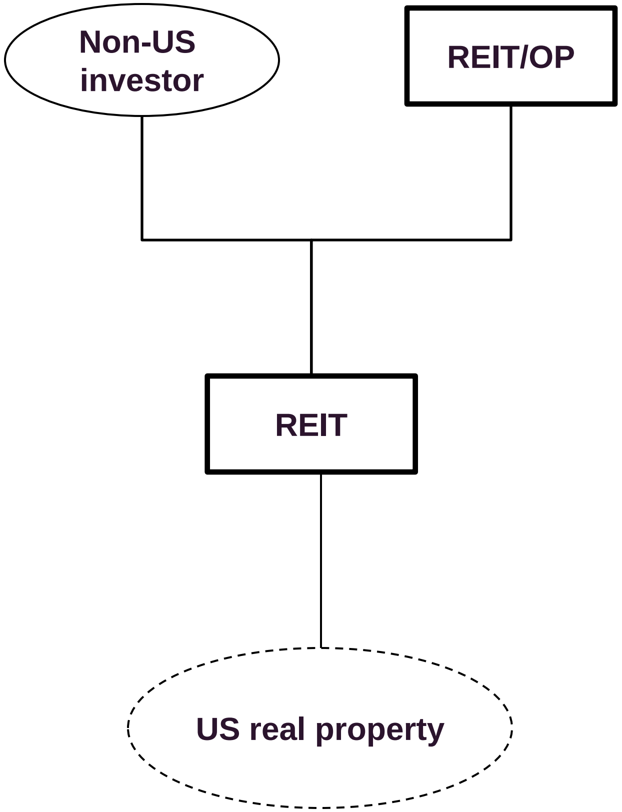
- Basic Consequences
  - Operating income taxable.
  - Gain on sale of property or JV interest taxable
- Foreign Government investor – generally section 892 is not helpful
- Issues associated with property contribution by non-US investor? Nonrecognition transactions under FIRPTA

Non-US Investor Invests Through REIT



- Dividends taxable
- Lower withholding rates for interest may favor leveraged REIT
- Gains from JV sales of USRPIs taxable under section 897(h)(1)
- Stock sale gain taxable (foreign-controlled REIT)
- Liquidating distributions taxable
- Other Issues
- Foreign Government
  - REIT is controlled commercial entity so section 892 not helpful

Non-US Investor and REIT Form Jointly Owned Private REIT



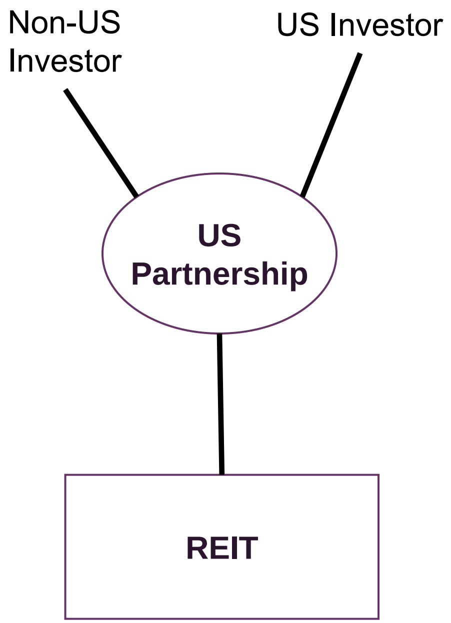
- Ordinary dividends taxable
- Distributions attributable to gains from property sales taxable
- Stock sale gain – No tax if REIT is domestically controlled
- Foreign Government Investors
  - Ordinary dividends exempt unless recipient or REIT is a controlled commercial entity
  - Distributions attributable to gains from property sales taxable
  - Stock sale gain exempt (but if seller or REIT is a controlled commercial entity, and if REIT is foreign controlled, then taxable)

Tax-related Deal Issues for Joint Ventures Between US and Non-US Investors

Single-Property Domestically Controlled REIT

- Exemptions for ordinary dividends for foreign pension funds under tax treaties and for foreign governments under section 892, combined with exemption for gain on sale of shares of domestically controlled REITs, led to widespread use of single-property domestically controlled REITs.
- Uncertainty whether liquidation distributions should be treated as section 897(h)(1) distributions of FIRPTA gains or as section 331 distributions in exchange for stock of a domestically controlled REIT.
  - PLR 9016021: liquidating distributions treated as section 331 distributions in exchange for stock (not a domestically controlled REIT, but section 331 treatment allowed shareholders to recover outside basis).
  - PLR 200453008: revoked PLR 9016021.
  - Notice 2007-55: liquidating distributions treated as section 897(h)(1) distributions of FIRPTA gain (and is taxable notwithstanding Section 892).
  - AM 2008-003: liquidating distributions to $\leq$ 5% shareholder of publicly traded REIT not recharacterized as ordinary dividends.

US Partnership to Hold Domestically Controlled REIT



- No FIRPTA withholding with US seller, whereas reliance on domestically controlled REIT status less certain.
- Partnership agreement addresses business deal regarding maintaining domestically controlled REIT status, exit structure, etc.
  - Could partnership provisions implicate REIT rules, e.g., transferable share requirement, preferential dividend rules, etc.?

Deal Issues – Non-US Investor/Seller

- Sale of REIT shares (or partnership owning REIT shares) is optimal exit strategy for non-US partner.
- Coordinated sale of entire REIT so buyer can liquidate and get a step-up (and pay higher price) preferred.
- Maintenance of domestically controlled REIT status.
  - US partner cannot sell its interest in REIT shares (or partnership owning REIT shares) to non-US person.
  - Buyer must maintain REIT status through end of REIT's taxable year for year of sale – and indemnify non-US seller if it fails to do so – given no FIRPTA exception for sales of domestically controlled non-REIT USRPHCs.

Deal Issues – US Partner/Seller

- May or may not benefit from REIT structure
- Possibility of haircut on exit if sell REIT shares (or partnership owning REIT shares)
- Restrictions on transfer of its interest
- Costs of establishing and maintaining the REIT structure and executing the domestically controlled REIT strategy

Deal Issues – "Typical" Joint Venture Matters

- Contributing appreciated property
  - Tax-deferral
  - Allocation of built-in gain
- Buy-sell provisions
  - Can both partners be "buyers" without affecting REIT qualification
  - Basis – if no step-up for the buying partner that is buying REIT shares
    - Impact on REIT distribution requirements
- Forced sale and drag and tag rights
  - Impact of REIT shares sale
    - Limiting buyers
    - Valuation / pricing
- Governance issues
  - REITs must be managed by directors or trustees

Deal Issues – Buyer Issues

- Confirming REIT status of target REIT
- Withholding issues
- Costs of liquidating the target REIT to get stepped-up basis

Deal Issues – Buyer Step-Up Strategy

- Properly and carefully structured, a Buyer post-closing can undertake a section 331 liquidation, e.g., into a partnership purchaser that results in a tax basis step up in the assets. Buyers has no outside gain, and liquidating REIT's inside gain offset with dividends-paid deduction.
  - The net impact to Buyer is akin to elections under section 336(e), 338, and 754
  - Buyers are increasingly comfortable and accommodating of this M&A structure
  - Structuring issue on how to handle "blocker" C corporations inserted into the structure to push the REIT across the domestically controlled threshold

    Will Buyer pay the tax on the inside gain of these C corporations?

    Will Buyer "downstream" merge the C corporations in tax-free reorganizations?
  - Buyer's section 331 liquidation for a basis step up may be delayed or difficult, if:
    - Target REIT was a "personal holding company" in Seller's hands
    - Buyers is a fund/partnership with foreign investors that would have FIRPTA exposure
    - Seller contractually insists on a delayed liquidation in order to maximally protect from FIRPTA taint any pre-closing dividend distributions to Seller from the target REIT.

Take-aways

- Structuring a REIT Joint Venture with a non-US partner means weighing access to capital against additional operational complexity, structure and potential friction costs on exit.

- Tax will play a key role in identifying costs associated with the operations, structure and exit strategy so that those costs can be allocated in the deal; up-front planning is key.
  - ✓ Number of entities
  - ✓ Funding, distributions and intercompany agreements
  - ✓ REIT qualification, procedures and documentation
  - ✓ Domestically controlled compliance and documentation
  - ✓ Indemnifications and warranties

Understanding the Unique Tax Rules Applicable to Foreign Governments

Sovereign Wealth Funds

- Overview
  - Sovereign wealth funds ("SWFs")
    - Government investment vehicles funded by foreign exchange assets and managed separately from official reserves
    - Rapidly growing in number and size
    - Roughly 50 countries have SWFs
    - The Sovereign Wealth Fund Institute estimates the top 25 SWFs have aggregate investments of USD 6 trillion (www.swfinstitute.org/fund/rankings)

Sovereign Wealth Funds

- Overview
  - Commodity SWFs – funded by commodity exports that are either owned or taxed by the government
  - Non-commodity SWFs – typically funded through transfers of assets from official foreign exchange reserves
    - The excess reserves generally result from large balance-of-payment surpluses
    - The “excess” reserves are transferred to investment funds that can be managed for higher returns

Sovereign Wealth Funds

- Other sovereign investors
  - International reserves – external assets that are controlled by and readily available to finance ministries and central banks for direct financing of international payments
  - Public pension funds – investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens
  - State owned enterprises – companies over which the state has significant control through full, majority or significant minority ownership

Sovereign Wealth Funds

- IRC Section 892 investors
  - Foreign government
    - Integral part
    - Controlled entity
  - May include:
    - SWF
    - Public pension funds
    - International reserves
  - Does not include:
    - State owned enterprises

Sovereign Wealth Funds

- IRC Section 892 exemption
  - Exempt income generally includes income from securities
    - Stocks, bonds, loans, but not interests in partnerships
  - Income derived by or from controlled commercial entities is not exempt

Sovereign Wealth Funds

- Controlled commercial entity
  - An entity (broadly defined) that engages in commercial activities where the foreign government (controlled entity or integral part):
    - Holds, directly or indirectly, a 50% or more (by vote or value) of the interests in the entity, or
    - Holds interests that provide the foreign government with “effective practical control”

Sovereign Wealth Funds

- Effective practical control
  - A sufficient interest by value or voting power or any other interest that provides the foreign government with effective practical control of the entity
  - Can be achieved through a minority interest that is sufficiently large to achieve effective control, or through the combination of an equity interest and a creditor, contractual or regulatory relationship
  - A foreign government may have effective practical control if it owns a small minority interest in an entity but is also a substantial creditor or is in control of a strategic natural resource used by the entity in its business
  - Veto or blocking rights on specific decisions/actions must be carefully evaluated.

Capital Gain Dividends and Other Section 897(h)(1) Distributions

Section 897(h)(1) Distributions

- Any distribution by a qualified investment entity (REIT or RIC) to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges of United States real property interests, be treated as gain recognized by such nonresident alien individual, a foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest

Section 897(h)(1) Distributions

- Notice 2007-55 clarifies that "any distribution" includes both current and liquidating distributions, notwithstanding section 331 which treats liquidating distributions as payments in exchange for stock
- What does "attributable to" mean in the context of section 302 or other non-pro rata distributions?
- "Attributable to" issues:
  - Netting of gains and losses from sale of USRPIs during the tax year
  - Netting prior year losses from the sale of USRPIs against current year gains
  - Netting current year operating losses against gain from the sale of USRPIs
  - Netting of net operating losses from prior years
- When is a current or liquidating REIT distribution "**attributable to**" gain from sales or exchanges of USRPIs?
  - Regulations and pronouncements of the Treasury and the Service do not prescribe a methodology
  - Analogies to other Code provisions?
  - NYSBA Tax Section Report on Notice 2007-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6), 7 January 2014
- Backed up by wash sale anti-abuse rule under section 897(h)(5)

Section 897(h)(1) Distributions

- Withholding on section 897(h)(1) distributions
  - Section 1445(e)(6) – 35% withholding
  - Treas. Reg. § 1.1445-8 – withholding required on largest amount that could have been declared as a REIT capital gain dividend, whether actually declared or not
    - Both broader and narrower than substantive tax liability under sections 897(h), 871(b) and 882

Other FIRPTA/Inbound Issues

Treatment of Distressed Debt Under FIRPTA

Treatment of Distressed Debt Under FIRPTA

- Is a deeply discounted loan that can only have a value in excess of its purchase price if the underlying value of the real estate securing the loan appreciates a USRPI under FIRPTA?
- USRPI includes an interest in United States real property <u>other than an interest solely as a creditor</u>
- An interest other than an interest solely as a creditor includes a loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person. Such interest is in its entirety an interest in real property other than solely as a creditor (Treas. Reg. section 1.897-1(d)(2)(i)).

Treatment of Distressed Debt Under FIRPTA *(cont'd)*

- Repossession and foreclosure rights
  - A right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property (Treas. Reg. § 1.897-1(d)(2)(ii)(C)).
  - Thus, no such right will of itself cause an interest in real property <u>which is otherwise an interest solely as a creditor</u> to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, <u>if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor</u> *(emphasis added).*

Fund/AIV Investments

AIV Options in Fund Investments

- Typically, real estate funds offer investments through a "main fund" or through one or more "alternative investment vehicles"
  - AIVs may exist for tax-exempt or for non-US investors
    - REITs may be used as blockers for one or both of these investor classes
  - Crossed or partially blended economics between the main fund and AIVs may create ECI, UBTI or REIT qualification issues
    - Issues for investors
    - Issues for sponsor (withholding obligations)

DESCRIPTION OF THE CHAIRMAN'S MARK OF PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS (REITs), REGULATED INVESTMENT COMPANIES (RICs) AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on February 11, 2015

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 9, 2015
JCX-30-15

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INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on February 11, 2015, of proposals relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA). This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the proposals.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of Proposals Relating to the Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA)* (JCX-30-15), February 9, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Proposals Relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and the Foreign Investment in Real Property Tax Act (FIRPTA)

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or of other capital assets.[2]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[3] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[4] In the case of a foreign corporation, the gain from the disposition or distribution of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payer of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment. Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on

[2] Secs. 871(b), 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

[4] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

any sale of stock that is regularly traded on an established securities market),[5] and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation during the applicable testing period.[6] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USPRI from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[7] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

U.S. real property holding corporations and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a domestic U.S. real property holding corporation ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during a "testing period," which is the shorter of the duration of the taxpayer's ownership of the stock since June 18, 1980, or the five-year period ending on the date of disposition of the stock.[8]

Under an exception, even if a corporation were a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the seller shareholder held (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.[9] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[10] The attribution rules also attribute

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[5] Sec. 1445(b). Other excepted circumstances include the sale of a personal residence where the amount realized does not exceed $300,000.

[6] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See Sec. 1445(e)(4) and 1445(e)(5).

[7] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

[8] Secs. 897(c)(1)(A)(ii) and 897(c)(2).

[9] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[10] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. (Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C)). Also, if five percent or more in value of the stock in a

stock ownership between spouses and between children, grandchildren, parents, and grandparents.

"Cleansing rule" exception where corporate gain recognized

An interest in a corporation is not a USRPI if, as of the date of disposition of such interest, such corporation did not hold any USRPIs and all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations.[11]

FIRPTA rules for foreign investment through REITS and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity", which includes any real estate investment trust ("REIT"). Prior to January 1, 2015, the term also included certain regulated investment companies ("RICs") that invest largely in U.S. real property interests (including stock of one or more REITs). On and after that date, such RICs are treated as qualified investment entities under FIRPTA only for the purpose of applying FIRPTA to certain distributions the RIC receives or makes that are attributable to its interest in a REIT.[12]

REITs and RICs must satisfy a number of requirements, and are generally taxable as U.S. domestic corporations, but are subject to a modified corporate tax regime that permits the corporation to deduct amounts distributed to shareholders. The shareholders generally include such distributions in income.

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[13]), stock of such entity is not a USRPI and a

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corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. (Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C)).

[11] Sec. 897(c)(1)(B).

[12] Sec. 897(h)(4)(A)(ii). The provision that expired after December 31, 2014, more generally treating such RICs as qualified investment entities, has expired previously but has subsequently been reinstated through December 31, 2014.

[13] The testing period for this purpose if the shorter of i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, ii) the five-year period ending on the date of the

foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC.[14] Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[15] The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose did not look through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[16]

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPI's, except for distributions to certain five-percent or smaller shareholders

Code section 897(h) provides that a distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[17] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[18] An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to both nonliquidating and liquidating distributions, and to distributions treated as sales or exchanges of stock by the investor as well as to dividend distributions) and that the IRS will issue regulations to that effect.[19]

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disposition or distribution, as the case may be, or iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[14] As noted previously, after December 31, 2014, a RIC is not included in the definition of a qualified investment entity for purposes of this rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

[15] Treas. Reg. Sec. 1.897-1(c)(2)(i) and Treas. Reg. Sec. 1.857-8(b).

[16] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

[17] Sec. 897(h)(1).

[18] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[19] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt

Code section 897(h)(1) provides an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located within the U.S., during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[20] Such distributions that are dividends are treated as dividends from the qualified investment entity,[21] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are not dividends are not subject to tax under FIRPTA.[22]

FIRPTA withholding and reporting of information regarding USRPHC status

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[23] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[24] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[25]

Treasury regulations[26] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform

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from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

[20] Sec. 897(h)(1), second sentence. As noted previously, after December 31, 2014, a RIC is not a qualified investment entity for this purpose.

[21] Secs. 852(b)(3)(E) and 857(b)(3)(F).

[22] AM 2008-003, February 15, 2008.

[23] Sec. 1445.

[24] Sec. 1445(b)(6).

[25] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[26] Treas. Reg. Sec. 1.897-2(h).

that person whether the interest constitutes a USRPI.[27] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT, nor to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[28]

General Code authorization of certain returns by foreign persons

Present law section 6039C provides for returns by foreign persons holding direct investments in U.S. real property interests for the calendar year, to the extent provided by regulations. No regulations have been issued under this section.

Corporate dividends-received deduction for certain U.S. source dividends received from foreign corporations

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[29]

[27] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation ("USRPHC"). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

[28] Treas. Reg. sec. 1.897-2(h)(3).

[29] Sec. 243.

Dividends from REITs are not eligible for the corporate dividends received deduction.[30] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[31]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[32] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.[33] Treasury regulations section 1.246-1 states that the deductions provided in sections "243… 244… and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

Description of Proposals

1. Publicly traded REITs and certain publicly traded qualified shareholder entities that hold REIT stock

In the case of REIT stock only, the proposal increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The proposal likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of U.S. real property interests, as a dividend, rather than as FIPRTA gain. Any distributions to such 10 percent (or less)

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[30] Secs. 243(d)(3) and 857(c)(1).

[31] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[32] Sec. 245.

[33] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

shareholders that are not dividends (for example, if the qualified investment entity surrendered its stock in a redemption that was not treated as a dividend) would be exempt from U.S. tax.[34]

For these purposes, the attribution rules of section 897(c)(6)(C) are modified to refer to the determination of whether a person holds more than 5 percent of a class of stock that is publicly traded (in the case of a non-REIT shareholder) or more than 10 percent (in the case of a REIT shareholder), as applicable. In either case, however, the proposal retains the present law attribution rules of section 897(c)(6)(C) that trigger attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation.

The proposal also provides that REIT stock held by a qualified shareholder is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as that "more than 10 percent" rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA. Also, the REIT may sell its assets and distribute the proceeds in a transaction that is treated as a sale of the qualified shareholder's REIT stock, without the application of FIRPTA. If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) does hold more than 10 percent of such class of REIT stock, then a percentage of the REIT stock held by the qualified shareholder equal to such investor's percentage ownership of the qualified shareholder is treated as a US real property interest in the hands of the qualified shareholder and is subject to FIRPTA.[35]

A qualified shareholder is defined as an entity that is (i) eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program, (ii) a qualified collective investment vehicle (as defined below), (iii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and (iv) that maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10 percent of that principal class of interests.

[34] This result would follow from application of the conclusion of AM 2008-83, Feb. 15, 2008. See Present Law, FIRPTA rules for foreign investment through REITs and RICs, *supra*.

[35] As one example, if an individual shareholder owns 10 percent of a REIT's stock directly and also owns 10 percent of the stock of a qualified shareholder that in turn owns 80 percent of that REIT's stock (thus indirectly owning another 8 percent of such REIT's stock), such shareholder is deemed to own more than 10 percent (*i.e.*, 18 percent) of that REIT's stock under the proposal. Accordingly, 10 percent (the investor's percentage ownership of the qualified shareholder) of the REIT stock held by the qualified shareholder is treated as a U.S. real property interest.

A qualified collective investment vehicle is defined as an entity that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT[36] (ii) would be classified as a U.S. real property holding corporation (determined without regard to the proposal's rules that exempt REIT stock held by the entity from treatment as a U.S. real property interest), or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

Effective Date

The disposition provisions of the proposal apply to dispositions on and after the date of enactment. The attribution rule change (to refer to the separate 5 percent and 10 percent limitations) is effective on the date of enactment. The distribution provisions apply to any distribution by a REIT on or after the date of enactment which is treated as a deduction for a taxable year of such REIT ending after such date.

2. Domestically controlled definition

For purposes of determining whether a qualified investment entity is domestically controlled, the proposal provides a number of new rules and presumptions.

First, a qualified investment entity shall be permitted to presume that stock held by a holder of less than five percent of a class of stock regularly traded on an established securities market in the United States is held by U.S. persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership. Second, any stock in the qualified investment held by another qualified investment entity (I) any class of stock of which is regularly traded on an established stock exchange, or (II) which is a regulated investment company which issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined applying the permitted foregoing presumptions) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Effective Date

The proposal is effective on the date of enactment.

[36] For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

3. Increase 10 percent FIRPTA withholding to 15 percent

The proposal generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The proposal applies to dispositions after the date which is 60 days after the date of the enactment.

4. Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status

The proposal requires disclosures of USRPHC status, by any corporation that is or was a U.S. real property holding corporation at any time during the five-year period ending on the date on which disclosure is made. Such a corporation must attach a statement regarding its status as a USRPHC within the past five years to its annual tax return, filed on or before the due date (including extensions). Such a corporation is also required to disclose such status on Form 1099s sent to shareholders, in annual reports, on websites, and, in the case of privately-held corporations, on stock certificates.

In the absence of disclosure to the contrary (in such form and manner as the Secretary of the Treasury may prescribe), any qualified investment entity (as defined in section 897(h)(4)) will be presumed for purposes of section 897 to be foreign controlled. Thus, if a foreign person disposes of the stock of a qualified investment entity that is domestically controlled under the rules provided in the proposal, but that does not disclose its domestically controlled status, the disposition is treated as one of stock of an entity that is not domestically controlled, and hence FIRPTA would generally apply to the disposition unless another exception applied.

A penalty is imposed for failure to comply with the USRPHC notification requirements. In the case of a corporation with gross receipts of less than $5,000,000, the penalty is $500,000. The penalty increases to $1,500,000 for corporations with gross receipts of $5,000,000 or more. In the case of a corporation that holds U.S. real property interests with a gross fair market value of $1 billion or more, the penalty is $5 million, increased to $10 million in the case of intentional failure to disclose or report. For purposes of determining gross receipts and gross fair market value under these penalty provisions, related-party aggregation rules apply.

Under regulations prescribed by the Secretary of the Treasury, publicly traded partnerships shall also be subject to these rules.

Effective Date

The proposal takes effect on January 1, 2016.

5. Require FIRPTA withholding by brokers

The proposal amends the FIRPTA withholding rules to provide that in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)), such broker shall be required to deduct and withhold a tax equal to 15 percent of the amount realized on the disposition. Certain exceptions apply.

Broker withholding is not required for sales of stock of a domestically controlled qualified investment entity (as defined in section 897(c)(4)) or for stock of a REIT that is not treated as a U.S. real property interest because it is being sold by an entity that is a qualified shareholder under the proposal. With respect to any disposition of any class of stock of a USRPHC which is regularly traded on an established securities market, broker withholding is not required if the transferor, immediately prior to the disposition, holds five percent or less of such class of stock (10 percent or less in the case of REIT stock). For that purpose, brokers are permitted to rely on public statements made by public companies, including statements related to the status of the company as a U.S. real property holding corporation or as a domestically controlled qualified investment entity.[37]

Broker withholding is only required if the broker had actual knowledge (or reasonably should have known) that the disposition was of stock of a U.S. real property holding corporation.

The proposal amends the Code provision that currently exempts from withholding the disposition of a share of a class of stock that is regularly traded on an established securities market, to require the broker withholding in accordance with the foregoing provisions.

Under regulations prescribed by the Secretary of the Treasury, similar withholding rules shall apply to brokers in the case of a disposition of a publicly traded partnership interest where such partnership would be a U.S. real property holding corporation if it were a U.S. corporation.

Effective Date

The proposal applies to dispositions after December 31, 2015.

6. Cleansing rule not applicable to RICs or REITs

Under the proposal, the so-called "cleansing rule" applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

[37] Under the immediately preceding proposal, any qualified investment entity (as defined in section 897(h)(4)) is presumed for FIPTRA purposes to be foreign controlled unless the entity has made a disclosure to the contrary in such form and manner as the Secretary of the Treasury may prescribe.

Effective Date

The proposal applies to dispositions after the date of enactment.

7. Dividends derived from RICs and REITs ineligible for deduction for U.S. source portion of dividends from certain foreign corporations

Under the proposal, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245 of the Code, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The proposal applies to dividends received from RICs and REITs on or after the date of enactment.

B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2015-20**	**2015-25**
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

[1] Gain of less than $500,000.
[2] Loss of less than $500,000.

C. Increase Continuous Levy Authority on Payments to Medicare Providers and Suppliers

Present Law

In general

Levy is the administrative authority of the IRS to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[38] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[39] the property is not exempt from levy,[40] and the IRS has provided both notice of intention to levy[41] and notice of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[42] at least 30 days before the levy is made. A levy on salary or wages generally is continuously in effect until released.[43] A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[44]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[45]

The CDP notice (and pre-levy CDP hearing) is not required if: (1) the Secretary finds that collection would be jeopardized by delay; (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund; (3) the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served; or (4) the Secretary has served a Federal contractor levy. In each of these four cases,

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[38] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[39] *Ibid*.

[40] Sec. 6334.

[41] Sec. 6331(d).

[42] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[43] Secs. 6331(e) and 6343.

[44] Sec. 6321.

[45] Secs. 6331(d)(3) and 6861.

however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[46]

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[47] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments" by the Federal government if the payees are delinquent on their tax obligations. With respect to payments to vendors of goods, services, or property sold or leased to the Federal government, the continuous levy may be up to 100 percent of each payment.[48] For payments to Medicare providers and suppliers, the levy is up to 15 percent for payments made within 180 days after December 19, 2014. For payments made after that date, the levy is up to 30 percent.[49]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by Treasury's Bureau of Fiscal Service ("BFS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct BFS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

Description of Proposal

The proposal provides that the present limitation of 30 percent of certain specified payments be increased by an amount sufficient to offset the estimated revenue loss of the provisions described in Part A, above.

Effective Date

The proposal is effective for payments made after 180 days after the date of enactment.

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[46] Sec. 6330(f).

[47] Pub. L. No. 105-34.

[48] Sec. 6331(h)(3).

[49] Pub. L. No. 113-295, Division B.

Tax Issues Arising from Inbound Investments into US REITs Meeting

Thursday, April 2nd
9:30am – 10:45am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
A. Cristina Arumi, Partner, Ernst & Young

Panelists:
James Croker, Partner, Alston & Bird LLP
Ameek Ponda, Partner & Director-Tax Department
Rohn Grazer, SVP & Director, Prologis, Inc.

DESCRIPTION OF THE CHAIRMAN'S MARK OF PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS (REITs), REGULATED INVESTMENT COMPANIES (RICs) AND THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on February 11, 2015

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 9, 2015
JCX-30-15

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INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on February 11, 2015, of proposals relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA). This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the proposals.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of Proposals Relating to the Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA)* (JCX-30-15), February 9, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Proposals Relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and the Foreign Investment in Real Property Tax Act (FIRPTA)

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or of other capital assets.[2]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[3] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[4] In the case of a foreign corporation, the gain from the disposition or distribution of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payer of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment. Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on

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[2] Secs. 871(b), 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

[4] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

any sale of stock that is regularly traded on an established securities market),[5] and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation during the applicable testing period.[6] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USPRI from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[7] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

U.S. real property holding corporations and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a domestic U.S. real property holding corporation ("USRPHC"), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during a "testing period," which is the shorter of the duration of the taxpayer's ownership of the stock since June 18, 1980, or the five-year period ending on the date of disposition of the stock.[8]

Under an exception, even if a corporation were a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the seller shareholder held (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.[9] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[10] The attribution rules also attribute

[5] Sec. 1445(b). Other excepted circumstances include the sale of a personal residence where the amount realized does not exceed $300,000.

[6] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See Sec. 1445(e)(4) and 1445(e)(5).

[7] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

[8] Secs. 897(c)(1)(A)(ii) and 897(c)(2).

[9] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[10] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. (Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C)). Also, if five percent or more in value of the stock in a

stock ownership between spouses and between children, grandchildren, parents, and grandparents.

<u>"Cleansing rule" exception where corporate gain recognized</u>

An interest in a corporation is not a USRPI if, as of the date of disposition of such interest, such corporation did not hold any USRPIs and all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations.[11]

FIRPTA rules for foreign investment through REITS and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity", which includes any real estate investment trust ("REIT"). Prior to January 1, 2015, the term also included certain regulated investment companies ("RICs") that invest largely in U.S. real property interests (including stock of one or more REITs). On and after that date, such RICs are treated as qualified investment entities under FIRPTA only for the purpose of applying FIRPTA to certain distributions the RIC receives or makes that are attributable to its interest in a REIT.[12]

REITs and RICs must satisfy a number of requirements, and are generally taxable as U.S. domestic corporations, but are subject to a modified corporate tax regime that permits the corporation to deduct amounts distributed to shareholders. The shareholders generally include such distributions in income.

<u>Stock of domestically controlled qualified investment entities not a USRPI</u>

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[13]), stock of such entity is not a USRPI and a

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corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. (Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C)).

[11] Sec. 897(c)(1)(B).

[12] Sec. 897(h)(4)(A)(ii). The provision that expired after December 31, 2014, more generally treating such RICs as qualified investment entities, has expired previously but has subsequently been reinstated through December 31, 2014.

[13] The testing period for this purpose if the shorter of i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, ii) the five-year period ending on the date of the

foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC.[14] Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[15] The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose did not look through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[16]

<u>FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPI's, except for distributions to certain five-percent or smaller shareholders</u>

Code section 897(h) provides that a distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[17] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.[18] An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to both nonliquidating and liquidating distributions, and to distributions treated as sales or exchanges of stock by the investor as well as to dividend distributions) and that the IRS will issue regulations to that effect.[19]

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disposition or distribution, as the case may be, or iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[14] As noted previously, after December 31, 2014, a RIC is not included in the definition of a qualified investment entity for purposes of this rule permitting stock of a "domestically controlled" qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

[15] Treas. Reg. Sec. 1.897-1(c)(2)(i) and Treas. Reg. Sec. 1.857-8(b).

[16] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

[17] Sec. 897(h)(1).

[18] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[19] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt

Code section 897(h)(1) provides an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located within the U.S., during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[20] Such distributions that are dividends are treated as dividends from the qualified investment entity,[21] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are not dividends are not subject to tax under FIRPTA.[22]

FIRPTA withholding and reporting of information regarding USRPHC status

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[23] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[24] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[25]

Treasury regulations[26] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform

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from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

[20] Sec. 897(h)(1), second sentence. As noted previously, after December 31, 2014, a RIC is not a qualified investment entity for this purpose.

[21] Secs. 852(b)(3)(E) and 857(b)(3)(F).

[22] AM 2008-003, February 15, 2008.

[23] Sec. 1445.

[24] Sec. 1445(b)(6).

[25] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[26] Treas. Reg. Sec. 1.897-2(h).

that person whether the interest constitutes a USRPI.[27] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT, nor to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[28]

General Code authorization of certain returns by foreign persons

Present law section 6039C provides for returns by foreign persons holding direct investments in U.S. real property interests for the calendar year, to the extent provided by regulations. No regulations have been issued under this section.

Corporate dividends-received deduction for certain U.S. source dividends received from foreign corporations

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[29]

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[27] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation ("USRPHC"). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

[28] Treas. Reg. sec. 1.897-2(h)(3).

[29] Sec. 243.

Dividends from REITs are not eligible for the corporate dividends received deduction.[30] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[31]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[32] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.[33] Treasury regulations section 1.246-1 states that the deductions provided in sections "243… 244… and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

Description of Proposals

1. Publicly traded REITs and certain publicly traded qualified shareholder entities that hold REIT stock

In the case of REIT stock only, the proposal increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The proposal likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of U.S. real property interests, as a dividend, rather than as FIPRTA gain. Any distributions to such 10 percent (or less)

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30 Secs. 243(d)(3) and 857(c)(1).

31 Secs. 243(d)(2) and 854(b)(1)(A) and (C).

32 Sec. 245.

33 IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

shareholders that are not dividends (for example, if the qualified investment entity surrendered its stock in a redemption that was not treated as a dividend) would be exempt from U.S. tax.[34]

For these purposes, the attribution rules of section 897(c)(6)(C) are modified to refer to the determination of whether a person holds more than 5 percent of a class of stock that is publicly traded (in the case of a non-REIT shareholder) or more than 10 percent (in the case of a REIT shareholder), as applicable. In either case, however, the proposal retains the present law attribution rules of section 897(c)(6)(C) that trigger attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation.

The proposal also provides that REIT stock held by a qualified shareholder is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as that "more than 10 percent" rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA. Also, the REIT may sell its assets and distribute the proceeds in a transaction that is treated as a sale of the qualified shareholder's REIT stock, without the application of FIRPTA. If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) does hold more than 10 percent of such class of REIT stock, then a percentage of the REIT stock held by the qualified shareholder equal to such investor's percentage ownership of the qualified shareholder is treated as a US real property interest in the hands of the qualified shareholder and is subject to FIRPTA.[35]

A qualified shareholder is defined as an entity that is (i) eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program, (ii) a qualified collective investment vehicle (as defined below), (iii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and (iv) that maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10 percent of that principal class of interests.

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[34] This result would follow from application of the conclusion of AM 2008-83, Feb. 15, 2008. See Present Law, FIRPTA rules for foreign investment through REITs and RICs, *supra*.

[35] As one example, if an individual shareholder owns 10 percent of a REIT's stock directly and also owns 10 percent of the stock of a qualified shareholder that in turn owns 80 percent of that REIT's stock (thus indirectly owning another 8 percent of such REIT's stock), such shareholder is deemed to own more than 10 percent (*i.e.*, 18 percent) of that REIT's stock under the proposal. Accordingly, 10 percent (the investor's percentage ownership of the qualified shareholder) of the REIT stock held by the qualified shareholder is treated as a U.S. real property interest.

A qualified collective investment vehicle is defined as an entity that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT[36] (ii) would be classified as a U.S. real property holding corporation (determined without regard to the proposal's rules that exempt REIT stock held by the entity from treatment as a U.S. real property interest), or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

Effective Date

The disposition provisions of the proposal apply to dispositions on and after the date of enactment. The attribution rule change (to refer to the separate 5 percent and 10 percent limitations) is effective on the date of enactment. The distribution provisions apply to any distribution by a REIT on or after the date of enactment which is treated as a deduction for a taxable year of such REIT ending after such date.

2. Domestically controlled definition

For purposes of determining whether a qualified investment entity is domestically controlled, the proposal provides a number of new rules and presumptions.

First, a qualified investment entity shall be permitted to presume that stock held by a holder of less than five percent of a class of stock regularly traded on an established securities market in the United States is held by U.S. persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership. Second, any stock in the qualified investment held by another qualified investment entity (I) any class of stock of which is regularly traded on an established stock exchange, or (II) which is a regulated investment company which issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined applying the permitted foregoing presumptions) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Effective Date

The proposal is effective on the date of enactment.

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[36] For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

3. Increase 10 percent FIRPTA withholding to 15 percent

The proposal generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The proposal applies to dispositions after the date which is 60 days after the date of the enactment.

4. Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status

The proposal requires disclosures of USRPHC status, by any corporation that is or was a U.S. real property holding corporation at any time during the five-year period ending on the date on which disclosure is made. Such a corporation must attach a statement regarding its status as a USRPHC within the past five years to its annual tax return, filed on or before the due date (including extensions). Such a corporation is also required to disclose such status on Form 1099s sent to shareholders, in annual reports, on websites, and, in the case of privately-held corporations, on stock certificates.

In the absence of disclosure to the contrary (in such form and manner as the Secretary of the Treasury may prescribe), any qualified investment entity (as defined in section 897(h)(4)) will be presumed for purposes of section 897 to be foreign controlled. Thus, if a foreign person disposes of the stock of a qualified investment entity that is domestically controlled under the rules provided in the proposal, but that does not disclose its domestically controlled status, the disposition is treated as one of stock of an entity that is not domestically controlled, and hence FIRPTA would generally apply to the disposition unless another exception applied.

A penalty is imposed for failure to comply with the USRPHC notification requirements. In the case of a corporation with gross receipts of less than $5,000,000, the penalty is $500,000. The penalty increases to $1,500,000 for corporations with gross receipts of $5,000,000 or more. In the case of a corporation that holds U.S. real property interests with a gross fair market value of $1 billion or more, the penalty is $5 million, increased to $10 million in the case of intentional failure to disclose or report. For purposes of determining gross receipts and gross fair market value under these penalty provisions, related-party aggregation rules apply.

Under regulations prescribed by the Secretary of the Treasury, publicly traded partnerships shall also be subject to these rules.

Effective Date

The proposal takes effect on January 1, 2016.

5. Require FIRPTA withholding by brokers

The proposal amends the FIRPTA withholding rules to provide that in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)), such broker shall be required to deduct and withhold a tax equal to 15 percent of the amount realized on the disposition. Certain exceptions apply.

Broker withholding is not required for sales of stock of a domestically controlled qualified investment entity (as defined in section 897(c)(4)) or for stock of a REIT that is not treated as a U.S. real property interest because it is being sold by an entity that is a qualified shareholder under the proposal. With respect to any disposition of any class of stock of a USRPHC which is regularly traded on an established securities market, broker withholding is not required if the transferor, immediately prior to the disposition, holds five percent or less of such class of stock (10 percent or less in the case of REIT stock). For that purpose, brokers are permitted to rely on public statements made by public companies, including statements related to the status of the company as a U.S. real property holding corporation or as a domestically controlled qualified investment entity.[37]

Broker withholding is only required if the broker had actual knowledge (or reasonably should have known) that the disposition was of stock of a U.S. real property holding corporation.

The proposal amends the Code provision that currently exempts from withholding the disposition of a share of a class of stock that is regularly traded on an established securities market, to require the broker withholding in accordance with the foregoing provisions.

Under regulations prescribed by the Secretary of the Treasury, similar withholding rules shall apply to brokers in the case of a disposition of a publicly traded partnership interest where such partnership would be a U.S. real property holding corporation if it were a U.S. corporation.

Effective Date

The proposal applies to dispositions after December 31, 2015.

6. Cleansing rule not applicable to RICs or REITs

Under the proposal, the so-called "cleansing rule" applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

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[37] Under the immediately preceding proposal, any qualified investment entity (as defined in section 897(h)(4)) is presumed for FIPTRA purposes to be foreign controlled unless the entity has made a disclosure to the contrary in such form and manner as the Secretary of the Treasury may prescribe.

Effective Date

The proposal applies to dispositions after the date of enactment.

7. Dividends derived from RICs and REITs ineligible for deduction for U.S. source portion of dividends from certain foreign corporations

Under the proposal, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245 of the Code, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The proposal applies to dividends received from RICs and REITs on or after the date of enactment.

B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2015-20**	**2015-25**
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

[1] Gain of less than $500,000.
[2] Loss of less than $500,000.

C. Increase Continuous Levy Authority on Payments to Medicare Providers and Suppliers

Present Law

In general

Levy is the administrative authority of the IRS to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[38] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[39] the property is not exempt from levy,[40] and the IRS has provided both notice of intention to levy[41] and notice of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[42] at least 30 days before the levy is made. A levy on salary or wages generally is continuously in effect until released.[43] A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[44]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[45]

The CDP notice (and pre-levy CDP hearing) is not required if: (1) the Secretary finds that collection would be jeopardized by delay; (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund; (3) the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served; or (4) the Secretary has served a Federal contractor levy. In each of these four cases,

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[38] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[39] *Ibid*.

[40] Sec. 6334.

[41] Sec. 6331(d).

[42] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[43] Secs. 6331(e) and 6343.

[44] Sec. 6321.

[45] Secs. 6331(d)(3) and 6861.

however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[46]

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[47] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments" by the Federal government if the payees are delinquent on their tax obligations. With respect to payments to vendors of goods, services, or property sold or leased to the Federal government, the continuous levy may be up to 100 percent of each payment.[48] For payments to Medicare providers and suppliers, the levy is up to 15 percent for payments made within 180 days after December 19, 2014. For payments made after that date, the levy is up to 30 percent.[49]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by Treasury's Bureau of Fiscal Service ("BFS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct BFS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

Description of Proposal

The proposal provides that the present limitation of 30 percent of certain specified payments be increased by an amount sufficient to offset the estimated revenue loss of the provisions described in Part A, above.

Effective Date

The proposal is effective for payments made after 180 days after the date of enactment.

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[46] Sec. 6330(f).

[47] Pub. L. No. 105-34.

[48] Sec. 6331(h)(3).

[49] Pub. L. No. 113-295, Division B.

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JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Tax Issues Arising From Inbound Investment Into US REITs

(a/k/a FIRPTA, FIRPTA, FIRPTA)

March 31-April 2, 2015

Cristina Arumi
Jim Croker
Rohn Grazer
Ameek Ponda

Overview of Topics

- Overview of US Taxation of Non-US Investors in US REITs
  - Legislative Proposals
- Domestically Controlled REITs
- REIT Joint Ventures
  - Preparing for the Exit Strategy
  - Understanding the Unique Tax Rules for Foreign Governments
- Capital Gain Dividends and other Section 897(h)(1) Distributions
  - Substantive Tax
  - Withholding Obligations
- Other FIRPTA/Inbound Issues
  - What is a USRPI?
  - Fund/Alternative Investment Vehicle (“AIV”) Investments

Overview of US Taxation of Non-US Investors in US REITs

Taxation of Non-US Persons

- Is the US-source income effectively connected with a US trade or business (“ECI”)?
  - If Yes:
    - Subject to US tax at regular rates
      - Corporations taxed at a maximum of 35% under current law on ordinary income and capital gains
      - Individuals taxed at a maximum of 39.6% on ordinary income and 20% on capital gains (25% on depreciation recapture)
    - Additional 30% branch profits tax imposed on non-US corporations, subject to exemption or reduction under an applicable tax treaty
    - Tax return filing obligations
    - US tax may be creditable against foreign tax obligations

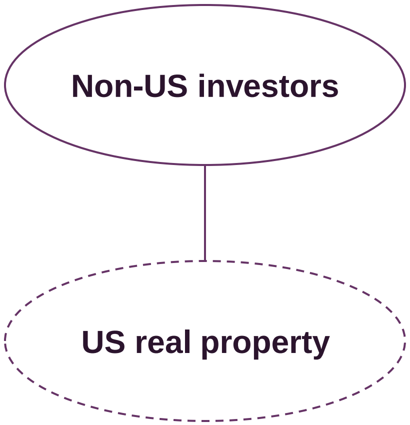
Taxation of Non-US Persons

- Is the US-source income effectively connected with a US trade or business?
  - If No:
    - US-source fixed or determinable annual or periodical income (i.e., dividends, interest, certain rents)
      - 30% US withholding tax on gross basis, but subject to exemption or reduction under applicable income tax treaties
    - Most capital gains
      - Generally not taxable
    - Generally no US tax return filing obligation

Taxation of Non-US Persons – US Real Estate

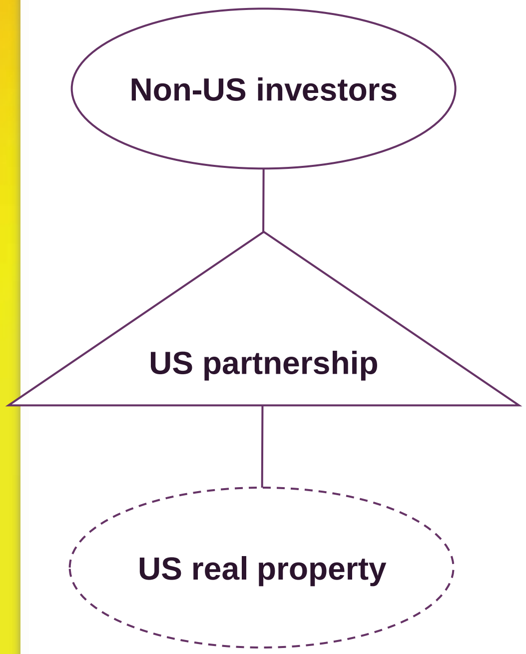
- Real estate rental income generally ECI (unless net lease)
- Gain from disposition of a US real property interest ("**USRPI**") is ECI and subject to withholding, US tax and tax return filing obligations under FIRPTA
  - USRPI includes US real estate and stock of a US corporation if the fair market value of such corporation's US real property interests is at least 50% of the value of most of its assets ("**USRPHC**")
    - Exception for sale of stock in domestically controlled REITs
    - Exception for sale of certain small interests in listed USRPHCs

Direct Investment



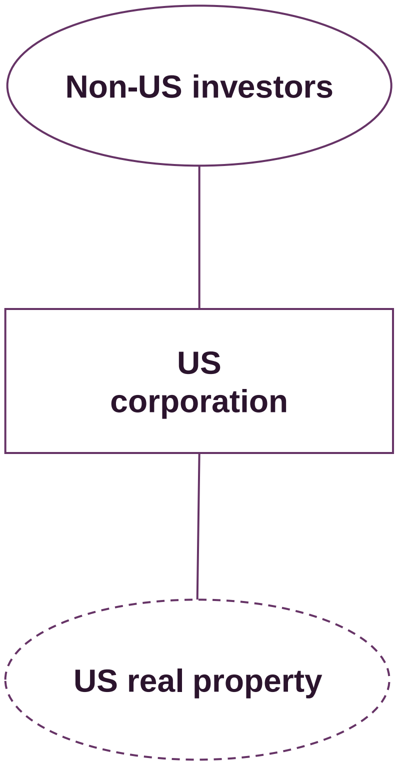
- ECI rules probably apply to all income (unless net lease property).
- Non-US investors must file US tax returns.
- Corporate foreign investors:
  - (a) Maximum 35% federal tax (under current law) on ordinary income and capital gains; state taxes also generally apply.
  - (b) Additional 30% US “branch profits tax” payment obligation for foreign corporate investors, which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%. May be reduced by applicable tax treaty and certain exceptions may apply.
- Individual foreign investors:
  - (a) Maximum 39.6% federal tax on ordinary income.
  - (b) Long-term capital gains eligible for 20%, or 25% in the case of unrecaptured section 1250 gain.
  - (c) US real property subject to US estate tax.

Investment Through Partnership



- Partnership income flows through to investors. Non-US investors will likely be treated as engaged in a US business as a result of directly investing in the US partnership, which engages in US business (unless net lease property). Thus, essentially same consequences as direct investment.
- Allocable shares of operating income and gains from the sale of real estate subject to US tax at regular rates.
- Non-US investors must file US tax returns. State taxes generally apply.
- The Partnership must withhold quarterly on net ECI allocable to non-US partners at highest applicable rates under section 1446 and the regulations thereunder.
- Additional 30% US “branch profits tax” payment obligation for foreign corporate investors (unless reduced by treaty or exceptions apply), which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%
- Potential US estate tax consequences.
- Sale of interest in the US partnership
  - Gain on sale (capital gain) likely treated as ECI and taxable to investors at regular individual or corporate rates, as applicable. See IRC § 897(g); Rev. Rul. 91-32.
  - Seller withholding obligations – see IRC § 1445(e)(5); Treas. Reg. § 1.1445-11T(b).

Investment Through US Corporation



- US corporation pays tax at regular rates on operating income and gains from sale.
- Dividends subject to 30% US withholding tax (subject to treaty reduction). No filing obligation on dividends.
- Return of capital distributions subject to 10% FIRPTA withholding in absence of applicable exception.
- Gain on sale of US corporation stock taxable under FIRPTA and subject to 10% withholding in absence of applicable exception.
- No branch profits tax for foreign corporate investor.
- Could capitalize US corporation with debt payable to shareholders in order to offset income with interest deductions. (Limitations under section 163(j) if debt-equity ratio exceeds 1.5-to-1. Also, limits in certain cases if rate is too high or interest is accruing but unpaid.)
- Interest payments may be exempt as “portfolio interest” if lending shareholders do not own more than 10% of stock. Otherwise, 30% US withholding tax applies to interest payments, subject to treaty reduction.
- US corporation stock subject to US estate tax, subject to treaty exemption.

U.S. Taxation of Non-U.S. Shareholders of U.S. REITs

	Listed (Equity) REIT	Nonlisted (Equity) REIT	Mortgage REIT
Ordinary Dividends	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate
C/G Dividends			
≤ 5% S/Hs	30% withholding, subject to applicable treaty rate	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
> 5% S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
Gain on Sale of Shares			
≤ 5% S/Hs	Exempt	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
> 5% S/Hs	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
Liquidating Distributions			
≤ 5% S/Hs	Exempt	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
> 5% S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI

Treaty Rates for Ordinary REIT Dividends

- US Model Treaty
  - 0% for pension funds that do not own more than 10% of the REIT
  - 15% for individuals who do not own more than 10% of the REIT
  - 15% for persons who do not own more than 5% of any class of the REIT's listed stock
  - 15% for $\leq$ 10% shareholders if the REIT is diversified, i.e., if no REIT property is worth more than 10% of the value of its total real property interests.
- Exemption for pension funds in certain (e.g., Canadian, Dutch, UK) treaties
  - Limitations, e.g., exemption inapplicable to dividends received by Canadian pension plan from "related" REIT or by Dutch pension plan that owns more than 80% of any class of the REIT's stock
- Idiosyncratic treaty rates – 10% dividend rate under US treaties with Japan and China

Taxation of Capital Gain Dividends

- Distributions that are attributable to gain from sale of USRPIs are treated as FIRPTA gain – subject to recharacterization rule for ≤ 5% shareholders (one-year look-back period) of publicly traded REITs. IRC §§ 897(h)(1) & 857(b)(3)(F).
- Treat as C/G dividends the maximum amount that could have been treated as a C/G dividend. Treas. Reg. § 1.1445-8(c)(2)(ii)(A).
- Retention of FIRPTA treatment for distributions through tiered REITs. IRC § 897(h)(1).
- Wash sale anti-abuse rule. IRC § 897(h)(5).
- 35% withholding. IRC § 1445(e)(6).
- Because "net capital gain" not determinable until end of year, can withhold in subsequent year. Treas. Reg. § 1.1445-8(c)(2)(ii)(C).

Legislative Proposals Affecting Taxation of Non-US Investors in US REITs

- Obama Budget Proposal
  - Would exempt foreign pension funds from FIRPTA.
- Senate Finance Committee Proposals
  - C/G dividends of publicly traded REITs would be recharacterized as ordinary dividends for $\leq$ 10% shareholders.
  - Gain on sale of shares of publicly traded REIT by $\leq$ 10% shareholders would not be taxable under FIRPTA.
  - FIRPTA would be inapplicable with respect to holdings in REITs (whether private or publicly traded) by certain listed Dutch beliggingsinstellings and listed Australian property trusts except with respect to investors therein that indirectly own more than 10% of the REIT's stock.
  - 15% withholding rate on sales of USRPHC stock.
  - Cleansed USRPHC rule would be inapplicable to REITs and RICs.

Domestically Controlled REITs

Benefit of Domestically Controlled REIT

- Section 897(h)(2) provides that stock in a “domestically controlled qualified investment entity” is not a USRPI
  - Therefore, a foreign person can sell stock in a domestically controlled REIT without a FIRPTA tax liability or FIRPTA withholding
  - But domestically controlled REIT status *does not* confer any FIRPTA exemption on capital gain dividends or other distributions from a REIT that are captured by section 897(h)(1)

Definition of Domestically Controlled REIT

- Section 897(h)(4)(B)
  - The term “domestically controlled qualified investment entity” means any qualified investment entity [REIT] in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.
  - Generally, the testing period is the five-year period ending on the date of disposition or, if shorter, the period during which the REIT was in existence.
    - USRPHC that makes REIT election after first USRPHC year?
  - Charter restrictions to maintain domestically controlled REIT status will not violate transferable share requirement. See, e.g., PLR 9630016.

Domestically Controlled REIT Status

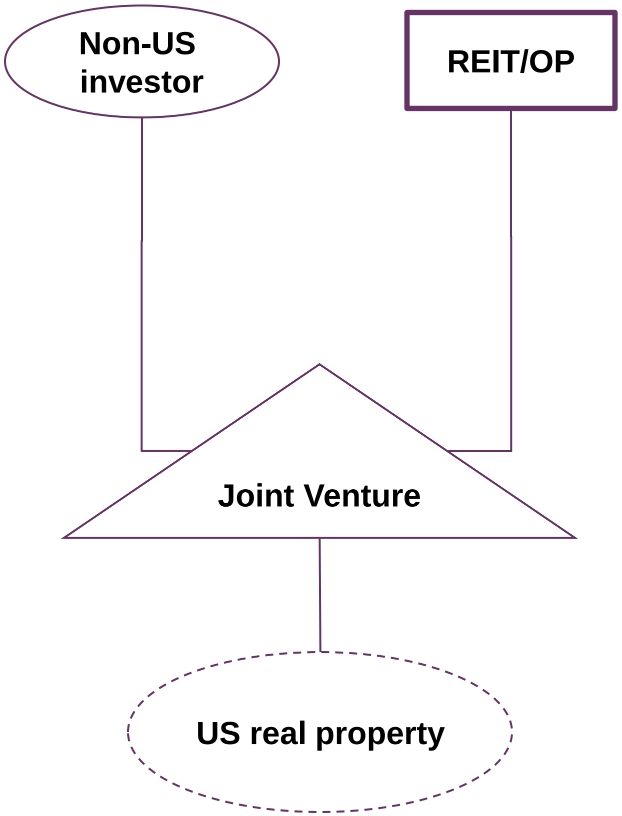
- What indirect ownership is/should be taken into account?
  - Actual owners of shares, i.e., persons required to include dividends in income to be taken into account. Treas. Reg. § 1.897-1(c)(2)(i).
  - No clear authority on whether to look through US partnerships, US C corporations, or US REITs, or whether base erosion could be relevant.
  - In PLR 200923001, the IRS concluded that it would not look through US C corporations, noting that they were not a REIT, RIC, hybrid entity, conduit, disregarded entity or other flow-through or look-through entity.
  - Publicly traded REIT disclosures regarding domestically controlled status versus practical impossibility to confirm domestically controlled status.
  - Process for establishing domestically controlled status for withholding agents uncertain. See Treas. Reg. §§ 1.897-2(g)(3) & (h)(3).

Legislative Proposals to Clarify Domestically Controlled Determination

- Senate Finance Proposals
  - Presumption that less than 5% shareholders of publicly traded REITs are US persons, absent actual knowledge to the contrary.
  - Stock held by a publicly traded REIT or an open-end RIC is treated as held by foreign persons unless the shareholder REIT or RIC is itself domestically controlled, in which case it would be treated as a US person. Look-through for other shareholder REITs and RICs.
  - Treated as not domestically controlled unless publicly disclose domestically controlled status.

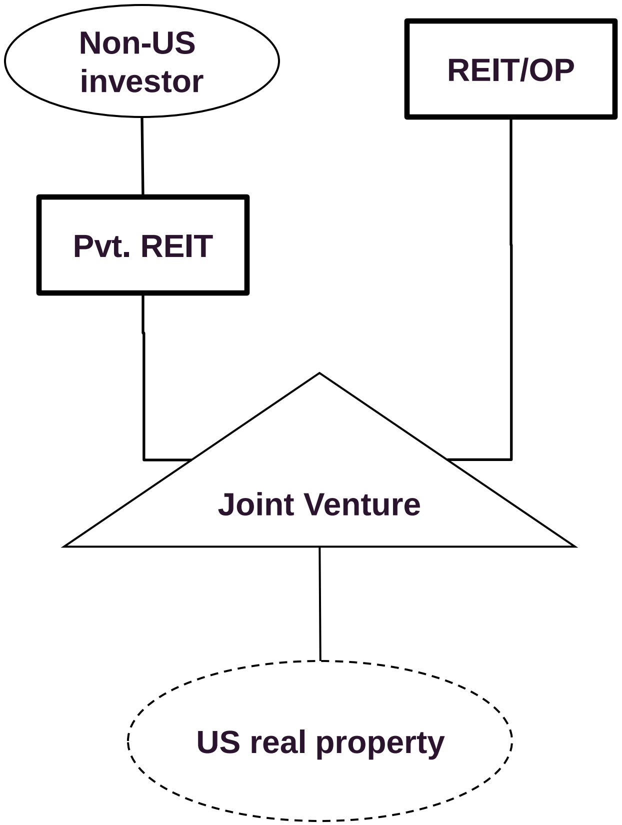
Structures for JV Between REIT and Non-US Investor

Simple JV with Non-US Investor



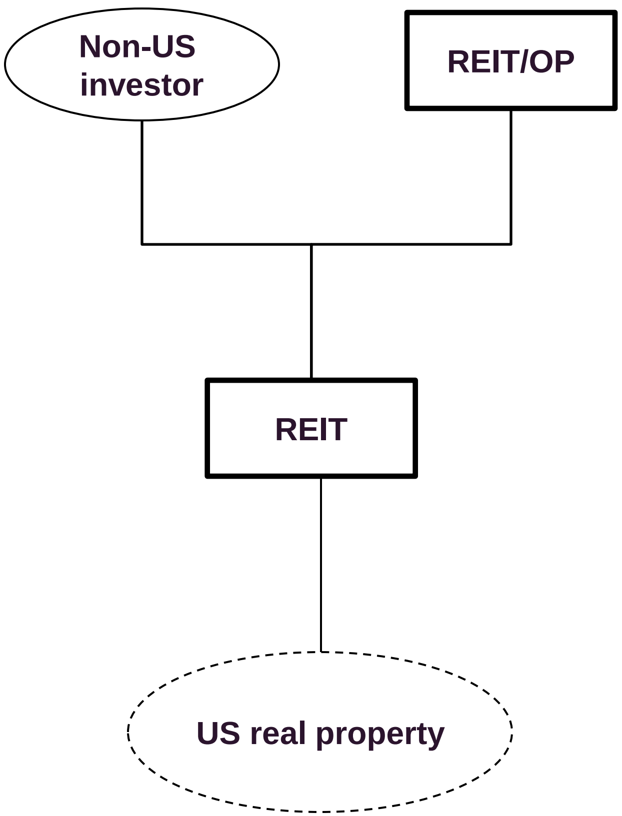
- Basic Consequences
  - Operating income taxable.
  - Gain on sale of property or JV interest taxable
- Foreign Government investor – generally section 892 is not helpful
- Issues associated with property contribution by non-US investor? Nonrecognition transactions under FIRPTA

Non-US Investor Invests Through REIT



- Dividends taxable
- Lower withholding rates for interest may favor leveraged REIT
- Gains from JV sales of USRPIs taxable under section 897(h)(1)
- Stock sale gain taxable (foreign-controlled REIT)
- Liquidating distributions taxable
- Other Issues
- Foreign Government
  - REIT is controlled commercial entity so section 892 not helpful

Non-US Investor and REIT Form Jointly Owned Private REIT



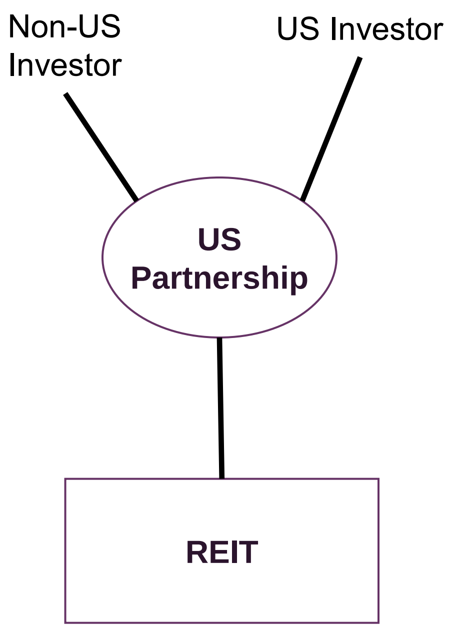
- Ordinary dividends taxable
- Distributions attributable to gains from property sales taxable
- Stock sale gain – No tax if REIT is domestically controlled
- Foreign Government Investors
  - Ordinary dividends exempt unless recipient or REIT is a controlled commercial entity
  - Distributions attributable to gains from property sales taxable
  - Stock sale gain exempt (but if seller or REIT is a controlled commercial entity, and if REIT is foreign controlled, then taxable)

Tax-related Deal Issues for Joint Ventures Between US and Non-US Investors

Single-Property Domestically Controlled REIT

- Exemptions for ordinary dividends for foreign pension funds under tax treaties and for foreign governments under section 892, combined with exemption for gain on sale of shares of domestically controlled REITs, led to widespread use of single-property domestically controlled REITs.
- Uncertainty whether liquidation distributions should be treated as section 897(h)(1) distributions of FIRPTA gains or as section 331 distributions in exchange for stock of a domestically controlled REIT.
  - PLR 9016021: liquidating distributions treated as section 331 distributions in exchange for stock (not a domestically controlled REIT, but section 331 treatment allowed shareholders to recover outside basis).
  - PLR 200453008: revoked PLR 9016021.
  - Notice 2007-55: liquidating distributions treated as section 897(h)(1) distributions of FIRPTA gain (and is taxable notwithstanding Section 892).
  - AM 2008-003: liquidating distributions to $\leq$ 5% shareholder of publicly traded REIT not recharacterized as ordinary dividends.

US Partnership to Hold Domestically Controlled REIT



- No FIRPTA withholding with US seller, whereas reliance on domestically controlled REIT status less certain.
- Partnership agreement addresses business deal regarding maintaining domestically controlled REIT status, exit structure, etc.
  - Could partnership provisions implicate REIT rules, e.g., transferable share requirement, preferential dividend rules, etc.?

Deal Issues – Non-US Investor/Seller

- Sale of REIT shares (or partnership owning REIT shares) is optimal exit strategy for non-US partner.
- Coordinated sale of entire REIT so buyer can liquidate and get a step-up (and pay higher price) preferred.
- Maintenance of domestically controlled REIT status.
  - US partner cannot sell its interest in REIT shares (or partnership owning REIT shares) to non-US person.
  - Buyer must maintain REIT status through end of REIT's taxable year for year of sale – and indemnify non-US seller if it fails to do so – given no FIRPTA exception for sales of domestically controlled non-REIT USRPHCs.

Deal Issues – US Partner/Seller

- May or may not benefit from REIT structure
- Possibility of haircut on exit if sell REIT shares (or partnership owning REIT shares)
- Restrictions on transfer of its interest
- Costs of establishing and maintaining the REIT structure and executing the domestically controlled REIT strategy

Deal Issues – "Typical" Joint Venture Matters

- Contributing appreciated property
  - Tax-deferral
  - Allocation of built-in gain
- Buy-sell provisions
  - Can both partners be "buyers" without affecting REIT qualification
  - Basis – if no step-up for the buying partner that is buying REIT shares
    - Impact on REIT distribution requirements
- Forced sale and drag and tag rights
  - Impact of REIT shares sale
    - Limiting buyers
    - Valuation / pricing
- Governance issues
  - REITs must be managed by directors or trustees

Deal Issues – Buyer Issues

- Confirming REIT status of target REIT
- Withholding issues
- Costs of liquidating the target REIT to get stepped-up basis

Deal Issues – Buyer Step-Up Strategy

- Properly and carefully structured, a Buyer post-closing can undertake a section 331 liquidation, e.g., into a partnership purchaser that results in a tax basis step up in the assets. Buyers has no outside gain, and liquidating REIT's inside gain offset with dividends-paid deduction.
  - The net impact to Buyer is akin to elections under section 336(e), 338, and 754
  - Buyers are increasingly comfortable and accommodating of this M&A structure
  - Structuring issue on how to handle "blocker" C corporations inserted into the structure to push the REIT across the domestically controlled threshold

    Will Buyer pay the tax on the inside gain of these C corporations?

    Will Buyer "downstream" merge the C corporations in tax-free reorganizations?
  - Buyer's section 331 liquidation for a basis step up may be delayed or difficult, if:
    - Target REIT was a "personal holding company" in Seller's hands
    - Buyers is a fund/partnership with foreign investors that would have FIRPTA exposure
    - Seller contractually insists on a delayed liquidation in order to maximally protect from FIRPTA taint any pre-closing dividend distributions to Seller from the target REIT.

Take-aways

- Structuring a REIT Joint Venture with a non-US partner means weighing access to capital against additional operational complexity, structure and potential friction costs on exit.

- Tax will play a key role in identifying costs associated with the operations, structure and exit strategy so that those costs can be allocated in the deal; up-front planning is key.
  - ✓ Number of entities
  - ✓ Funding, distributions and intercompany agreements
  - ✓ REIT qualification, procedures and documentation
  - ✓ Domestically controlled compliance and documentation
  - ✓ Indemnifications and warranties

Understanding the Unique Tax Rules Applicable to Foreign Governments

Sovereign Wealth Funds

- Overview
  - Sovereign wealth funds ("SWFs")
    - Government investment vehicles funded by foreign exchange assets and managed separately from official reserves
    - Rapidly growing in number and size
    - Roughly 50 countries have SWFs
    - The Sovereign Wealth Fund Institute estimates the top 25 SWFs have aggregate investments of USD 6 trillion (www.swfinstitute.org/fund/rankings)

Sovereign Wealth Funds

- Overview
  - Commodity SWFs – funded by commodity exports that are either owned or taxed by the government
  - Non-commodity SWFs – typically funded through transfers of assets from official foreign exchange reserves
    - The excess reserves generally result from large balance-of-payment surpluses
    - The “excess” reserves are transferred to investment funds that can be managed for higher returns

Sovereign Wealth Funds

- Other sovereign investors
  - International reserves – external assets that are controlled by and readily available to finance ministries and central banks for direct financing of international payments
  - Public pension funds – investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens
  - State owned enterprises – companies over which the state has significant control through full, majority or significant minority ownership

Sovereign Wealth Funds

- IRC Section 892 investors
  - Foreign government
    - Integral part
    - Controlled entity
  - May include:
    - SWF
    - Public pension funds
    - International reserves
  - Does not include:
    - State owned enterprises

Sovereign Wealth Funds

- IRC Section 892 exemption
  - Exempt income generally includes income from securities
    - Stocks, bonds, loans, but not interests in partnerships
  - Income derived by or from controlled commercial entities is not exempt

Sovereign Wealth Funds

- Controlled commercial entity
  - An entity (broadly defined) that engages in commercial activities where the foreign government (controlled entity or integral part):
    - Holds, directly or indirectly, a 50% or more (by vote or value) of the interests in the entity, or
    - Holds interests that provide the foreign government with “effective practical control”

Sovereign Wealth Funds

- Effective practical control
  - A sufficient interest by value or voting power or any other interest that provides the foreign government with effective practical control of the entity
  - Can be achieved through a minority interest that is sufficiently large to achieve effective control, or through the combination of an equity interest and a creditor, contractual or regulatory relationship
  - A foreign government may have effective practical control if it owns a small minority interest in an entity but is also a substantial creditor or is in control of a strategic natural resource used by the entity in its business
  - Veto or blocking rights on specific decisions/actions must be carefully evaluated.

Capital Gain Dividends and Other Section 897(h)(1) Distributions

Section 897(h)(1) Distributions

- Any distribution by a qualified investment entity (REIT or RIC) to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges of United States real property interests, be treated as gain recognized by such nonresident alien individual, a foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest

Section 897(h)(1) Distributions

- Notice 2007-55 clarifies that “any distribution” includes both current and liquidating distributions, notwithstanding section 331 which treats liquidating distributions as payments in exchange for stock
- What does “attributable to” mean in the context of section 302 or other non-pro rata distributions?
- “Attributable to” issues:
  - Netting of gains and losses from sale of USRPIs during the tax year
  - Netting prior year losses from the sale of USRPIs against current year gains
  - Netting current year operating losses against gain from the sale of USRPIs
  - Netting of net operating losses from prior years
- When is a current or liquidating REIT distribution “**attributable to**” gain from sales or exchanges of USRPIs?
  - Regulations and pronouncements of the Treasury and the Service do not prescribe a methodology
  - Analogies to other Code provisions?
  - NYSBA Tax Section Report on Notice 2007-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6), 7 January 2014
- Backed up by wash sale anti-abuse rule under section 897(h)(5)

Section 897(h)(1) Distributions

- Withholding on section 897(h)(1) distributions
  - Section 1445(e)(6) – 35% withholding
  - Treas. Reg. § 1.1445-8 – withholding required on largest amount that could have been declared as a REIT capital gain dividend, whether actually declared or not
    - Both broader and narrower than substantive tax liability under sections 897(h), 871(b) and 882

Other FIRPTA/Inbound Issues

Treatment of Distressed Debt Under FIRPTA

Treatment of Distressed Debt Under FIRPTA

- Is a deeply discounted loan that can only have a value in excess of its purchase price if the underlying value of the real estate securing the loan appreciates a USRPI under FIRPTA?
- USRPI includes an interest in United States real property <u>other than an interest solely as a creditor</u>
- An interest other than an interest solely as a creditor includes a loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person. Such interest is in its entirety an interest in real property other than solely as a creditor (Treas. Reg. section 1.897-1(d)(2)(i)).

Treatment of Distressed Debt Under FIRPTA *(cont'd)*

- Repossession and foreclosure rights
  - A right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property (Treas. Reg. § 1.897-1(d)(2)(ii)(C)).
  - Thus, no such right will of itself cause an interest in real property which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor *(emphasis added).*

Fund/AIV Investments

AIV Options in Fund Investments

- Typically, real estate funds offer investments through a “main fund” or through one or more “alternative investment vehicles”
  - AIVs may exist for tax-exempt or for non-US investors
    - REITs may be used as blockers for one or both of these investor classes
  - Crossed or partially blended economics between the main fund and AIVs may create ECI, UBTI or REIT qualification issues
    - Issues for investors
    - Issues for sponsor (withholding obligations)

Cybersecurity Roundtable Meeting

Thursday, April 2nd
11am – 12:15pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Heidi Roth, SVP, CAO & Controller, Kilroy Realty Corporation
Anthony Buffomante, Principal, KPMG LLP
Kurt Manske, VP-Compliance & Corporate Information Technology, QTS Realty Trust, Inc.

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Cyber Security

March 31-April 2, 2015

Agenda

1

State of the Union for Cyber Security

- New Vectors of Threats
- Dynamic World of Change
- Real Estate Cyber Security Risks
- Common Cyber Security Mistakes

2

Planning Your Response

- 5 steps to minimize your exposure
- Assess your Readiness
- Lessons learned from Law Enforcement

3

Appendix Materials

- Cyber Maturity Assessment Areas of Focus

New “Vectors” of Threats are Accelerating the Concern

Yesterday…

Bad “Actors”

- Isolated criminals
- “Script Kiddies”

“Target of Opportunity”

Targets

- Identity Theft
- Self Promotion Opportunities
- Theft of Services

Today…

Bad “Actors”

- Organized criminals
- Foreign States
- Hactivists
- Insiders

“Target of Choice”

Targets

- Intellectual Property
- Financial Information
- Strategic Access

Dynamic World of Change

KPMG Approach

Traditional Approach

Business Delivery "Stack"

BUSINESS LAYER
- Industry Leading Practices
- Geopolitical Drivers
- Business Process
- Corporate Objectives

ENABLEMENT LAYER
- Application
- Data

INFRASTRUCTURE LAYER
- Servers/Hosts
- Networks
- Physical Environment

Areas of Dynamic Change

- Driving Growth & Profitability
- New Products/Services
- Mergers/Acquisitions
- Globalization
- Strategic Sourcing
- Competitive Differentiation
- Increased Regulatory Scrutiny

- Mobile & Cloud Deployments
- "Big Data," BI & Analytics
- Self service & Consumerization

- Virtualization & Cloud Platforms
- Internetworking/VPNs
- New Operating Systems
- Low cost computing models
- Changing DataCenter models

Real Estate Cyber Security Risks

- Cash – wire transfer fraud
- Employee personal information
- Application data (tax returns, financial information, etc.)
- Tenant information – residential / senior living (HIPAA)
- Third-party vendor risks
- Building automation

The Five Most Common Cyber Security Mistakes

Mistake #1:

"We have to achieve 100 percent security."

Reality:

100 percent security is neither feasible nor the appropriate goal.

The Five Most Common Cyber Security Mistakes

Mistake #2:

"When we invest in best-in-class technical tools, we are safe."

Reality:

Effective Cyber Security is less dependent on technology than you think.

The Five Most Common Cyber Security Mistakes

Mistake #3:

"Our weapons have to be better than those of our attackers."

Reality:

The security policy should primarily be determined by your goals, not those of your attackers.

The Five Most Common Cyber Security Mistakes

Mistake #4:

"Cyber Security compliance is all about effective monitoring."

Reality:

The ability to learn is just as important as the ability to monitor.

The Five Most Common Cyber Security Mistakes

Mistake #5:

“We need to recruit the best professionals to defend ourselves against cyber crime.”

Reality:

Cyber Security is not a department, but an attitude.

Planning Your Response
Example Cyber Security Framework

Planning Your Response
Five Steps to Minimize Your Exposure

1	Assess your Readiness to Respond	Perform a cyber maturity assessment to look at areas such as Leadership and Governance, Human Factors, Information Risk Management, Business Continuity and Crisis Management.
2	Hone in on your critical assets	Identify your critical assets but remember that what you consider to be of no value, may be considered valuable to an attacker. Take a look at the lifecycle of your critical information assets from creation all the way to destruction.
3	Select your defense	Based on your assessment and your critical assets, select your defenses. Know what threats you are going to defend against – trying to prevent them all it gets very expensive
4	Boost your security awareness and education	Everyone in the organization – from the boardroom to the mailroom – must understand the value and sensitivity of the information they possess and, more importantly, how to protect it.
5	Enhance Monitoring & Incident Response	Being able to adequately respond to a security incident through established tested processes should not be taken lightly. Supported by a security monitoring platform and good threat intelligence, you can get a better grip on monitoring and responding to cyber crime.

Planning Your Response
Assess Your Readiness – Cyber Maturity Assessment

LEGAL AND COMPLIANCE

Regulatory and international certification standards as relevant

OPERATIONS AND TECHNOLOGY

The level of control measures implemented to address identified risks and minimize the impact of compromise

BUSINESS CONTINUITY AND CRISIS MANAGEMENT

Preparations for a security event and ability to prevent or minimize the impact through successful crisis and stakeholder management

LEADERSHIP AND GOVERNANCE

Board demonstrating due diligence, ownership and effective management of risk

HUMAN FACTORS

The level and integration of a security culture that empowers and ensures the right people, skills, culture and knowledge

INFORMATION RISK MANAGEMENT

The approach to achieve comprehensive and effective risk management of information throughout the organization and its delivery and supply partners

Planning Your Response
Assess Your Readiness – Cyber Maturity Assessment

Leadership and Governance
Board demonstrating due diligence, ownership and effective management of risk

Topics
Understanding of Cyber
Board Involvement
Third-Party Supplier Relationships
Identification of Critical Data
Ownership and Governance for Data Protection
Program Management

Human Factors
The level and integration of a security culture that empowers and ensures the right people, skills, culture and knowledge

Topics
Training and Awareness
Culture
Personnel Security Measures
Talent Management
Organizational Roles and Responsibilities

Planning Your Response
Assess Your Readiness – Cyber Maturity Assessment

Information Risk Management
The approach to achieve comprehensive and effective risk management of information throughout the organization and its delivery and supply partners

Topics
Risk Management Approach and Policies
Risk Tolerance Identification
Risk Assessment and Measures
Asset Management
Information Sharing
Third Party Accreditation
Ability to Detect Attacks & Integrate Improvements

Business Continuity and Crisis Management
Preparations for a security event and ability to prevent or minimize the impact through successful crisis and stakeholder Management

Topics
Ability to Manage Cyber Events
Financial Ramifications & Budget
Resources Required & Training
Robust Plans
Communications
Testing

Planning Your Response
Assess Your Readiness – Cyber Maturity Assessment

Operations and Technology
The level of control measures implemented to address identified risks and minimize the impact of compromise

Topics
Threat and Vulnerability Management
Logical Security Controls
Physical Security Controls
Security Monitoring
Incident Response
Integration with IT Service Management

Legal and Compliance
Regulatory and international certification standards as relevant

Topics
Inventory of compliance requirements
Compliance program components
Role of the Audit Committee
Litigation inventory
Cyber insurance

Tony Buffomante
KPMG LLP
Principal, Information Protection Services

200 E. Randolph
Chicago, IL 60601

abuffomante@kpmg.com
312-665-1748

Cybersecurity Questions for CEOs

Cyber threats constantly evolve with increasing intensity and complexity. The ability to achieve mission objectives and deliver business functions is increasingly reliant on information systems and the Internet, resulting in increased cyber risks that could cause severe disruption to a company's business functions or operational supply chain, impact reputation, or compromise sensitive customer data and intellectual property.

Organizations will face a host of cyber threats, some with severe impacts that will require security measures that go beyond compliance. For example, according to a 2011 Ponemon Institute study, the average cost of a compromised record in the U.S. was $194 per record and the loss of customer business due to a cyber breach was estimated at $3 million.

This document provides key questions to guide leadership discussions about cybersecurity risk management for your company, along with key cyber risk management concepts.

5 Questions CEOs Should Ask About Cyber Risks

1) How Is Our Executive Leadership Informed About the Current Level and Business Impact of Cyber Risks to Our Company?
2) What Is the Current Level and Business Impact of Cyber Risks to Our Company? What Is Our Plan to Address Identified Risks?
3) How Does Our Cybersecurity Program Apply Industry Standards and Best Practices?
4) How Many and What Types of Cyber Incidents Do We Detect In a Normal Week? What is the Threshold for Notifying Our Executive Leadership?
5) How Comprehensive Is Our Cyber Incident Response Plan? How Often Is It Tested?

Key Cyber Risk Management Concepts

Incorporate cyber risks into existing risk management and governance processes.

Cybersecurity is NOT implementing a checklist of requirements; rather it is managing cyber risks to an acceptable level. Managing cybersecurity risk as part of an organization's governance, risk management, and business continuity frameworks provides the strategic framework for managing cybersecurity risk throughout the enterprise.

Elevate cyber risk management discussions to the CEO.

CEO engagement in defining the risk strategy and levels of acceptable risk enables more cost effective management of cyber risks that is aligned with the business needs of the organization. Regular communication between the CEO and those held accountable for managing cyber risks provides awareness of current risks affecting their organization and associated business impact.

Implement industry standards and best practices, don't rely on compliance.

A comprehensive cybersecurity program leverages industry standards and best practices to protect systems and detect potential problems, along with processes to be informed of current threats and enable timely response and recovery. Compliance requirements help to establish a good cybersecurity baseline to address known vulnerabilities, but do not adequately address new and dynamic threats, or counter sophisticated adversaries. Using a risk based approach to apply cybersecurity standards and practices allows for more comprehensive and cost effective management of cyber risks than compliance activities alone.

Homeland Security

Cybersecurity Questions for CEOs

Evaluate and manage your organization's specific cyber risks.

Identifying critical assets and associated impacts from cyber threats are critical to understanding a company's specific risk exposure– whether financial, competitive, reputational, or regulatory. Risk assessment results are a key input to identify and prioritize specific protective measures, allocate resources, inform long-term investments, and develop policies and strategies to manage cyber risks to an acceptable level.

Provide oversight and review.

Executives are responsible to manage and oversee enterprise risk management. Cyber oversight activities include the regular evaluation of cybersecurity budgets, IT acquisition plans, IT outsourcing, cloud services, incident reports, risk assessment results, and top-level policies.

Develop and test incident response plans and procedures.

Even a well-defended organization will experience a cyber incident at some point. When network defenses are penetrated, a CEO should be prepared to answer, "What is our Plan B?" Documented cyber incident response plans that are exercised regularly help to enable timely response and minimize impacts.

Coordinate cyber incident response planning across the enterprise.

Early response actions can limit or even prevent possible damage. A key component of cyber incident response preparation is planning in conjunction with the Chief Information Officer/Chief Information Security Officer, business leaders, continuity planners, system operators, general counsel, and public affairs. This includes integrating cyber incident response policies and procedures with existing disaster recovery and business continuity plans.

Maintain situational awareness of cyber threats.

Situational awareness of an organization's cyber risk environment involves timely detection of cyber incidents, along with the awareness of current threats and vulnerabilities specific to that organization and associated business impacts. Analyzing, aggregating, and integrating risk data from various sources and participating in threat information sharing with partners helps organizations identify and respond to incidents quickly and ensure protective efforts are commensurate with risk.

A network operations center can provide real-time and trend data on cyber events. Business-line managers can help identify strategic risks, such as risks to the supply chain created through third-party vendors or cyber interdependencies. Sector Information-Sharing and Analysis Centers, government and intelligence agencies, academic institutions, and research firms also serve as valuable sources of threat and vulnerability information that can be used to enhance situational awareness.

About DHS

The Department of Homeland Security (DHS) is responsible for safeguarding our Nation's critical infrastructure from physical and cyber threats that can affect our national security, public safety, and economic prosperity.

For more information, please visit: www.dhs.gov/cyber.

To report a cyber incident: https://forms.us-cert.gov/report/ or (888) 282-0870

KPMG

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Cyber security: it's not just about technology

The five most common mistakes

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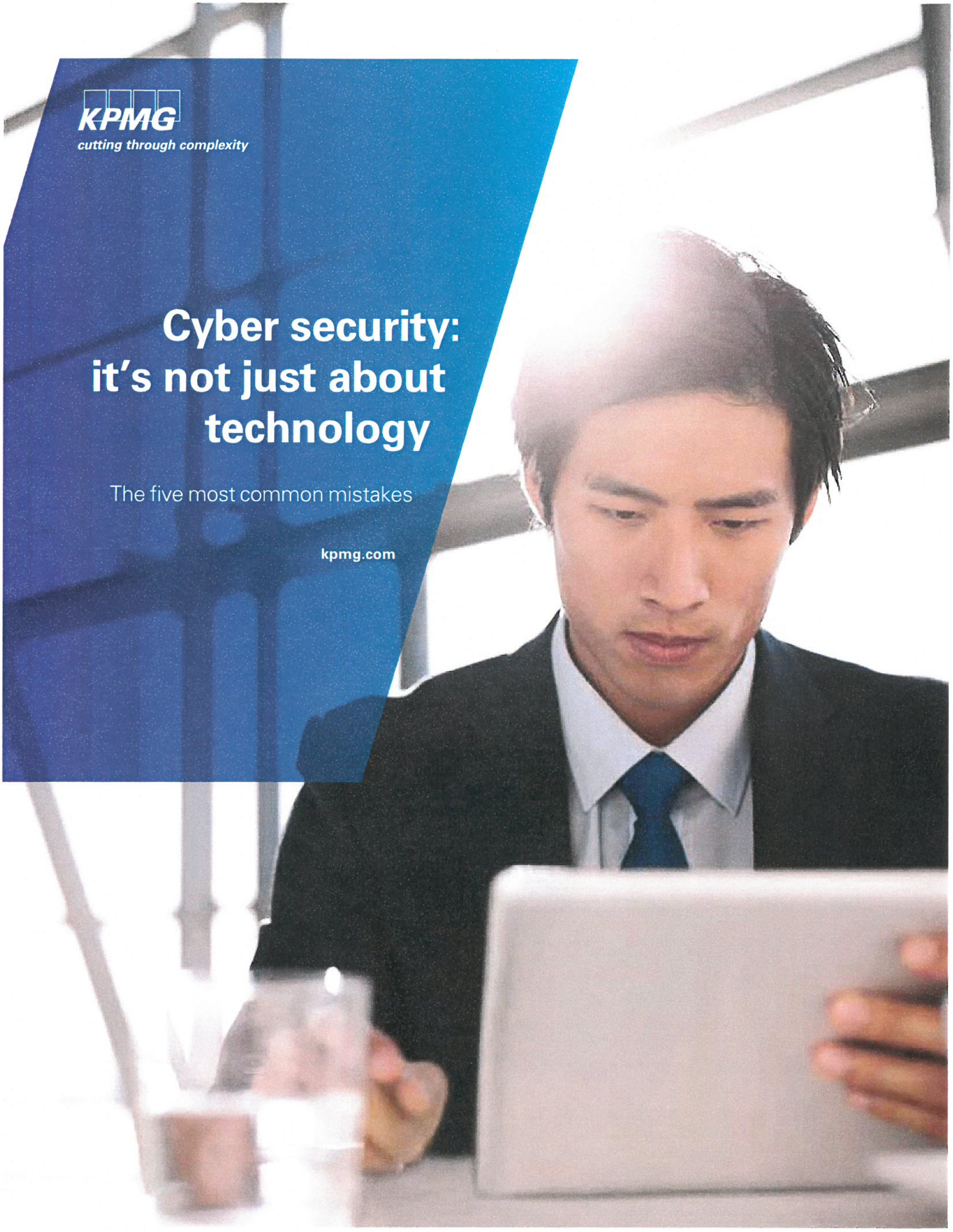

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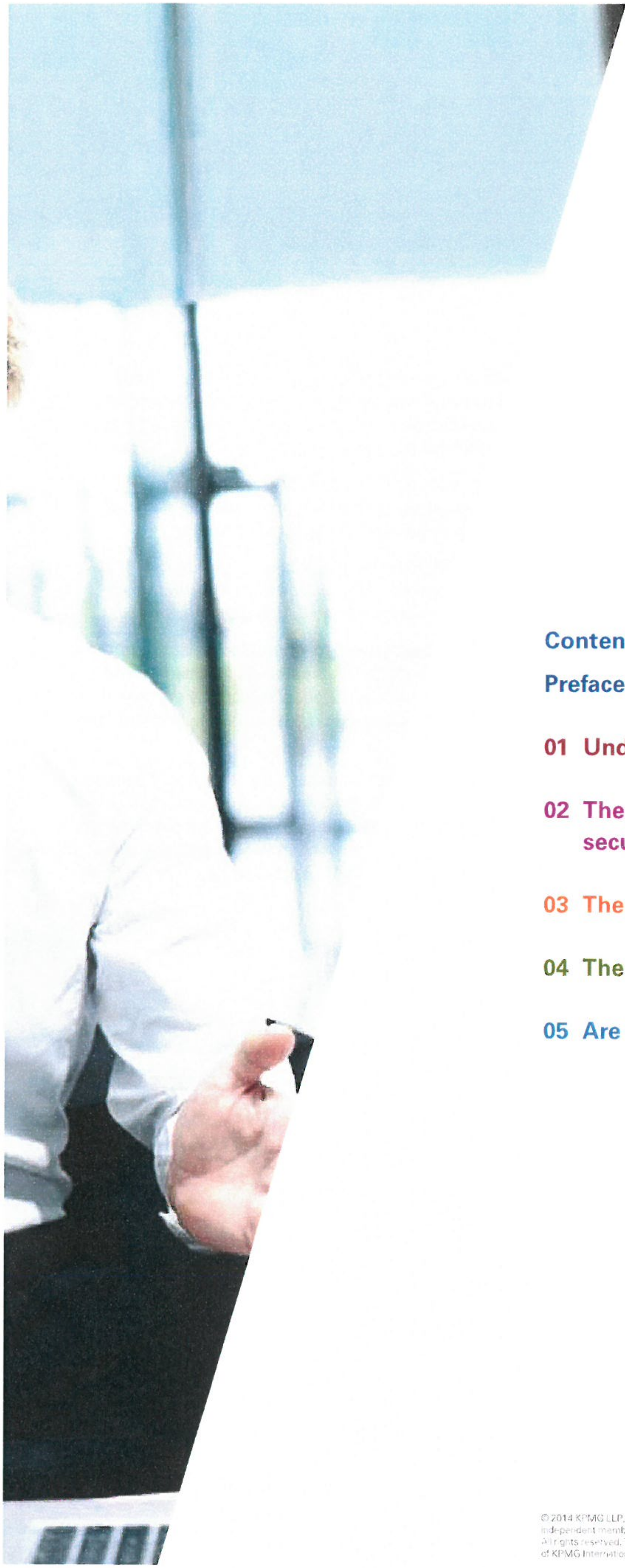


Contents

Preface

Cyber security is an important concern for every organization. Daily occurrences demonstrate the risk posed by cyber attackers—from individual, opportunistic hackers, to professional and organized groups of cyber criminals with strategies for systematically stealing intellectual property and disrupting business.

The management of any organization faces the task of ensuring that its organization understands the risks and sets the right priorities. This is no easy task in light of the technical jargon involved and the pace of change.

Focusing on technology alone to address these issues is not enough. Effectively managing cyber risk means putting in place the right governance and the right supporting processes, along with the right enabling technology.

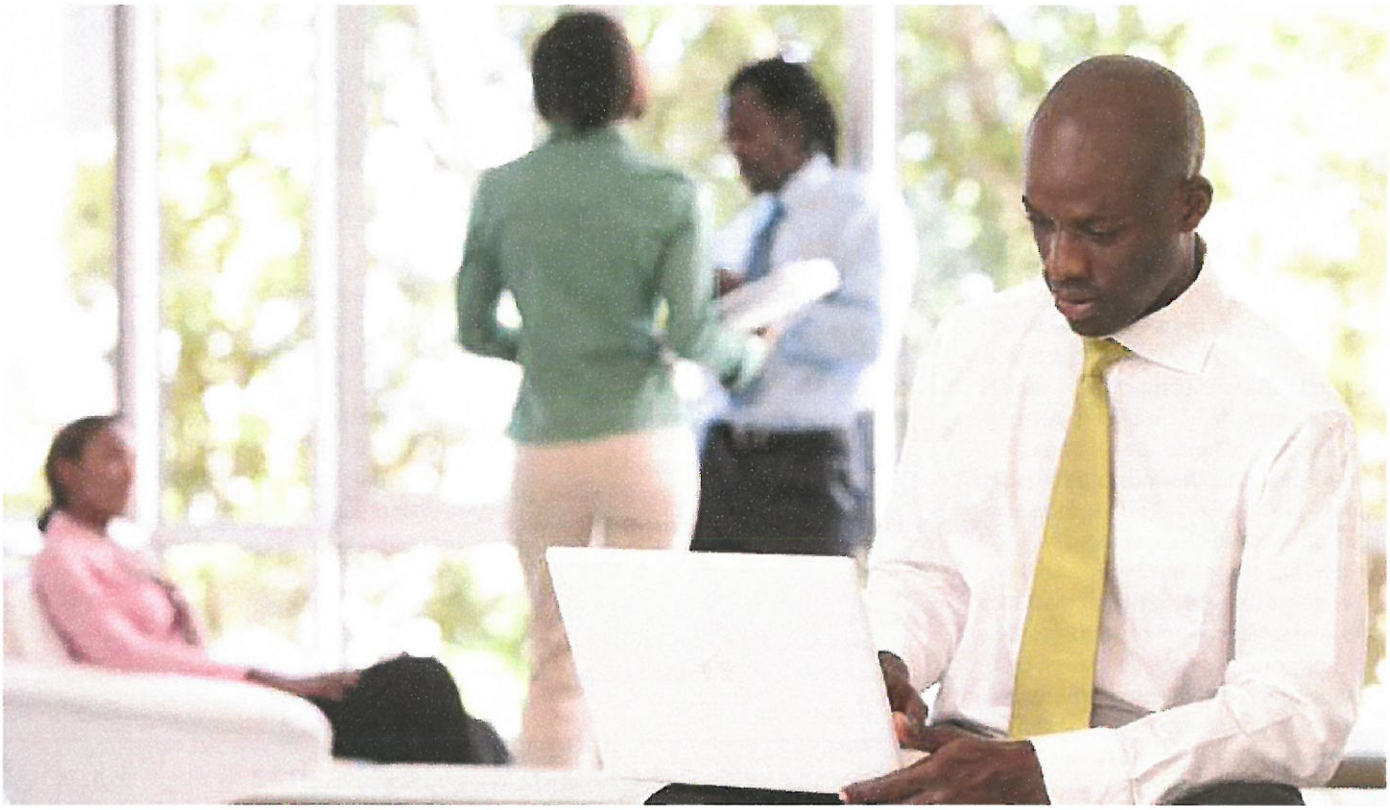
This complexity, however, cannot be an excuse for company management to divest responsibility to technical "experts." It is essential that leaders take control of allocating resources to deal with cyber security, actively manage governance and decision making over cyber security, and build an informed and knowledgeable organizational culture.

This white paper provides essential insights for management to get the basics right. We'll cover the world of cyber crime today, explore five common cyber security mistakes, explain the importance of customizing cyber security policies, outline the critical dimensions of a strong cyber security model, and look at key questions to help you navigate the "new normal" of cyber security.

Steve Barlock
Principal, Advisory
Information Protection and Business Resilience
T: 415-963-7025
E: sbarlock@kpmg.com

Tony Buffomante
Principal, Advisory
Information Protection and Business Resilience
T: 312-665-1748
E: abuffomante@kpmg.com

Fred Rica
Principal, Advisory
Information Protection and Business Resilience
T: 973-912-4524
E: frica@kpmg.com



What is cyber crime and who is carrying it out?

Cyber crime is a range of illegal digital activities targeted at organizations in order to cause harm. The term applies to a wide range of targets and attack methods.

Understanding the "actor," i.e. the person or organization that is sponsoring or conducting the attacks, is essential for effective defense.

Actors can be divided into four categories:

1. An individual hacker, generally acting alone and motivated by being able to show what he/she can do
2. The activist, focused on raising the profile of an ideology or political viewpoint, often by creating fear and disruption
3. Organized crime, focused solely on financial gain through a variety of mechanisms, from phishing to selling stolen company data
4. Governments, focused on improving their geopolitical position and/or commercial interests

Attacks by these different actors have a number of different characteristics, such as the type of target, the attack methods and scale of impact.

01

Understanding the cyber risk

The amount of data continues to grow exponentially, as does the rate at which organizations share data through online networks. Billions of machines – tablets, smartphones, ATM machines, security installations, oil fields, environmental control systems, thermostats and much more – are all linked together, increasing inter-dependencies exponentially. Organizations increasingly open their IT systems to a wide range of machines and lose direct control of data security. Furthermore, business continuity, both in society and within companies, is increasingly dependent on IT. Disruption to these core processes can have a major impact on service availability.

Cyber criminals are very aware of these vulnerabilities. Driven by a wide range of motivations – from pure financial gain, to raising the profile of an ideology, to espionage or terrorism – individual hackers, activists, organized criminals and governments are attacking government and company networks within increasing volume and severity.

But while the cyber threat is very real and its impact can be debilitating, the media often sketches an alarmist picture of cyber security, creating a culture of disproportionate fear. Not all organizations are necessarily easy targets for cyber criminals. For example, a small or midsized company has a very different risk profile than a multinational organization.

What is true for any government or organization is that cyber crime risks can be controlled. Cyber criminals are not invincible geniuses, and while they can cause real damage to your business, you can take steps to protect yourself against them. You may not be able to achieve 100 percent security, but by treating cyber security as "business as usual" and balancing investment between risks and potential impacts, your organization will be well prepared to combat cyber crime.

Organizations can reduce the risks to their business by building up capabilities in three critical areas – prevention, detection and response.

Prevention

Prevention begins with governance and organization. It is about installing fundamental measures, including placing responsibility for dealing with cyber crime within the organization and developing awareness training for key staff.

Detection

Through monitoring of critical events and incidents, an organization can strengthen its technological detection measures. Monitoring and data mining together form an excellent instrument to detect strange patterns in data traffic, to find the location on which the attacks focus and to observe system performance.

Response

Response refers to activating a well-rehearsed plan as soon as evidence of a possible attack occurs. During an attack, the organization should be able to directly deactivate all technology affected. When developing a response and recovery plan, an organization should perceive cyber security as a continuous process and not as a one-off solution.

	Prevention	Detection	Response
Management and organization	Appointing cyber crime responsibilities	Ensuring a 24/7 stand-by (crisis) organization	Using forensic analysis skills
Processes	Cyber crime response tests (simulations) Periodic scans and penetration tests	Procedures for follow-up of incidents	Cyber crime response plan
Technology	Ensuring adequate desktop security Ensuring network segmentation	Implementing logging of critical processes Implementing central monitoring of security incidents	Deactivating or discontinuing IT services under attack

02

The five most common cyber security mistakes

To many, cyber security is a bit of a mystery. This lack of understanding has created many misconceptions among management about how to approach cyber security. From our years of experience, we have seen the following five cyber security mistakes repeated over and over – often with drastic results.

1

Mistake: **"We have to achieve 100 percent security"**

Reality: **100 percent security is neither feasible nor the appropriate goal**

Almost every airline company claims that flight safety is its highest priority while recognizing that there is an inherent risk in flying. The same applies to cyber security. Whether it remains private or is made public, almost every large, well-known organization will unfortunately experience information theft.

Developing the awareness that 100 percent protection against cyber crime is neither a feasible nor an appropriate goal is already an important step towards a more effective policy, because it allows you to make choices about your defensive posture. A good defensive posture is based on understanding the threat (i.e., the criminal) relative to organizational vulnerability (prevention), establishing mechanisms to detect an imminent or actual breach (detection) and establishing a capability that immediately deals with incidents (response) to minimize loss.

In practice, the emphasis is often skewed towards prevention – the equivalent to building impenetrable walls to keep the intruders out. Once you understand that perfect security is an illusion and that cyber security is "business as usual," you also understand that more emphasis must be placed on detection and response. After a cyber crime incident, which may vary from theft of information to a disruptive attack on core systems, an organization must be able to minimize losses and resolve vulnerabilities.

2

Mistake: **"When we invest in best-of-class technical tools, we are safe"**

Reality: **Effective cyber security is less dependent on technology than you think**

The world of cyber security is dominated by specialist suppliers that sell technical products, such as products that enable rapid detection of intruders. These tools are essential for basic security, and must be integrated into the technology architecture, but they are not the basis of a holistic and robust cyber security policy and strategy. The investment in technical tools should be the output, not the driver, of cyber security strategy. Good security starts with developing a robust cyber defense capability. Although this is generally led by the IT department, the knowledge and awareness of the end user is critical. The human factor is and remains, for both IT professionals and the end user, the weakest link in relation to security. Investment in the best tools will only deliver the return when people understand their responsibilities to keep their networks safe. Social engineering, in which hackers manipulate employees to gain access to systems, is still one of the main risks that organizations face.

Technology cannot help in this regard and it is essential that managers take ownership of dealing with this challenge. They have to show genuine interest and be willing to study how best to engage with the workforce to educate staff and build awareness of the threat from cyber attack. This is often about changing the culture such that employees are alert to the risks and are proactive in raising concerns with supervisors.

3

Mistake: **"Our weapons have to be better than those of the hackers"**

Reality: **The security policy should primarily be determined by your goals, not those of your attackers**

The fight against cyber crime is an example of an unwinnable race. The attackers keep developing new methods and technology and the defense is always one step behind. So is it useful to keep investing in increasingly sophisticated tools to prevent attack?

While it is important to keep up to date and to obtain insights into the intention of attackers and their methods, it is critical for managers to adopt a flexible, proactive and strategic approach to cyber security. Given the immeasurable value of a company's information assets, and the severe implication of any loss on the core business, cyber security policies need to prioritize investment into critical asset protection, rather the latest technology or system to detect every niche threat.

First and foremost, managers need to understand what kinds of attackers their business attracts and why. An organization may perceive the value of its assets differently than a criminal. How willing are you to accept risks to certain assets over others? Which systems and people store your key assets, keeping in mind that business and technology have developed as chains and are therefore codependent on each other's security?

4

Mistake: **"Cyber security compliance is all about effective monitoring"**

Reality: **The ability to learn is just as important as the ability to monitor**

Reality shows that cyber security is very much driven by compliance. This is understandable, because many organizations have to accommodate a range of laws and legislation. However, it is counterproductive to view compliance as the ultimate goal of cyber security policy.

Only an organization that is capable of understanding external developments and incident trends and using this insight to inform policy and strategy will be successful in combating cyber crime in the long term. Therefore, effective cyber security policy and strategy should be based on continuous learning and improvement.

- Organizations need to understand how threats evolve and how to anticipate them. This approach is ultimately more cost-effective in the long term than developing ever-higher security "walls." This goes beyond the monitoring of infrastructure: it is about smart analysis of external and internal patterns in order to understand the reality of the threat and the short-, medium- and long-term risk implications. This insight should enable organizations to make sensible security investment choices, including investing to save. Unfortunately, in practice, many organizations do not take a strategic approach and do not collect and use the internal data available to them.
- Organizations need to ensure that incidents are evaluated in such a way that lessons can be learned. In practice, however, actions are driven by real-time incidents and often are not recorded or evaluated. This destroys the ability of the organization to learn and put better security arrangements in place in the future.

- The same applies to monitoring attacks. In many cases, organizations have certain monitoring capabilities, but the findings are not shared with the wider organization. No lessons, or insufficient lessons, are learned from the information received. Furthermore, monitoring needs to be underpinned by an intelligence requirement. Only if you understand what you want to monitor does monitoring become an effective tool to detect attacks.
- Organizations need to develop an enterprise-wide method for assessing and reporting cyber security risks. This requires protocols to determine risk levels and escalations, and methods for equipping the board with insight into strategic cyber risks and the impacts to core business.

5

Mistake: **"We need to recruit the best professionals to defend ourselves from cyber crime"**

Reality: **Cyber security is not a department, but an attitude**

Cyber security is often seen as the responsibility of a department of specialist professionals. This mindset may result in a false sense of security and lead to the wider organization not taking responsibility.

The real challenge is to make cyber security a mainstream approach. This means, for example, that cyber security should become part of HR policy, even in some cases linked to remuneration. It also means that cyber security should have a central place when developing new IT systems, and not, as is often the case, be given attention only at the end of such projects.

03

The key is customization

The risks of cyber crime for a local entrepreneur compared to a globally operating multinational are vast. The former may not have the resources or expertise to adequately detect or prevent cyber crime. But the latter is a more attractive target to criminals: it is more visible, more dependent on IT, and has far more valuable assets.

It is clear that both businesses need to adopt a customized approach to cyber security, based on the character of the organization, its risk appetite and the knowledge available. Consider how a jeweler arrives at the proper level of security through a strategic, realistic and customized approach to protecting its assets. Then compare it to the current common corporate approach to cyber security.

Jeweler's perspective on theft security	Corporate perspective on cyber security
I know which assets to protect and have set up the appropriate measures.	I take measures without a having a clear idea of the assets it is essential to protect.
I perceive theft as a risk in the business and know that realistically I can't be in business if I want 100 percent security.	I see cyber crime as something exotic and strive to achieve 100 percent security.
I focus on measures that prevent a person from leaving with valuable goods.	I focus on measures that prevent a person from entering and forget to take measures that prevent a person from taking away information.
I do not let security suppliers spook me and I make my own purchasing decisions.	My security policy depends on the tools available in the marketplace, without knowing exactly what I need.
When it goes wrong or almost goes wrong, I learn a lesson.	When it goes wrong or almost goes wrong, I panic.
I train employees in how to reduce the risk of theft and talk to them when they make mistakes.	I view cyber security as mainly a matter for specialist professionals and don't want to burden the rest of the organization with it.
I invest in tools because they assist the continuity of my business.	I invest in tools because it is mandatory and because the media reports on incidents every day.

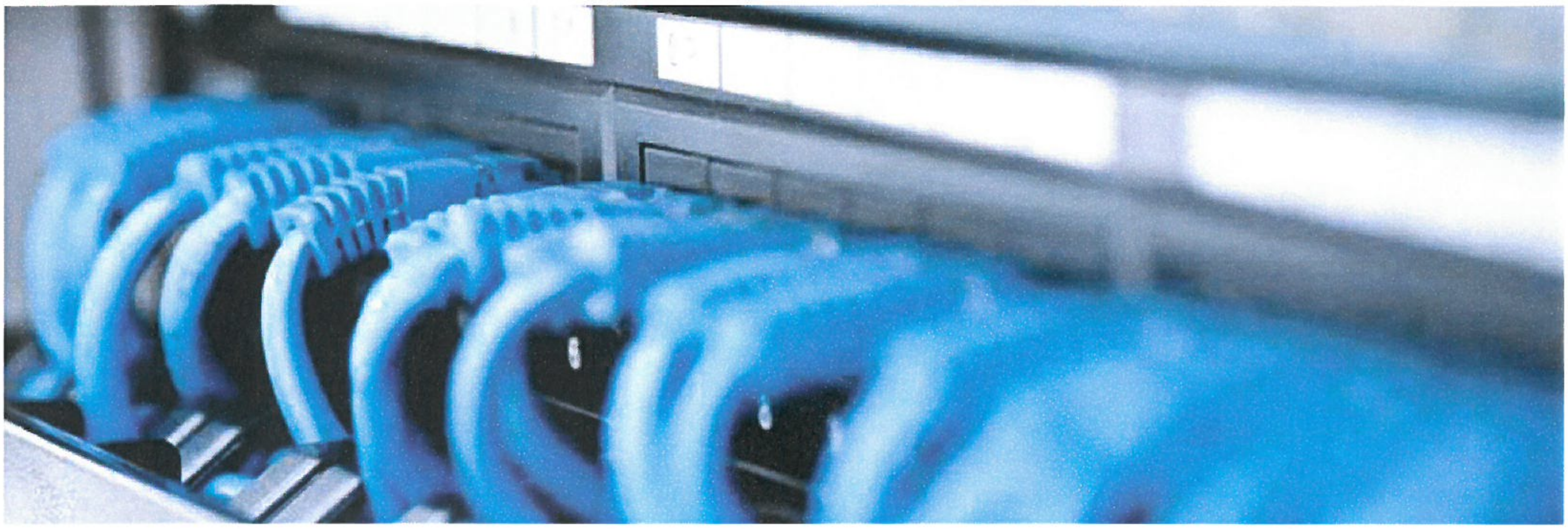
04
The six dimensions of cyber maturity

As management, you want to know whether your organization has an adequate approach to cyber security. At KPMG LLP (KPMG), we consider six key dimensions that together provide a comprehensive and in-depth view of an organization's cyber maturity.

Leadership and Governance
Is the board demonstrating due diligence, ownership and effective management of risk?

Human Factors
What is the level and integration of a security culture that empowers and ensures the right people, skills, culture and knowledge?

Information Risk Management
How robust is the approach to achieve comprehensive and effective risk management of information throughout the organization and its delivery and supply partners?



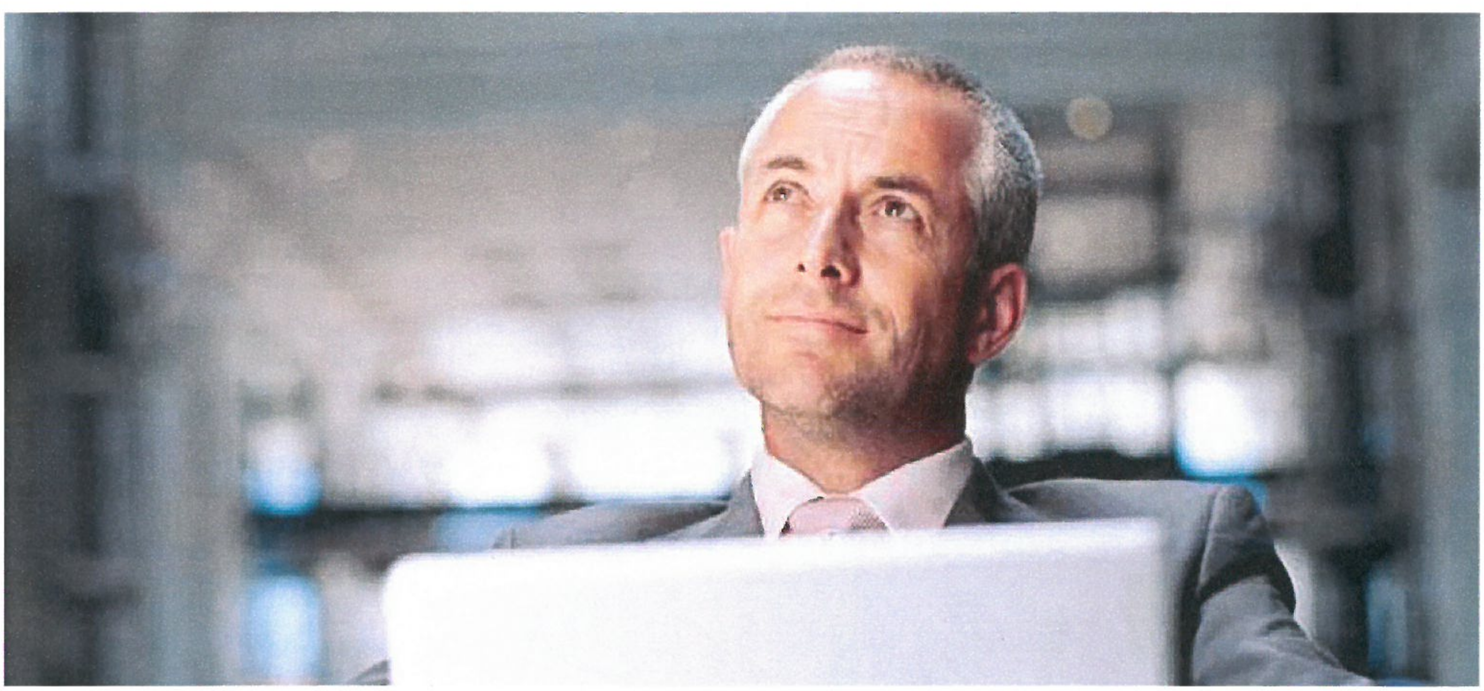
Business Continuity
Have we made preparations for a security event and the ability to prevent or minimize the impact through successful crisis and stakeholder management?

Operations and Technology
What is the level of control measures implemented to address identified risks and minimize the impact of compromise?

Legal and Compliance
Are we complying with relevant regulatory and international certification standards?

Addressing all six of these key dimensions can lead to a holistic cyber security model, providing the following advantages to any organization:

- Minimizing the risk of an attack on an organization by an outside cyber criminal, as well as limiting the impact of successful attacks
- Better information on cyber crime trends and incidents to facilitate decision making
- Clearer communication on the theme of cyber security, enabling everyone to know his or her responsibilities and what needs to be done when an incident has occurred or is suspected
- Improved reputation, as an organization that is well prepared and has given careful consideration to its cyber security is better placed to reassure its stakeholders
- Increased knowledge of competence in relation to cyber security
- Benchmarking the organization in relation to peers in the field of cyber security
-



05
Are you ready for action?

Cyber security must be on your agenda. Your management, boards, shareholders and clients all expect you to pay sufficient attention to this problem.

But just because you recognize the problem doesn't mean you are ready for action.

Developing a strategic, customized and comprehensive cyber security program, driven from the top, will help you avoid five common cyber security mistakes:

1. "We have to achieve 100 percent security"
2. "When we invest in best-of-class technical tools, we are safe"
3. "Our weapons have to be better than those of the hackers"
4. "Cyber security compliance is all about effective monitoring"
5. "We need to recruit the best professionals to defend ourselves from cyber crime"

If you have taken a holistic view of cyber security and can answer the following questions about your approach, **you are ready for action!**

1. How big is the risk for your organization and the organizations you do business with?

- How attractive is your organization to potential cyber criminals?
- How dependent is your organization on the services of partners, suppliers and other organizations, and how integrated are the corresponding IT processes?
- Do you know which processes and/or systems represent the greatest assets from a cyber security perspective?
- Have you considered how much risk you are willing to take in relation to these processes and/or systems, since there is no such thing as 100 percent security?
- Do your partners have the same risk appetite and cyber security measures as you do?
- Have you developed clear business cases for your cyber security investments?

2. Do governance processes and the organizational culture enable effective risk management?

- Do you know how the culture of your organization contributes to (or hampers) good cyber security?
- When was the last time your board communicated something about the importance of cyber security?
- Are you prepared to act in the event of a crisis or incident? Do you know how you should communicate and who should do it?
- Can you provide assurance to stakeholders on your cyber security policy?

3. How large should your cyber security budget be and how should you spend it?

Depending on the risk profile of your organization, the budget for cyber security should probably be in the range of three percent to five percent of your total IT budget. Currently, a significant part of such budgets is often spent on implementing technological solutions and solving problems from the past. The key question you need to answer is:

- Is at least three to five percent of the total IT budget dedicated to cyber security?
- How much of your cyber security budget is spent on solving past problems?
- How much is spent on structural investments in better security systems?
- How much is spent on systems and tools?
- How much is spent on awareness and culture change?

For more information on the cyber maturity assessment, incident response or KPMG's cyber security services, please visit us at www.kpmg.com/US/informationprotection or contact one of our Information Protection and Business Resilience team leaders:

Steve Barlock
Principal, Advisory
Information Protection and Business Resilience
T: 415-963-7025
E: sbarlock@kpmg.com

Tony Buffomante
Principal, Advisory
Information Protection and Business Resilience
T: 312-665-1748
E: abuffomante@kpmg.com

Fred Rica
Principal, Advisory
Information Protection and Business Resilience
T: 973-912-4524
E: frica@kpmg.com

kpmg.com

Boards of Directors, Corporate Governance and Cyber-Risks: Sharpening the Focus

Commissioner Luis A. Aguilar

"Cyber Risks and the Boardroom" Conference
New York Stock Exchange
New York, NY

June 10, 2014

Good afternoon. Thank you for that kind introduction. I am glad to be back at the New York Stock Exchange. In anticipating today's conference, I thought back to an earlier trip to the NYSE where in April 2009, I had the opportunity to ring the closing bell. Before I begin my remarks, let me issue the standard disclaimer that the views I express today are my own, and do not necessarily reflect the views of the U.S. Securities and Exchange Commission ("SEC" or "Commission"), my fellow Commissioners, or members of the staff.

I am pleased to be here and to have the opportunity to speak about cyber-risks and the boardroom, a topic that is both timely and extremely important. Over just a relatively short period of time, cybersecurity has become a top concern of American companies, financial institutions, law enforcement, and many regulators.[1] I suspect that not too long ago, we would have been hard-pressed to find many individuals who had even heard of cybersecurity, let alone known what it meant. Yet, in the past few years, there can be no doubt that the focus on this issue has dramatically increased.[2]

Cybersecurity has become an important topic in both the private and public sectors, and for good reason. Law enforcement and financial regulators have stated publicly that cyber-attacks are becoming both more frequent and more sophisticated.[3] Indeed, according to one survey, U.S. companies experienced a 42% increase between 2011 and 2012 in the number of successful cyber-attacks they experienced per week.[4] As I am sure you have heard, recently there have also been a series of well-publicized cyber-attacks that have generated considerable media attention and raised public awareness of this issue. A few of the more well-known examples include:

- The October 2013 cyber-attack on the software company Adobe Systems, Inc., in which data from more than 38 million customer accounts was obtained improperly;[5]
- The December 2013 cyber-attack on Target Corporation, in which the payment card data of approximately 40 million Target customers and the personal data of up to 70 million Target customers was accessed without authorization;[6]
- The January 2014 cyber-attack on Snapchat, a mobile messaging service, in which a reported 4.6 million user names and phone numbers were exposed;[7]
- The sustained and repeated cyber-attacks against several large U.S. banks, in which their public websites have been knocked offline for hours at a time;[8] and

- The numerous cyber-attacks on the infrastructure underlying the capital markets, including quite a few on securities exchanges.[9]

In addition to becoming more frequent, there are reports indicating that cyber-attacks have become increasingly costly to companies that are attacked. According to one 2013 survey, the average annualized cost of cyber-crime to a sample of U.S. companies was $11.6 million per year, representing a 78% increase since 2009.[10] In addition, the aftermath of the 2013 Target data breach demonstrates that the impact of cyber-attacks may extend far beyond the direct costs associated with the immediate response to an attack.[11] Beyond the unacceptable damage to consumers, these secondary effects include reputational harm that significantly affects a company's bottom line. In sum, the capital markets and their critical participants, including public companies, are under a continuous and serious threat of cyber-attack, and this threat cannot be ignored.[12]

As an SEC Commissioner, the threats are a particular concern because of the widespread and severe impact that cyber-attacks could have on the integrity of the capital markets infrastructure and on public companies and investors.[13] The concern is not new. For example, in 2011, staff in the SEC's Division of Corporation Finance issued guidance to public companies regarding their disclosure obligations with respect to cybersecurity risks and cyber-incidents.[14] More recently, because of the escalation of cyber-attacks, I helped organize the Commission's March 26, 2014 roundtable to discuss the cyber-risks facing public companies and critical market participants like exchanges, broker-dealers, and transfer agents.[15]

Today, I would like to focus my remarks on what boards of directors can, and should, do to ensure that their organizations are appropriately considering and addressing cyber-risks. Effective board oversight of management's efforts to address these issues is critical to preventing and effectively responding to successful cyber-attacks and, ultimately, to protecting companies and their consumers, as well as protecting investors and the integrity of the capital markets.

The Role of the Boards of Directors in Overseeing Cyber-Risk Management

Background on the Role of Boards of Directors

When considering the board's role in addressing cybersecurity issues, it is useful to keep in mind the broad duties that the board owes to the corporation and, more specifically, the board's role in corporate governance and overseeing risk management. It has long been the accepted model, both here and around the world, that corporations are managed under the direction of their boards of directors.[16] This model arises from a central tenet of the modern corporation — the separation of ownership and control of the corporation. Under this structure, those who manage a corporation must answer to the true owners of the company — the shareholders.

It would be neither possible nor desirable, however, for the many, widely-dispersed shareholders of any public company to come together and manage, or direct the management of, that company's business and affairs. Clearly, effective full-time management is essential for public companies to function. But management without accountability can lead to self-interested decision-making that may not benefit the company or its shareholders. As a result, shareholders elect a board of directors to represent their interests, and, in turn, the board of directors, through effective corporate governance, makes sure that management effectively serves the corporation and its shareholders.[17]

Corporate Boards and Risk Management Generally

Although boards have long been responsible for overseeing multiple aspects of management's activities, since the financial crisis, there has been an increased focus on what boards of directors are doing to address risk management.[18] Indeed, many have noted that, leading up to the financial crisis, boards of directors may not have been doing enough to oversee risk management within their companies, and that this failure contributed to the unreasonably risky behavior that resulted in the destruction of untold billions in shareholder value and plunged the country and the global economy into recession.[19] Although primary responsibility for risk management has historically belonged to management, the boards are responsible for overseeing that the corporation has established appropriate risk management programs and for overseeing how management implements those programs.[20]

The importance of this oversight was highlighted when, in 2009, the Commission amended its rules to require disclosure about, among other things, the board's role in risk oversight, including a description of whether and how the board administers its oversight function, such as through the whole board, a separate risk committee, or the audit committee.[21] The Commission did not mandate any particular structure, but noted that "risk oversight is a key competence of the board" and that "disclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company."[22]

The evidence suggests that boards of directors have begun to assume greater responsibility for overseeing the risk management efforts of their companies.[23] For example, according to a recent survey of 2013 proxy filings by companies comprising the S&P 200, the full boards of these companies are increasingly, and nearly universally, taking responsibility for the risk oversight of the company.[24]

Clearly, boards must take seriously their responsibility to ensure that management has implemented effective risk management protocols. Boards of directors are already responsible for overseeing the management of all types of risk, including credit risk, liquidity risk, and operational risk[25] — and there can be little doubt that cyber-risk also must be considered as part of board's overall risk oversight. The recent announcement that a prominent proxy advisory firm is urging the ouster of most of the Target Corporation directors because of the perceived "failure…to ensure appropriate management of [the] risks" as to Target's December 2013 cyber-attack is another driver that should put directors on notice to proactively address the risks associated with cyber-attacks.[26]

What Boards of Directors Can and Should Be Doing to Oversee Cyber-Risk

Given the significant cyber-attacks that are occurring with disturbing frequency, and the mounting evidence that companies of all shapes and sizes are increasingly under a constant threat of potentially disastrous cyber-attacks, ensuring the adequacy of a company's cybersecurity measures needs to be a critical part of a board of director's risk oversight responsibilities. [27]

In addition to the threat of significant business disruptions, substantial response costs, negative publicity, and lasting reputational harm, there is also the threat of litigation and potential liability for failing to implement adequate steps to protect the company from cyber-threats.[28] Perhaps unsurprisingly, there has recently been a series of derivative lawsuits brought against companies and their officers and directors relating to data breaches resulting from cyber-attacks.[29] Thus, boards that choose to ignore, or minimize, the importance of cybersecurity oversight responsibility, do so at their own peril.

Given the known risks posed by cyber-attacks, one would expect that corporate boards and senior management universally would be proactively taking steps to confront these cyber-risks. Yet, evidence suggests that there may be a gap that exists between the magnitude of the exposure presented by cyber-risks and the steps, or lack thereof, that many corporate boards have taken to address these risks. Some have noted that boards are not spending enough time or devoting sufficient corporate resources to addressing cybersecurity issues.[30] According to one survey, boards were not undertaking key oversight activities related to cyber-risks, such as reviewing annual budgets for privacy and IT security programs, assigning roles and responsibilities for privacy and security, and receiving regular reports on breaches and IT risks.[31] Even when boards do pay attention to these risks, some have questioned the extent to which boards rely too much on the very personnel who implement those measures.[32] In light of these observations, directors should be asking themselves what they can, and should, be doing to effectively oversee cyber-risk management.

NIST Cybersecurity Framework

In considering where to begin to assess a company's possible cybersecurity measures, one conceptual roadmap boards should consider is the Framework for Improving Critical Infrastructure Cybersecurity, released by the National Institute of Standards and Technology ("NIST") in February 2014. The NIST Cybersecurity Framework is intended to provide companies with a set of industry standards and best practices for managing their cybersecurity risks.[33] In essence, the Framework encourages companies to be proactive and to think about these difficult issues in advance of the occurrence of a possibly devastating cyber-event. While the Framework is voluntary guidance for any company, some commentators have already suggested that it will likely become a baseline for best practices by companies, including in assessing legal or regulatory exposure to these issues or for insurance purposes.[34] At a minimum, boards should work with management to assess their corporate policies to ensure how they match-up to the Framework's guidelines — and whether more may be needed.

Board Structural Changes to Focus on Appropriate Cyber-Risk Management

The NIST Cybersecurity Framework, however, is a bible without a preacher if there is no one at the company who is able to translate its concepts into action plans. Frequently, the board's risk oversight function lies either with the full board or is delegated to the board's audit committee. Unfortunately, many boards lack the technical expertise necessary to be able to evaluate whether management is taking appropriate steps to address cybersecurity issues. Moreover, the board's audit committee may not have the expertise, support, or skills necessary to add oversight of a company's cyber-risk management to their already full agenda.[35] As a result, some have recommended mandatory cyber-risk education for directors.[36] Others have suggested that boards be at least adequately represented by members with a good understanding of information technology issues that pose risks to the company.[37]

Another way that has been identified to help curtail the knowledge gap and focus director attention on known cyber-risks is to create a separate enterprise risk committee on the board. It is believed that such committees can foster a "big picture" approach to company-wide risk that not only may result in improved risk reporting and monitoring for both management and the board, but also can provide a greater focus — at the board level — on the adequacy of resources and overall support provided to company executives responsible for risk management.[38] The Dodd-Frank Act already requires large financial institutions to establish independent risk committees on their boards.[39] Beyond the financial institutions required to do so, some public companies have chosen to proactively create such risk committees on their boards.[40] Research suggests that 48% of corporations currently have board-level risk committees that are responsible for privacy and security risks, which represents a dramatic increase from the 8% that reported having such a committee in 2008.[41]

Clearly, there are various mechanisms that boards can employ to close the gap in addressing cybersecurity concerns — but it is equally clear that boards need to be proactive in doing so. Put simply, boards that lack an adequate understanding of cyber-risks are unlikely to be able to effectively oversee cyber-risk management.

I commend the boards that are proactively addressing these new risks of the 21st Century. However, while enhancing board knowledge and board involvement is a good business practice, it is not necessarily a panacea to comprehensive cybersecurity oversight.

Internal Roles and Responsibilities Focused on Cyber-Risk

In addition to proactive boards, a company must also have the appropriate personnel to carry out effective cyber-risk management and to provide regular reports to the board. One 2012 survey reported that less than two-thirds of responding companies had full-time personnel in key roles responsible for privacy and security, in a manner that was consistent with internationally accepted best practices and standards.[42] In addition, a 2013 survey found that the companies that detected more security incidents and reported lower average financial losses per incident shared key attributes, including that they employed a full-time chief information security officer (or equivalent) who reported directly to senior management.[43]

At a minimum, boards should have a clear understanding of who at the company has primary responsibility for cybersecurity risk oversight and for ensuring the adequacy of the company's cyber-risk management practices.[44] In addition, as the evidence shows, devoting full-time personnel to cybersecurity issues may help prevent and mitigate the effects of cyber-attacks.

Board Preparedness

Although different companies may choose different paths, ultimately, the goal is the same: to prepare the company for the inevitable cyber-attack and the resulting fallout from such an event. As it has been noted, the primary distinction between a cyber-attack and other crises that a company may face is the speed with which the company must respond to contain the rapid spread of damage.[45] Companies need to be prepared to respond within hours, if not minutes, of a cyber-event to detect the cyber-event, analyze the event, prevent further damage from being done, and prepare a response to the event.[46]

While there is no "one-size-fits-all" way to properly prepare for the various ways a cyber-attack can unfold, and what responses may be appropriate, it can be just as damaging to have a poorly-implemented response to a cyber-event. As others have observed, an "ill-thought-out response can be far more damaging than the attack itself."[47] Accordingly, boards should put time and resources into making sure that management has developed a well-constructed and deliberate response plan that is consistent with best practices for a company in the same industry.

These plans should include, among other things, whether, and how, the cyber-attack will need to be disclosed internally and externally (both to customers and to investors).[48] In deciding the nature and extent of the disclosures, I would encourage companies to go beyond the impact on the company and to also consider the impact on others. It is possible that a cyber-attack may not have a direct material adverse impact on the company itself, but that a loss of customers' personal and financial data could have devastating effects on the lives of the company's customers and many Americans. In such cases, the right thing to do is to give these victims a heads-up so that they can protect themselves.[49]

Conclusion

Let me conclude my remarks by reaffirming the significance of the role of good corporate governance. Corporate governance performed properly, results in the protection of shareholder assets. Fortunately, many boards take on this difficult and challenging role and perform it well. They do so by, among other things, being active, informed, independent, involved, and focused on the interests of shareholders.

Good boards also recognize the need to adapt to new circumstances — such as the increasing risks of cyber-attacks. To that end, board oversight of cyber-risk management is critical to ensuring that companies are taking adequate steps to prevent, and prepare for, the harms that can result from such attacks. There is no substitution for proper preparation, deliberation, and engagement on cybersecurity issues. Given the heightened awareness of these rapidly evolving risks, directors should take seriously their obligation to make sure that companies are appropriately addressing those risks.

Those of you who have taken the time and effort to be here today clearly recognize the risks, and I commend you for being proactive in dealing with the issue.

Thank you for inviting me to speak to you today.

[1] For example, the Director of the Federal Bureau of Investigation (FBI), James Comey, said last November that "resources devoted to cyber-based threats will equal or even eclipse the resources devoted to non-cyber based terrorist threats." *See,* Testimony of James B. Comey, Jr., Director, FBI, U.S. Department of Justice, before the Senate Committee on Homeland Security and Governmental Affairs (Nov. 14, 2013), *available at* http://www.hsgac.senate.gov/hearings/threats-to-the-homeland. *See also,* Testimony of Jeh C. Johnson, Secretary, U.S. Department of Homeland Security, before the House Committee on Homeland Security (Feb. 26, 2014) ("DHS must continue efforts to address the growing cyber threat to the private sector and the '.gov' networks, illustrated by the real, pervasive, and ongoing series of attacks on public and private infrastructure."), *available at* http://docs.house.gov/meetings/HM/HM00/20140226/101722/HHRG-113-HM00-Wstate-

JohnsonJ-20140226.pdf; Testimony of Ari Baranoff, Assistant Special Agent in Charge, United States Secret Service Criminal Investigative Division, before the House Committee on Homeland Security, Subcommittee on Cybersecurity, Infrastructure Protection, and Security Technologies (Apr. 16, 2014), *available at* http://docs.house.gov/meetings/HM/HM08/20140416/102141/HHRG-113-HM08-Wstate-BaranoffA-20140416.pdf ("Advances in computer technology and greater access to personally identifiable information (PII) via the Internet have created online marketplaces for transnational cyber criminals to share stolen information and criminal methodologies. As a result, the Secret Service has observed a marked increase in the quality, quantity, and complexity of cybercrimes targeting private industry and critical infrastructure."); Remarks by Secretary of Defense Leon E. Panetta to the Business Executives for National Security (Oct. 11, 2012), *available at* http://www.defense.gov/transcripts/transcript.aspx?transcriptid=5136 ("As director of the CIA and now Secretary of Defense, I have understood that cyber attacks are every bit as real as the more well-known threats like terrorism, nuclear weapons proliferation and the turmoil that we see in the Middle East. And the cyber threats facing this country are growing.").

[2] *See, e.g.*, Martin Lipton, *et al.*, *Risk Management and the Board of Directors — An Update for 2014*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 22, 2014), *available at* http://blogs.law.harvard.edu/corpgov/2014/04/22/risk-management-and-the-board-of-directors-an-update-for-2014/ (noting that cybersecurity is a risk management issue that "merits special attention" from the board of directors in 2014); PwC 2012 Annual Corporate Directors Survey, *Insights from the Boardroom 2012: Board evolution: Progress made yet challenges persist*, *available at* http://www.pwc.com/en_US/us/corporate-governance/annual-corporate-directors-survey/assets/pdf/pwc-annual-corporate-directors-survey.pdf (finding that 72% of directors are engaged with overseeing and understanding data security issues and risks related to compromising customer data); Michael A. Gold, *Cyber Risk and the Board of Directors–Closing the Gap*, Bloomberg BNA (Oct. 18, 2013) *available at* http://www.bna.com/cyber-risk-and-the-board-of-directors-closing-the-gap// ("The responsibility of corporate directors to address cyber security is commanding more attention and is obviously a significant issue."); Deloitte Development LLC, *Hot Topics: Cybersecurity … Continued in the boardroom*, Corporate Governance Monthly (Aug. 2013), *available at* http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/USEng/Documents/Deloitte%20Periodicals/Hot%20Topics/Hot%20Topics%20-%20Cybersecurity%20%20%20Continued%20in%20the%20boardroom%20-August%202013%20-Final.pdf ("Not long ago, the term 'cybersecurity' was not frequently heard or addressed in the boardroom. Cybersecurity was often referred to as an information technology risk, and management and oversight were the responsibility of the chief information or technology officer, not the board. With the rapid advancement of technology, cybersecurity has become an increasingly challenging risk that boards may need to address."); Holly J. Gregory, *Board Oversight of Cybersecurity Risks*, Thomson Reuters Practical Law (Mar. 1, 2014), *available at* http://us.practicallaw.com/5-558-2825 ("The risk of cybersecurity breaches (and the harm that these breaches pose) is one of increasing significance for most companies and therefore an area for heightened board focus.").

[3] For example, on December 9, 2013, the Financial Stability Oversight Council held a meeting to discuss cybersecurity threats to the financial system. *See*, U.S. Department of the Treasury Press Release, "Financial Stability Oversight Council to Meet December 9," *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2228.aspx. During that meeting, Assistant Treasury Secretary Cyrus-Amir-Mokri said that "[o]ur experience over the last couple of years shows that cyber-threats to financial institutions and markets are growing in both frequency and sophistication." *See,* Remarks of Assistant Secretary Cyrus Amir-Mokri on Cybersecurity at a Meeting of the Financial Stability Oversight Council (Dec. 9, 2013), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2234.aspx. In addition, in testimony before the House Financial Services Committee in 2011, the Assistant Director of the FBI's Cyber Division stated that the number and sophistication of malicious incidents involving financial institutions has increased dramatically over the past several years and offered numerous examples of such attacks, which included fraudulent monetary transfers, unauthorized financial transactions from compromised bank and brokerage accounts, denial of service attacks on U.S. stock exchanges, and hacking incidents in which confidential information was misappropriated. *See,* Testimony of Gordon M. Snow, Assistant Director, Cyber Division, FBI, U.S. Department of Justice, before the House Financial Services Committee, Subcommittee on Financial Institutions and Consumer Credit (Sept. 14, 2011), *available at* http://financialservices.house.gov/uploadedfiles/091411snow.pdf.

[4] *2012 Cost of Cyber Crime Study: United States*, Ponemon Institute LLC and HP Enterprise Security (Oct. 2012), *available at* http://www.ponemon.org/local/upload/file/2012_US_Cost_of_Cyber_Crime_Study_FINAL6%20.pdf.

[5] *See, e.g.,* Jim Finkle, *Adobe says customer data, source code accessed in cyber attack*, Reuters (Oct. 3, 2013), *available at* http://www.reuters.com/article/2013/10/03/us-adobe-cyberattack-idUSBRE99212Y20131003; Jim Finkle, *Adobe data breach more extensive than previously disclosed*, Reuters (Oct. 29, 2013), *available at* http://www.reuters.com/article/2013/10/29/us-adobe-cyberattack-idUSBRE99S1DJ20131029; Danny Yadron, *Hacker Attack on Adobe Sends Ripples Across Web*, Wall Street Journal (Nov. 11, 2013), *available at* http://online.wsj.com/news/articles/SB10001424052702304644104579192393329283358.

[6] *See,* Testimony of John Mulligan, Executive Vice President and Chief Financial Officer of Target, before the Senate Judiciary Committee (Feb. 4, 2014), *available at* http://www.judiciary.senate.gov/imo/media/doc/02-04-14MulliganTestimony.pdf; Target Press Release, "Target Confirms Unauthorized Access to Payment Card Data in U.S. Stores" (Dec. 19, 2013), *available at* http://pressroom.target.com/news/target-confirms-unauthorized-access-to-payment-card-data-in-u-s-stores.

[7] *See, e.g.,* Andrea Chang and Salvador Rodriguez, *Snapchat becomes target of widespread cyberattack*, L.A. Times (Jan. 2, 2014), *available at* http://articles.latimes.com/2014/jan/02/business/la-fi-snapchat-hack-20140103; Brian Fung, *A Snapchat security breach affects 4.6 million users. Did Snapchat drag its feet on a fix?* Washington Post (Jan. 1, 2014), *available at* http://www.washingtonpost.com/blogs/the-switch/wp/2014/01/01/a-snapchat-security-breach-affects-4-6-million-users-did-snapchat-drag-its-feet-on-a-fix/.

[8] *See, e.g.,* Joseph Menn, *Cyber attacks against banks more severe than most realize*, Reuters (May 18, 2013), *available at* http://www.reuters.com/article/2013/05/18/us-cyber-summit-banks-idUSBRE94G0ZP20130518; Bob Sullivan, *Bank Website Attacks Reach New Highs*, CNBC (Apr. 3, 2013), *available at* http://www.cnbc.com/id/100613270.

[9] For example, according to a 2012 global survey of securities exchanges, 53% reported experiencing a cyber-attack in the previous year. *See,* Rohini Tendulkar, *Cyber-crime, securities markets, and systemic risk*, Joint Staff Working Paper of the IOSCO Research Department and World Federation of Exchanges (July 16, 2013), *available at* http://www.iosco.org/research/pdf/swp/Cyber-Crime-Securities-Markets-and-Systemic-Risk.pdf. Forty-six securities exchanges responded to the survey.

[10] *See*, HP Press Release, *HP Reveals Cost of Cybercrime Escalates 70 Percent, Time to Resolve Attacks More Than Doubles* (Oct. 8, 2013), *available at* http://www8.hp.com/us/en/hp-news/press-release.html?id=1501128.

[11] *See*, Target Financial News Release, *Target Reports Fourth Quarter and Full-Year 2013 Earnings* (Feb. 26, 2014), *available at* http://investors.target.com/phoenix.zhtml?c=65828&p=irol-newsArticle&ID=1903678&highlight (including a statement from then-Chairman, President and CEO Gregg Steinhafel that Target's fourth quarter results "softened meaningfully following our December announcement of a data breach."); Elizabeth A. Harris, *Data Breach Hurts Profit at Target*, N.Y. Times (Feb. 26, 2014), *available at* http://www.nytimes.com/2014/02/27/business/target-reports-on-fourth-quarter-earnings.html?_r=0 (noting that "[t]he widespread theft of Target customer data had a significant impact on the company's profit, which fell more than 40 percent in the fourth quarter" of 2013).

[12] I also want to note that at the Investment Company Institute's ("ICI") general membership meeting, held just last month, the issue of cybersecurity was front and center. Among the issues raised during the meeting was the "huge risk to brand" for a firm if they have a security failure in the event of a cyber-attack. A separate panel at the ICI conference devoted to cybersecurity also discussed the shift in focus from building "hard walls" to protect against risks from outside the company to cybersecurity focused on "inside" risks, such as ensuring that individuals with mobile applications or other types of flexible applications don't introduce, intentionally or unintentionally, malware or other kinds of security breaches that could lead to a cyber-attack on the company. *See, e.g.,* Jackie Noblett, *Cyber Breach a "Huge Risk to Brand,"* Ignites (May 29, 2014), *available at* http://ignites.com/c/897654/86334/cyber_breach_huge_risk_brand?referrer_module=emailMorningNews&module_order=7.

[13] *See,* Commissioner Luis A. Aguilar, *The Commission's Role in Addressing the Growing Cyber-Threat* (Mar. 26, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541287184.

[14] On October 13, 2011, staff in the Commission's Division of Corporation Finance (Corp Fin) issued guidance on issuers' disclosure obligations relating to cyber security risks and cyber incidents. *See,* SEC's Division of Corporation Finance, *CF Disclosure Guidance: Topic No. 2—Cybersecurity* ("SEC Guidance") (Oct. 31, 2011), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm. Among other things,

this guidance notes that securities laws are designed to elicit disclosure of timely, comprehensive, and accurate information about risks and events that a reasonable investor would consider important to an investment decision, and cybersecurity risks and events are not exempt from these requirements. The guidance identifies six areas where cybersecurity disclosures may be necessary under Regulation S-K: (1) Risk Factors; (2) Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A); (3) Description of Business; (4) Legal Proceedings; (5) Financial Statement Disclosures; and (6) Disclosure Controls and Procedures. The SEC Guidance further recommends that material cybersecurity risks should be disclosed and adequately described as Risk Factors. Where cybersecurity risks and incidents that represent a material event, trend or uncertainty reasonably likely to have a material impact on the organization's operations, liquidity, or financial condition — it should be addressed in the MD&A. If cybersecurity risks materially affect the organization's products, services, relationships with customers or suppliers, or competitive conditions, the organization should disclose such risks in its description of business. Data breaches or other incidents can result in regulatory investigations or private actions that are material and should be discussed in the Legal Proceedings section. Cybersecurity risks and incidents that represent substantial costs in prevention or response should be included in Financial Statement Disclosures where the financial impact is material. Finally, where a cybersecurity risk or incident impairs the organization's ability to record or report information that must be disclosed, Disclosure Controls and Procedures that fail to address cybersecurity concerns may be ineffective and subject to disclosure. Some have suggested that such disclosures fail to fully inform investors about the true costs and benefits of companies' cybersecurity practices, and argue that the Commission (and not the staff) should issue further guidance regarding issuers' disclosure obligations. *See,* Letter from U.S. Senator John D. Rockefeller IV to Chair White (Apr. 9, 2013), *available at* http://www.commerce.senate.gov/public/?a=Files.Serve&File_id=49ac989b-bd16-4bbd-8d64-8c15ba0e4e51.

[15] *See* SEC Press Release, *SEC Announces Agenda, Panelists for Cybersecurity Roundtable* (Mar. 24, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541253749; *Cybersecurity Roundtable Webcast* (Mar. 26, 2014), *available at* http://www.sec.gov/news/otherwebcasts/2014/cybersecurity-roundtable-032614.shtml. In addition, the SEC's National Exam Program has included cybersecurity among its areas of focus in its National Examination Priorities for 2014. *See,* SEC's National Exam Priorities for 2014, *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf. In addition, it was recently announced that SEC examiners will review whether asset managers have policies to prevent and detect cyber-attacks and are properly safeguarding against security risks that could arise from vendors having access to their systems. *See,* Sarah N. Lynch, *SEC examiners to review how asset managers fend off cyber attacks*, Reuters (Jan. 30, 2014), *available at* http://www.reuters.com/article/2014/01/30/us-sec-cyber-assetmanagers-idUSBREA0T1PJ20140130. FINRA has also identified cybersecurity as one of its examination priorities for 2014. *See,* FINRA's 2014 Regulatory and Examination Priorities Letter (Jan. 2, 2014), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf.

To continue the discussion and to allow the public to weigh in on this important topic, the SEC set up a public comment file associated with the Cybersecurity Roundtable. To date, we have received ten comment letters from academics, software companies, and other interested parties, *available at* http://www.sec.gov/comments/4-673/4-673.shtml. *See, e.g.*, Jodie Kelly, Senior Vice President and General Counsel, BSA| The Software Alliance comment letter (Apr. 30, 2014) (highlighting the importance of strong internal controls related to software assets as a first line of defense against cyber-attacks, and noting that verifying legal use of software is a critical first step in deterring cyber-attacks because the "existence and availability of pirated and counterfeit software exposes corporate information technology networks to significant risks in many ways."); Tom C.W. Lin, Associate Professor of Law, Temple University Beasley School of Law comment letter (Apr. 29, 2014) (expressing support for the roundtable and the Commission's attention to cybersecurity and highlighting four broad issues for the Commission's consideration: (1) cybersecurity threats to the high-speed, electronically connected modern capital markets can create systemic risks; (2) due to technological advances, financial choices are made by both people and machines, which does not comport congruently with many traditional modes of securities regulation; (3) incentives, in addition to penalties, should be designed to encourage firms to upgrade their cybersecurity capabilities; and (4) private regulation of cybersecurity should be vigorously enhanced and leveraged to better complement government regulation); Dave Parsonage, CEO, MitoSystems, Inc. comment letter (Apr. 3, 2014); Gail P. Ricketts, Senior IT Compliance and Risk Analyst, ON Semiconductor comment letter (Mar. 26, 2014) (suggesting future roundtables include speakers from outside the financial services industry, such as manufacturing); Michael Utzig, IT Director, Hefren Tillotson, Inc. comment letter (Mar. 26, 2014) (noting that readily available technologies that can protect email communications are not widely used despite universal understanding that cybersecurity is a high-priority); Cathy Santoro comment letter (Mar. 26, 2014) (raising questions about the interactions between banks and service providers and the measures being undertaken regarding mobile payment cybersecurity risks); Duane Kuroda, Senior Threat Researcher, NetCitadel comment letter (Mar. 25, 2014) (noting that the panel discussion should focus on the process and people involved in responding to breaches and not just their detection); William Pfister, Jr. comment letter (Mar. 25, 2014) (requesting that one of the panels address the potential conflicts between national security and required disclosure). Many of these letters are generally supportive of the Commission's efforts and focus in this area, and some identify issues and concerns that were not discussed in detail during the roundtable and warrant further attention. For example, one commenter highlighted the need for companies to adopt sound internal controls over the legal use of software, noting that pirated and counterfeit software can expose companies to heightened risk of cyber-attacks and recommending that registrants report on the status of such internal controls.[15] *See, e.g.*, Jodie Kelly, Senior Vice President and General Counsel, BSA| The Software Alliance comment letter (Apr. 30, 2014) (noting, among other things, that unlicensed software eliminates the opportunity for security updates and patches from legitimate vendors when security breaches are identified, and that malware and viruses may be contained within pirated software itself or reside on the networks from which it is downloaded. BSA recommends that registrants report on the status of their internal controls in the area of licensing and legal use of software, and that such controls should, at a minimum, ensure that software is only purchased from authorized vendors and that companies should have procedures to conduct periodic software inventories and limit exposure to malware and viruses brought into their systems by linkage of employees' personal devices to corporate systems). I encourage others to comment and provide valuable input on this critical issue.

[16] *See, e.g.*, Model Bus. Corp. Act § 8.01 (2002); Del. Gen. Corp. Law § 141(a).

[17] For additional thoughts on the importance of effective corporate governance, *see* Commissioner Luis A. Aguilar, *Looking at Corporate Governance from the Investor's Perspective*, *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541547078.

[18] *See, e.g.*, Committee of Sponsoring Organizations of the Treadway Commission, *Effective Enterprise Risk Oversight: The Role of the Board of Directors* (2009), *available at* http://www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409_001.pdf ("Clearly, one result of the financial crisis is an increased focus on the effectiveness of board risk oversight practices."); Committee of Sponsoring Organizations of the Treadway Commission, *Board Risk Oversight: A Progress Report — Where Boards of Directors Currently Stand in Executing Their Risk Oversight Responsibilities* (Dec. 2010), *available at* http://www.coso.org/documents/Board-Risk-Oversight-Survey-COSO-Protiviti_000.pdf ("Risk oversight is a high priority on the agenda of most boards of directors. Recently, the importance of this responsibility has become more evident in the wake of an historic global financial crisis, which disclosed perceived risk management weaknesses across financial services and other organizations worldwide. Based on numerous legislative and regulatory actions in the United States and other countries as well as initiatives in the private sector, it is clear that expectations for more effective risk oversight are being raised not just for financial services companies, but broadly across all types of businesses."); David A. Katz, *Boards Play A Leading Role in Risk Management Oversight*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Oct. 8, 2009), *available at* http://blogs.law.harvard.edu/corpgov/2009/10/08/boards-play-a-leading-role-in-risk-management-oversight/ ("Just as the Enron and other high-profile corporate scandals were seen as resulting from a lack of ethics and oversight, the credit market meltdown and resulting financial crisis have been blamed in large part on inadequate risk management by corporations and their boards of directors. As a result, along with the task of implementing corporate governance procedures and guidelines, a company's board of directors is expected to take a leading role in overseeing risk management structures and policies.").

[19] Nicola Faith Sharpe, *Informational Autonomy in the Boardroom*, 201 U. Ill. L. Rev. 1089 (2013) ("The financial crisis of 2007-2008 was one of the worst in U.S. history. In a single quarter, the blue chip company Lehman Brothers (who eventually went bankrupt) lost $2.8 billion. While commentators have identified multiple reasons why the crisis occurred, many posit that boards mismanaged risk and failed in their oversight duties, which directly contributed to their firms failing."); Lawrence J. Trautman and Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 J. Marshall J. Computer & Info. L. 313 (Spring 2011) ("With accusations that boards of directors of financial institutions were asleep at the wheel while their companies engaged in risky behavior that erased millions of dollars of shareholder value and plunged the country into recession, increasing pressure is now being placed on public company boards to shoulder the burden of risk oversight for the companies they serve."); William B. Asher, Jr., Michael T. Gass, Erik Skramstad, and Michele Edwards, *The Role of Board of Directors in Risk Oversight in a Post-Crisis Economy*, Bloomberg

Law Reports-Corporate Law Vol. 4, No. 13, *available at* http://www.choate.com/uploads/113/doc/Asher,%20Gass%20-The%20Role%20of%20Board%20of%20Directors%20in%20Risk%20Oversight%20in%20a%20Post-Crisis%20Economy.pdf ("Senior management and corporate directors face renewed criticism surrounding risk management practices and apparent failures in oversight that are considered, at least in part, to be at the root of the recent crisis.").

[20] *See, e.g.,* Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 Iowa J. Corp. L. 967 (2009) ("Although primary responsibility for risk management rests with the corporation's top management team, the board of directors is responsible for ensuring that the corporation has established appropriate risk management programs and for overseeing management's implementation of such programs."); Martin Lipton, *Risk Management and the Board of Directors–An Update for 2014*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 22, 2014), *available at* http://blogs.law.harvard.edu/corpgov/2014/04/22/risk-management-and-the-board-of-directors-an-update-for-2014/ (". . . the board cannot and should not be involved in actual day-to day risk *management*. Directors should instead, through their risk oversight role, satisfy themselves that the risk management policies and procedures designed and implemented by the company's senior executives and risk managers are consistent with the company's strategy and risk appetite, that these policies and procedures are functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision making throughout the organization. The board should establish that the CEO and the senior executives are fully engaged in risk management and should also be aware of the type and magnitude of the company's principal risks that underlie its risk oversight. Through its oversight role, the board can send a message to management and employees that comprehensive risk management is neither an impediment to the conduct of business nor a mere supplement to a firm's overall compliance program, but is instead an integral component of strategy, culture and business operations.").

[21] *Proxy Disclosure Enhancements*, SEC Rel. No. 33-9089 (Dec. 16, 2009), 74 Fed. Reg. 68334, *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf.

[22] *Id.* That amendment also required disclosure of a company's compensation policies and practices as they relate to a company's risk management in order to help investors identify whether the company has established a system of incentives that could lead to excessive or inappropriate risk taking by its employees.

[23] *Supra* note 19, William B. Asher, Jr. *et al.*, *The Role of Board of Directors in Risk Oversight in a Post-Crisis Economy* ("We know today, however, that risk management has indeed forced its way into the boardroom and that there has been a substantial change in the relationship between the overseers of public companies and their shareholders.").

[24] *Risk Intelligent Proxy Disclosures — 2013: Trending upward*, Deloitte (2013), *available at* http://deloitte.wsj.com/riskandcompliance/files/2014/01/Risk_Intelligent_Proxy_Disclosures_2013.pdf (noting that 91% of the issuers of proxy disclosures noted that "the full board is responsible for risk.").

[25] See, *Proxy Disclosure Enhancements*, *supra* note 21.

[26] Paul Ziobro, *Target Shareholders Should Oust Directors, ISS Says*, Wall St. Journal (May 28, 2014), *available at* http://online.wsj.com/article/BT-CO-20140528-709863.html; Bruce Carton, *ISS Recommends Ouster of Seven Target Directors for Data Breach Failures*, ComplianceWeek (May 29, 2014), *available at* http://www.complianceweek.com/iss-recommends-ouster-of-seven-target-directors-for-data-breach-failures/article/348954/?DCMP=EMC-CW-WeekendEdition.

[27] *See, e.g.*, *Risk Management and the Board of Directors–An Update for* 2014, *supra* note 2 (noting that cybersecurity is a risk management issue that "merits special attention" from the board of directors in 2014); Alice Hsu, Tracy Crum, Francine E. Friedman, and Karol A. Kepchar, *Cybersecurity Update: Are Data Breach Disclosure Requirements On Target?*, The Metropolitan Corporate Counsel (Jan. 24, 2014), *available at* http://www.metrocorpcounsel.com/articles/27148/cybersecurity-update-are-data-breach-disclosure-requirements-target ("As part of a board's risk management oversight function, directors should assess the adequacy of their company's data security measures. Among other things, boards should have a clear understanding of the company's cybersecurity risk profile and who has primary responsibility for cybersecurity risk oversight and should ensure the adequacy of the company's cyber risk management practices, as well as the company's insurance coverage for losses and costs associate with data breaches.").

[28] Charles R. Ragan, *Information Governance: It's a Duty and It's Smart Business*, 19 Rich. J.L. & Tech. 12 (2013), *available at* http://jolt.richmond.edu/v19i4/article12.pdf. (indicating that "[t]he principles thus enunciated raise the specter of potential liability if officers and directors utterly fail to ensure the adequacy of information systems."); J. Wylie Donald and Jennifer Black Strutt, *Cybersecurity: Moving Toward a Standard of Care for the Board,* Bloomberg BNA (Nov. 4, 2013), *available at* http://www.bna.com/cybersecurity-moving-toward-a-standard-of-care-for-the-board/ (quoting from a Delaware Chancery Court decision stating that directors may be liable if "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.").

[29] *See, e.g., Collier v. Steinhafel et al.* (D.C. Minn. Jan. 2014), case number 0:14-cv-00266 (alleging that Target's board and top executives harmed the company financially by failing to take adequate steps to prevent the cyber-attack then by subsequently providing customers with misleading information about the extent of the data theft.); *Dennis Palkon et al. v. Stephen P. Holmes et al*. (D.C.N.J. May 2014), case number 2:14-cv-01234 (alleging that Wyndham's board and top executives harmed the company financially by failing to take adequate steps to safeguard customers' personal and financial information.).

[30] Steven P. Blonder, *How closely is the board paying attention to cyber risks?*, Inside Counsel (formerly Corporate Legal Times) (Apr. 9, 2014), *available at* http://www.insidecounsel.com/2014/04/09/how-closely-is-the-board-paying-attention-to-cyber. (Indicating that "[i]n all likelihood, absent an incident, it is likely that board members are not spending sufficient time evaluating or analyzing the risks inherent in new technologies, as well as their related cybersecurity risks.").

[31] Jody R. Westby, *Governance of Enterprise Security: CyLab 2012 Report — How Boards & Senior Executives Are Managing Cyber Risks*, Carnegie Mellon University CyLab (May 16, 2012), at 5. (Hereinafter "CyLab 2012 Report.").

[32] *Supra note 30,* Steven P. Blonder, *How Closely is the Board Paying Attention to Cyber Risks?* (stating that "[f]urther, even if a board has evaluated these risks, to what extent is such an evaluation dependent on a company's IT department — the same group implementing the existing technology protocols?").

[33] The National Institute of Standards and Technology Framework for Improving Critical Infrastructure Cybersecurity (Feb. 12, 2014) (the "NIST Cybersecurity Framework"), *available at* http://www.nist.gov/cyberframework/upload/cybersecurity-framework-021214.pdf, was released in response to President Obama's issued Executive Order 13636, titled "Improving Critical Infrastructure Cybersecuity," dated February 12, 2013. The NIST Cybersecurity Framework sets out five core functions and categories of activities for companies to implement that relate generally to cyber-risk management and oversight, which the NIST helpfully boiled down to five terms: Identify, Protect, Detect, Respond and Recover. This core fundamentally means the following: companies should (i) *identify* known cybersecurity risks to their infrastructure; (ii) develop safeguards to *protect* the delivery and maintenance of infrastructure services; (iii) implement methods to *detect* the occurrence of a cybersecurity event; (iv) develop methods to *respond* to a detected cybersecurity event; and (v) develop plans to *recover* and restore the companies' capabilities that were impaired as a result of a cybersecurity event. *See also,* Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom*, The Metropolitan Corporate Counsel (Mar. 17, 2014), *available at* http://www.sheppardmullin.com/media/article/1280_MCC-Cybersecurity-Breaching%20The%20Boardroom.pdf.

[34] *Supra note* 2*,* Holly J. Gregory, *Board Oversight of Cybersecurity Risks; supra note* 33, Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom* (stating that "[w]hile adoption of the Cybersecurity Framework is voluntary, it will likely become a key reference for regulators, insurance companies and the plaintiffs' bar in assessing whether a company took steps reasonably designed to reduce and manage cybersecurity risks.").

[35] Matteo Tonello, *Should Your Board Have a Separate Risk Committee?*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 12, 2012), *available at* https://blogs.law.harvard.edu/corpgov/2012/02/12/should-your-board-have-a-separate-risk-committee/ (asking "[d]oes the audit committee have the time, the skills, and the support to do the job, given everything else it is required to do?").

[36] *See, e.g.*, Katie W. Johnson, *Publicly Traded Companies Should Prepare To Disclose Cybersecurity Risks, Incidents*, Bloomberg BNA (Mar. 17, 2014), *available at* http://www.bna.com/publicly-traded-companies-n17179885721/ (citing Mary Ellen Callahan, Chair of the Privacy and Information Governance Practice at Jenner & Block, LLP at the International Association of Privacy Professionals Global Privacy Summit, held in March 2014); Michael A. Gold, *Cyber Risk and the Board of Directors — Closing the Gap*, Bloomberg BNA (Oct. 18, 2013), *available at* http://www.bna.com/cyber-risk-and-the-board-of-directors-closing-the-gap// (suggesting that companies would do well to have "[m]andatory cyber risk education for directors," among other things.); *see also, The Comprehensive National*

Cybersecurity Initiative, initially launched by then-President George W. Bush in 2008, referencing "Initiative #8. Expand cyber education," and *available at* http://www.whitehouse.gov/issues/foreign-policy/cybersecurity/national-initiative.

[37] *Supra* note 19, Lawrence J. Trautman and Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*.

[38] *Supra* note 35, Matteo Tonello, *Should Your Board Have a Separate Risk Committee?*; *supra* note 33, Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom*.

[39] Dodd-Frank Act Section 165(h).

[40] *Supra* note 19, Lawrence J. Trautman and Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*.

[41] Deloitte Audit Committee Brief, *Cybersecurity and the audit committee* (Aug. 2013), at 2, *available at* http://deloitte.wsj.com/cfo/files/2013/08/ACBrief_August2013.pdf.

[42] *See*, *supra* note 31, CyLab 2012 Report, at 27.

[43] PricewaterhouseCoopers LLP, *The Global State of Information Security Survey 2014*, at 4, *available at* http://www.pwc.com/gx/en/consulting-services/information-security-survey/download.jhtml (the "PwC IS Survey"). The PwC IS Survey also noted other shared attributes, such as having (i) an overall information security strategy; (ii) measured and reviewed the effectiveness of their security measures within the past year; and (iii) an understanding as to exactly what type of security events have occurred in the past year. *See also*, *supra* note 2, Holly Gregory, *Board Oversight of Cybersecurity Risks*.

[44] *Supra* note 27, Alice Hsu, *et al.*, *Cybersecurity Update: Are Data Breach Disclosure Requirements on Target?*.

[45] *See, e.g.,* Roland L. Trope and Stephen J. Humes, *Before Rolling Blackouts Begin: Briefing Boards on Cyber Attacks That Target and Degrade the Grid,* 40 Wm. Mitchell L. Rev. 647 (2014), at 656 (stating that "unlike other corporate crises, boards and management must be ready to address severe cyber incidents with response and recovery plans that activate upon discovery of an intrusion and with little or no time for deliberation.") Some observers have even suggested that companies conduct "cyberwar games" organized around hypothetical business scenarios in order to reenact how a company might respond in a real cybersecurity situation in order to fix what vulnerabilities are teased out from the simulated scenario. Tucker Bailey, James Kaplan, and Allen Weinberg, *Playing war games to prepare for a cyberattack*, McKinsey & Company Insights & Publications (July 2012). Other observers have suggested that companies implement a response plan that takes into consideration a number of factors, such as (i) how much risk the company can accept if systems or services have to shut down; (ii) for how long the company can sustain operations using limited or backup technology; and (iii) how quickly the company can restore full operations. *See, Former FBI Agent Mary Galligan on Preparing for a Cyber Attack,* CIO Journal, Deloitte Insights (Mar. 3, 2104), *available at* http://deloitte.wsj.com/cio/2014/03/03/former-fbi-agent-mary-galligan-on-preparing-for-a-cyber-attack/.

[46] *See, e.g., id*., Roland L. Trope and Stephen J. Humes, *Before Rolling Blackouts Begin: Briefing Boards on Cyber Attacks That Target and Degrade the Grid*, at 656.

[47] *Supra* note 45, Tucker Bailey, James Kaplan, and Allen Weinberg, *Playing War Games to Prepare for a Cyberattack*.

[48] *Supra* note 33, Ariel Yehezkel and Thomas Michael, *Cybersecurity: Breaching the Boardroom*, Metropolitan Corporate Counsel (stating that "Boards should prepare for worst-case scenario cybersecurity breaches and help management develop immediate response plans, including public disclosure procedures and economic recovery strategies, to mitigate potential damages." In addition, "[b]oards should consider disclosing cybersecurity risks and protective measures on relevant SEC filings, as such disclosures can generate confidence in investors rather than fear.") The U.S. Department of Commerce also has suggested that a company's cybersecurity preparedness could include cybersecurity insurance, which is specifically designed to mitigate losses from a variety of cyber incidents, including data breaches, business interruption, and network damage. *Cybersecurity Insurance*, U.S. Department of Homeland Security, *available at* http://www.dhs.gov/publication/cybersecurity-insurance*.* Despite the increased threats of cyber-attacks, the cybersecurity insurance market has been slow to develop, and many companies have chosen to forego available policies, citing their perceived high cost, a lack of awareness about what they cover, and their confidence (or ignorance) about their actual risk of a cyber-attack. *Id.* Moreover, despite the fact that cyber incidents are not covered by general liability policies, one survey noted that 57% of respondents indicated that their boards are not reviewing their existing policies for cyber-related risks. *See*, *supra* note 31, CyLab 2012 Report, at 15.

[49] The Department of Justice recently unsealed indictments against five Chinese military officials who allegedly conspired to steal information from U.S. companies across different industries. In connection with this indictment, it was recently reported that three U.S. public companies identified as victims of this conspiracy failed to report the theft of trade secrets and other data to their investors, despite the Commission's disclosure guidance on this topic. Two of the companies, Alcoa Inc. and Allegheny Technologies Inc., said that the thefts were not "material," and therefore did not have to be disclosed to investors. *See,* Chris Strohm, Dave Michaels and Sonja Elmquist, *U.S. Companies Hacked by Chinese Didn't Tell Investors*, Bloomberg (May 21, 2014), *available at* http://www.bloomberg.com/news/2014-05-21/u-s-companies-hacked-by-chinese-didn-t-tell-investors.html*; See also, supra note 14.*

Last modified: June 10, 2014

Human Resources Roundtable Meeting

Wednesday, April 1st
2:45pm – 4pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Denise Dank, SVP-Chief HR Officer, Duke Realty Corporation
Ellen Jacobs, SVP-Corporate Services, Digital Realty

AGENDA

REITWISE ROUNDTABLE: HUMAN RESOURCES

Wednesday, April 1, 2015
2:45 pm – 4:00 pm

Discussion Leaders:

Denise Dank, SVP-Chief HR Officer, Duke Realty Corporation
Ellen Jacobs, SVP-Corporate Services & Human Resources, Digital Realty

I. Introduction

II. Fostering Leadership

III. Mentoring/Motivating Staff

IV. Compensation Issues

FPL ADVISORY GROUP

Ferguson Partners
FPL Associates

191 North Wacker Drive
Suite 2850
Chicago, Illinois 60606
www.fpladvisorygroup.com
312 368 0569 *Phone*
312 368 5089 *Fax*

Dear Colleague:

We're pleased to present you with the following copy of *Leadership Perspectives*. This feature FPL publication discusses the leadership qualities that drive success (and also lead to failure) in an organization. Topics of special interest include:

- Overvaluing the Wrong Leadership Attributes
- Entrepreneurial Personalities and the Ability to Scale Organizations
- Handling Adversity: The Most Reliable Indicator of True Leadership
- Lessons to Be Learned From Bad Leaders
- Strong Followers Can Be Toxic For Leaders
- The Proper Balance of Leadership and Organizational Management
- Emotional Intelligence
- When is a Narcissist Good for a Company?

We hope you find the following observations to be timely and of interest. We look forward to receiving your feedback.

Best regards,
FPL ADVISORY GROUP

William J. Ferguson
Co-Chairman and Co-CEO

Boston
Chicago
London
New York
Tokyo

One of the most fundamental mistakes (in assessing leadership) is the tendency to overvalue certain characteristics, attributes, and skills.

Focus on Identifying Leaders, Not Leadership Development

In predicting which individuals are most likely to succeed in broader leadership roles, most organizations overvalue certain attributes and undervalue others. To make matters worse, these organizations do not have the right procedures in place to produce a complete and accurate picture of their top prospects. The best evaluation process is one in which each candidate is assessed by a group of others, including the individual's manager and other executives who have observed his/her behavior directly over time and in different circumstances. This process enables the group to probe a wide range of leadership criteria and obtain balanced and complete information. Think of it as an annual physical!

Overvaluing certain characteristics, attributes, and skills can be hugely problematic. For example, being a team player often ranks high on the list. But in fact, the best leaders are not usually team players. They feel little need to work in a group. They are independent thinkers and don't mind making decisions by themselves—decisions that set them apart from the pack. Team players are typically consensus managers. Exceptional leaders are willing to take risks by picking people who are unlike themselves.

Another common misconception is that leaders actively try to develop others through close mentoring relationships. In fact, many excellent leaders instead prefer to select strong people and delegate responsibilities fully to them. This provides them with various opportunities to grow through their own experiences and to make their own mistakes.

In addition, organizations often overvalue people who are good implementers and problem solvers. Often these proficient individuals rely too heavily on systems, policies, and procedures and rigidly expect everyone to operate in that same style. True leaders are adept at handling problems that are nebulous or ambiguous. Thus, an ability to handle and even thrive in ill-defined and complex situations is critical. In short, exceptional leaders are comfortable acting in gray areas and, in fact, are often able to exploit ill-defined and complicated situations to their advantage.

Furthermore, too often organizations overvalue stand-up presentation skills. While these skills are certainly important, a more difficult shortcoming to correct, and one that people sometimes minimize, is a lack of one-on-one social skills. Leaders can't enlist people they need to support their cause without the ability to engage, convince, and inspire.

Raw ambition is seen by many organizations as a key criterion. Unfortunately, a person's ambition can be understated. In fact, many exceptional leaders are modest and display little ambition even though they are fiercely competitive on the inside. A high degree of personal humility is far more evident among exceptional leaders than is raw ambition.

In short, many top executives at organizations tend to favor those with backgrounds, experiences, and characteristics similar to their own. This is a fatal flaw! The best way to assess a person's capacity to lead is through a group evaluation that includes the individual's manager, his/her manager's manager, and several people senior to the individual who have worked with him/her directly. And while leadership development should never be undervalued, the real focus should be accurately identifying leaders in the first place. Some would argue that leadership talent is hard-wired in people before they reach their mid-twenties. By the time they arrive at the corporate doorstep, they are reasonably complete packages. In reality, these people don't change very much once they enter the corporate world, and those changes that do occur are mainly a matter of a consolidation of strengths.

Unfortunately, most entrepreneurs have four fatal flaws.

Entrepreneurial Personalities and the Ability to Scale Organizations

There is a common myth that the entrepreneurial personality and the executive personality can never meld together. This is simply not true. The problem is not so much one of leadership personality as it is of approach.

Unfortunately, most entrepreneurs have four fatal flaws. First, they tend to be too loyal to comrades. This blind loyalty can become a liability in managing more complex organizations. The second tendency, being task-oriented, is critical to entrepreneurs' success, but excessive attention to detail can cause a large organization to lose sight of its long-term goals. Next, the single-mindedness of an entrepreneur is important for launching a business, but this can limit a company's potential as it grows. Finally, working in isolation, which is typical of most entrepreneurs, is disastrous for a leader whose expanding organization increasingly relies on many other people.

Successful leaders who scale businesses deal honestly with problems and quickly weed out non-performers. They move past distractions and establish strategic priorities. They learn how to deal effectively with diverse employees, customers, and external constituencies. Most importantly, they make the company's continuing health and welfare a top concern.

Handling Adversity: The Most Reliable Indicator of True Leadership

There is a theory that one of the most common attributes found among successful leaders is that they have endured intense, often traumatic, experiences that transformed them and became the source of their distinctive leadership abilities. These were points in time when they were forced to question who they were and what was important to them. These experiences made them stronger and more confident and changed their sense of purpose in some fundamental way. Most critical to these great leaders was an adaptive capacity and an ability to transcend adversity and emerge stronger than before.

These transformative experiences often lead to a new or altered sense of identity. For example, experiencing prejudice is particularly traumatic, because it forces an individual to confront a distorted picture of himself/herself and often unleashes profound feelings of anger, bewilderment, and even withdrawal. The experience of prejudice is often a clarifying event because it allows a person to gain a clearer vision of who they are, the role they play, and their place in the world.

Another transformative experience can involve episodes of illness or violence. However, not all experiences need to be traumatic. They often can involve a positive if not deeply challenging experience such as having a demanding boss or mentor.

In short, successful leaders find meaning in debilitating experiences. For example, they engage others in a shared meaning, diving into a chaotic work environment to mobilize employees. Secondly, they utilize a distinctive and compelling voice often to defuse potentially violent situations. Thirdly, they represent a sense of integrity where values often prevail even in emotionally charged situations. But most importantly, they embody this adaptive capacity where they transcend adversity with all its intended stresses to emerge stronger than before. They understand how to grasp the context of a problem and consider all the constituencies involved. In short, they have the perseverance and toughness to emerge from devastating circumstances without losing hope.

The reality is that most people, including leaders, prefer conformity to controversy.

Lessons to Be Learned From Bad Leaders

Machiavelli argued that the only truly bad leadership is weak leadership. He admired unscrupulous leaders who exercised power and authority with an iron fist. In contrast to Machiavelli, the Founding Fathers of the United States understood that leadership is easily corrupted and, therefore, went to extraordinary lengths to construct a Constitution that makes it hard for leaders to accomplish much without the negotiated consent of their followers.

Interestingly, business leadership is painted with a brush almost the polar opposite of many of the political tyrannies. Unlike power wielders, business leaders cannot treat people as things. In short, the model of business leadership is one of benevolence. However, leadership is not a moral concept. Leaders are like the rest of us: trustworthy and deceitful, cowardly and brave, greedy and generous! To assume that all good leaders are good people is dangerous. It is only when we recognize and manage our feelings that can we achieve greatness.

Leaders fall from grace when they are unaware of their darker sides and so fail to guard against them. The real problem is not so much that leaders have a dark side; rather it is that they (and everyone else for that matter) choose to pretend that it doesn't exist!

Strong Followers Can Be Toxic For Leaders

A particular problem can arise for strong leaders who attract and empower strong followers. Not only can well meaning followers become united and persuasive about a particular course of action, but followers can fool leaders with flattery and isolate them from uncomfortable realities. Hence, leaders need to become more skeptical and set boundaries. Leaders need to make an extra effort to unearth disagreement and find followers who will pose hard questions.

The reality is that most people, including leaders, prefer conformity to controversy. This can be quite dangerous, especially in the American culture, where people form and express quick opinions. We are not a reflective society. Americans like to brainstorm and move on. Furthermore, leaders are sensitized to undermining their employees' commitment to a particular cause. Spending political capital and overruling employees one too many times can de-motivate them.

This situation becomes increasingly dangerous with narcissistic leaders, who will often leverage their leadership positions to further their personal interests. However, an even more serious problem is that leaders who invite flattery insulate themselves from the bad news they need to know.

So the question becomes – how does one guard against this problem? Most importantly, leaders can protect themselves from their companies by setting good examples. Followers tend to model themselves after their leaders. Straightforward leaders are less likely to be manipulated, and effective leaders won't condone or encourage unethical behavior in their ranks. In short, honest followers have just as great an investment in unmasking manipulative colleagues as their leaders do.

To avoid being misled by one's followers, leaders should keep their vision and values front and center so no one gets distracted. People must be encouraged to disagree, and truth tellers must be cultivated. Leaders should set a good ethical climate for their organizations. Also, while delegating responsibility is important, leaders need to stay involved. Finally, leaders need to honor their intuition and guard against being manipulated.

The Proper Balance of Leadership and Organizational Management Drives Business Success

Businesses must find ways to train good managers and develop leaders at the same time. Without a solid organizational framework, even the most brilliant leaders will spin their wheels, frustrating co-workers and accomplishing little. But without an entrepreneurial culture, a business will stagnate and rapidly lose competitive power.

Managerial development focuses on building competence, control, and the appropriate balance of power. In contrast, the essential leadership elements of inspiration, vision, and human passion drive corporate success. Managers embrace process, seek stability and control, and distinctively try to resolve problems quickly. In contrast, leaders tolerate chaos and a lack of structure. In this sense, they are more like artists than scientists. The reality is that organizations need both managers and leaders to succeed.

In contrast to managers, leaders are wired differently. They tend to work from high-risk positions. For managers, a survival instinct dominates, and hence, they have an ability to tolerate mundane, practical work. In contrast, leaders sometimes react to mundane work as an affliction. Furthermore, managers prefer to work with people. They avoid solitary activity because it makes them anxious. They like to collaborate. In contrast, human relations in leader-dominated structures often appear turbulent, intense, and at times, even disorganized.

While leaders work in organizations, they never belong to them. Their sense of who they are does not depend on memberships, work roles, or other social indicators of identity. They bring about change to profoundly alter human, economic, and political relationships.

There are certain common threads among great leaders. Most are indifferent students. The reason for mediocrity is not the absence of ability but normally the inability to pay attention to ordinary tasks. Secondly, leaders form important one-on-one apprenticeship relationships which accelerate and intensify their development. And gifted people repeatedly demonstrate the important part a teacher plays in developing an individual. Great teachers take risks. They bet initially on talent they perceive in younger people.

Emotional Intelligence

According to research completed by the psychologist and author, Daniel Goleman, among others attributes, emotional intelligence may be the key attribute that distinguishes outstanding performers. The chief components to emotional intelligence—self-awareness, self-regulation, motivation, empathy, and social skills—all need to be integrated into one complete package. This is not to say that technical skills and native intelligence are not also key drivers behind success, but emotional intelligence seems to be a differentiating factor.

Of the chief components of emotional intelligence, self-awareness is all about having a deep understanding of one's emotions, strengths, weaknesses, needs, and drives. People with strong self-awareness are neither overly critical nor unrealistically hopeful. Rather, they are honest with themselves and others.

Biological impulses drive our emotions. We cannot do away with them, but we can do much to manage them. Extraordinary leaders find ways to control bad moods and emotional impulses, and even channel them in useful ways. Controlling one's feelings and impulses allows a leader to create an environment of trust and fairness. Leaders who have mastered their emotions are able to roll with the changes, especially with everything that happens in such a competitive role. Finally, self-regulation enhances integrity because many of the bad things

Emotional intelligence may be the key attribute that distinguishes outstanding performers.

that happen in companies, whether it's exaggerating profits or abusing power for selfish ends, are a function of compulsive behavior.

All effective leaders are driven to achieve beyond expectations—their own and everyone else's. And these leaders are motivated by the drive to achieve rather than by external rewards. These are people who have the passion for the work itself. Such people seek out creative challenges, love to learn, and take great pride in a job well done. They also display an unflagging energy to do things better. People with such energy often seem restless with the status quo. They are persistent with their questions about why things are done one way rather than in another. They are eager to explore new approaches to their work. And if you set a high performance bar for yourself, you will do the same for the organization when you're in a leadership role.

Of all the dimensions in emotional intelligence, empathy is the most easily recognized. But it doesn't mean a leader should adopt other people's emotions as his/her own or try to please everybody. Empathy means thoughtfully considering employees' feelings—along with other factors—in the process of making intelligent decisions. For business leaders empathy is increasingly important as globalization becomes a reality for most organizations. Cross-cultural dialogue can easily lead to miscues and misunderstandings. Empathy is an effective antidote. And finally, empathy plays a key role in the retention of talent, which is extraordinarily important in today's information economy where the company's assets "head up and down the elevator" every day.

Like empathy, social skills are about a person's ability to manage relationships with others. It is friendliness with a purpose—moving people in the direction you desire. Leaders tend to be very effective at managing relationships where they can understand and control their own emotions and can empathize with the feelings of others. After all, a leader's task is to get work done through other people, and social skills make this possible. A leader who cannot express his/her empathy may as well not have it at all. A leader's motivation will be useless if he/she cannot communicate passion to the organization. Social skills allow leaders to put their emotional intelligence to work.

As is true of the debate as to whether leaders are hard-wired at an early age, the question remains as to whether people are born with certain levels of empathy or if they acquire it as a result of life's experiences. The answer appears to be both. There is a genetic component to emotional intelligence. But emotional intelligence increases with age. Some maturity is a key driver in developing emotional intelligence as well. However, for those who want to build their emotional intelligence, it can only happen with sincere desire and a concerted effort. A casual solution simply won't work.

When is a Narcissist Good for a Company?

Narcissists are good for companies in extraordinary times, those that need people with the passion and daring to take them in new directions. But narcissists can also lead companies into disaster by refusing to listen to the advice and warnings of their managers. Narcissists personify the phrase "Only the paranoid survive." Recommendations about creating teamwork and being more receptive to subordinates don't resonate with narcissists. They didn't get where they are by listening to others. So why should they listen to anyone when they're leading an organization? Narcissists must work hard to overcome the limits of their personalities. One solution is to find a trusted sidekick who can point out the operational requirements of the narcissist's overly grandiose vision and hence keep him/her rooted in realty.

Narcissists are good for companies in extraordinary times, those that need people with the passion and daring to take them in new directions.

Freud described narcissists as "people who impress others as being personalities." They are leaders especially suited to give fresh stimulus. However, narcissists also have a dark side. They can be emotionally isolated and highly distrustful. And achievements can feed feelings of grandiosity. But the reality is that we are all somewhat narcissistic. And there are productive narcissists. These are people that can see the big picture and find meaning in the risky challenge of changing the world and leaving behind a legacy. They have the audacity to push through the massive transformations that society periodically undertakes. They're also charmers who can convert the masses with their rhetoric. However, narcissism can turn unproductive when narcissists become unrealistic dreamers who nurture grand schemes and harbor the illusion that only circumstances or enemies can block their success.

Narcissistic leaders bring both strengths and weaknesses to the role. They have compelling visions for organizations and have an ability to attract followers. In fact, they are quite dependent on their followers—they need affirmation and preferably adulation. However, this charisma is a double-edged sword and fosters both closeness and isolation. As he/she becomes more successful, the narcissist listens even less to the words of caution and advice. Rather than try to persuade those who disagree with him/her, the individual feels justified in ignoring them and thus creates further isolation.

The downside to narcissists is extreme as well. They are sensitive to criticism and will typically become emotionally isolated. As the more independent-minded players leave or are pushed out, succession becomes a particular problem. In addition, narcissists are poor listeners because they often feel threatened or attacked because of their sensitivity to criticism. Narcissists are furthermore not particularly empathetic and in fact are more street smart. Because of their lack of empathy and extreme independence, narcissists find it difficult to mentor or be mentored. And finally, narcissistic leaders are relentless and ruthless in their pursuit of victory. Hence, their organizations are generally characterized by intense internal competition.

In short, narcissists thrive in chaotic times. They like risk and often ignore the cost. In this age of innovation, there is no substitute for narcissistic leaders. They don't try to anticipate the future as much as create it. But narcissistic leaders can also self-destruct and lead their organizations terribly astray. With a trusted sidekick, who will keep them grounded, narcissistic leaders can recognize their limitations and ultimately lead a business successfully. For those who don't recognize their limitations, it could be the worst of times! ■

We hope you find the thoughts and insights provided here to be valuable. We look forward to receiving your comments and observations.

Mortgage REITs Roundtable Meeting

Wednesday, April 1st
9:45am – 11am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Jack DeCicco, CFO, Annaly Commercial Real Estate Group, Inc.
Phillip Reinsch, EVP & CFO, Capstead Mortgage Corporation

BREAKING NEWS

10:40 AM

Procter & Gamble to Explore Sale or IPO of Beauty Brands

Mortgage REITs Joining FHLBs Again Even as Regulator Weighs Ban

by Jody Shenn, and Heather Perlberg,

11:59 AM EDT March 13, 2015

(Bloomberg) -- The Federal Home Loan Bank of Indianapolis is again admitting mortgage-investment firms as members, even as the overseer of the government-chartered system of 12 regional lenders considers barring such companies.

The FHLB in Indiana recently accepted another insurer owned by a real-estate investment trust, spokeswoman Carrie O'Connor said, after holding off on such approvals while its regulator, the Federal Housing Finance Agency, gathered comments through January on its proposed ban. She wouldn't name the REIT that joined Ladder Capital Corp. and Invesco Mortgage Capital Inc., which have units as members of the cooperative.

"We felt we had an obligation to address good-faith applications," O'Connor wrote in an e-mail.

The move may mark the return of a trend that began in 2012 when investment firms that buy mortgage debt started joining the system to tap cheap and dependable financing. That halted last year as the FHFA proposed banning captive insurers -- which mainly offer coverage to their owners or customers of those parent companies -- after a growing number of REITs used the type of guarantors to gain memberships.

The regulator said REITs could add risks to the system, which encompasses $830 billion of outstanding debt, and might not be permitted as members under the law that says FHLBs can admit banks and insurers. To lend to those owners, the FHLBs jointly raise money with sales of bonds perceived by investors and credit graders as government-backed.

Peter Garuccio, an FHFA spokesman, declined to comment on the Indianapolis FHLB's move and the timeline for the regulator's decision on its September proposal. The FHLBs had voluntarily paused admissions of captive insurers in June.

'Getting Tired'

"Maybe this is somebody's way of saying, 'I'm getting tired of waiting, maybe I can force a decision,'" Michael Widner, an analyst who covers mortgage REITs at Keefe, Bruyette & Woods, said in a telephone interview.

Mortgage REITs responded to the proposal by saying their businesses match the FHLBs' mission of supporting real estate and that they don't present unusual risks, partly because their borrowing is backed by collateral.

"They're looking at this and saying this rule doesn't make a lot of sense," Scott D. Geromette, a partner at Honigman Miller Schwartz and Cohn LLP, who represents some REIT-owned insurers that are FHLB members and some that want to be, said in a telephone interview.

Current REIT members, which also include Annaly Capital Management Inc., Two Harbors Investment Corp. and Redwood Trust Inc., have been boosting their use of the system. Five of their units that joined the Indianapolis, Des Moines or Chicago FHLBs since 2012 were borrowing about $6 billion on Dec. 31, up from $3 billion on June 30, according to data compiled by Bloomberg from their disclosures.

Kicked Out

The Des Moines FHLB in Iowa hasn't admitted any new members of this type in the past year, spokeswoman Angie Richard said in an e-mail. Melissa Warden, a spokeswoman for the Chicago FHLB, declined to comment.

While captive insurers could retain membership for five years if the FHFA's proposal is enacted, those admitted since it was released would be kicked out immediately if the rule is "adopted as proposed," according to the FHFA's plan. "Any new member is fully aware of the potential impact" of the rule, said O'Connor of the Indianapolis FHLB.

Most of the more than 1,300 comments the FHFA's proposal drew addressed issues unrelated to the captive insurer ban.

FHFA Director Melvin L. Watt said this month at the Goldman Sachs Housing Finance Conference that while his agency had no "bias against REITs," there are questions about whether they should be allowed to be members under the law.

"We get called on quite often to do things that we simply don't have the power to do that ought to be done in the legislative branch," he said.

To contact the reporters on this story: Jody Shenn in New York at jshenn@bloomberg.net; Heather Perlberg in Washington at hperlberg@bloomberg.net

To contact the editors responsible for this story: Shannon D. Harrington at sharrington6@bloomberg.net Michael Aneiro, Faris Khan

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Financial Stability Policies for Shadow Banking

Tobias Adrian

Staff Report No. 664
February 2014

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JEL classification: E44, G00, G01, G28

Abstract

This paper explores financial stability policies for the shadow banking system. I tie policy options to economic mechanisms for shadow banking that have been documented in the literature. I then illustrate the role of shadow bank policies using three examples: agency mortgage real estate investment trusts, leveraged lending, and captive reinsurance affiliates. For each example, the economic mechanisms are explained, the potential risks emanating from the activities are described, and policy options to mitigate such risks are listed. The overarching theme of the analysis is that any policy prescription for the shadow banking system is highly specific to the particular activity.

Key words: shadow bank policies, systemic risk, financial intermediation

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Adrian: Federal Reserve Bank of New York (e-mail: tobias.adrian@ny.frb.org). This paper was prepared for the Federal Reserve Bank of Chicago's Sixteenth Annual International Banking Conference *Shadow Banking within and across National Borders*. The author thanks Adam Ashcraft, Nicola Cetorelli, Michael Holscher, Morgan Lewis, Antoine Martin, and Robert Patallano for feedback.

1. Introduction

The Financial Stability Board (2011) defines shadow banking as the system of credit intermediation that involves entities and activities outside the regular banking system. Shadow credit intermediation thus takes place in an environment where prudential regulatory standards and supervisory oversight are either not applied or are applied to a materially lesser or different degree than is the case for regular banks engaged in similar activities. While the vast majority of shadow credit intermediation is regulated in some way, it is typically not subject to prudential supervision, which is the main objective to the regulation of the traditional banking system.

The majority of shadow banking activities are conducted outside of the commercial banking system. However, some activities take place under the umbrella of bank holding companies or insurance companies, and banks themselves feature prominently in the shadow banking system. For example, banks extend backup lines of credit that allow independent or off balance sheet entities to issue short-term liabilities. Furthermore, bank holding companies house money market funds, the triparty repo market, and many different types of activities related to securitization. The connection between bank and nonbank credit intermediation activities thus has to be one focus of shadow bank policies.

More generally, shadow banking can be defined as maturity transformation, liquidity transformation and credit risk transfer outside of institutions with direct access to government backstops such as depository institutions, i.e. traditional commercial banks. This definition encompasses a large section of the financial system, as is illustrated by Figure 1, which plots shadow bank liabilities and commercial bank liabilities as a fraction of the nominal gross domestic product since the 1960s. The figure illustrates that traditional bank liabilities have been roughly constant at around 70 percent of GDP over the past fifty years. Shadow credit intermediation, on the other hand, has grown from less than one percent of GDP in 1960 to over 70 percent today, with a peak close to 80 percent in mid 2007, just before the onset of the global financial crisis. In 2007, shadow bank liabilities were in fact larger than traditional commercial bank liabilities. Another sector plotted in Figure 1 are liabilities of bank holding companies and broker dealers. While large commercial banks in the U.S. are part of bank holding companies, they are separate legal entities with distinct regulations. Importantly, only commercial bank subsidiaries have access to the discount window and deposit insurance, not the bank holding company, or other subsidiaries such as broker dealer subsidiaries. Bank holding company and broker dealer liabilities have also grown in recent decades, though their size is relatively small.

The remainder of the paper is organized as follows. I explain seven economic mechanisms of shadow bank intermediation in some detail in section 2. Section 3 provides an overview of financial stability policies aimed at risks emanating from the shadow banking sector, following the seven economic mechanisms from section 2. Sections 4-6 provide three case studies of shadow banking activities. Section 4 explains agency mortgage real estate investment trusts, section 5 analyzes leveraged lending, and section 6 dives into the shadow insurance sector. Each of the three case studies presents the economics of the respective activity, the risks emanating from the activity, and finally policy options. Section 7 concludes.

2. The Economics Shadow Banking

The literature has identified seven distinct economic mechanisms that motivate shadow bank activities. I discuss each of these mechanisms in more detail, drawing on previous work by Adrian and Ashcraft (2012b) and Adrian, Ashcraft and Cetorelli (2013).

i) Specialization

Through the shadow intermediation process, the shadow banking system transforms risky, long-term loans (subprime mortgages, for example) into seemingly credit-risk-free, short-term, money-like instruments. Unlike the traditional banking system, where the entire process takes place within a single institution, the shadow banking system decomposes the credit intermediation into a chain of wholesale-funded, securitization-based lending. Shadow credit intermediation is performed through chains of nonbank financial intermediaries in a multistep process that can be interpreted as a "vertical slicing" of the traditional bank's credit intermediation process into seven steps. Pozsar, Adrian, Ashcraft, and Boesky (2013) explain the seven steps of shadow bank credit intermediation in detail.

1. Loan origination (loans and leases, nonconforming mortgages, etc.) is performed by non-bank finance companies.

2. Loan warehousing is conducted by single- and multi-seller conduits and is funded through asset-backed commercial paper (ABCP).

3. The pooling and structuring of loans into term asset-backed securities (ABS) is conducted by broker-dealers' ABS syndicate desks.

4. ABS warehousing is facilitated through trading books and is funded through repos, total return swaps, or hybrid and repo conduits.

5. The pooling and structuring of ABS into CDOs is also conducted by broker-dealers' ABS.

6. ABS intermediation is performed by limited-purpose finance companies (LPFCs), structured investment vehicles (SIVs), securities arbitrage conduits, and credit hedge funds, which are funded in a variety of ways including, for example, repo, ABCP, MTNs, bonds, and capital notes.

7. The funding of all the above activities and entities is conducted in wholesale funding markets by money market intermediaries (money market funds, enhanced cash funds) and direct money market investors such as securities lenders.

This intermediation chain closely intertwined with commercial banks, bank holding companies, and security broker dealers. The seven steps are furthermore complemented by risk repositories of insurance companies, which provide credit risk transfer at various stages of the intermediation chain.

ii) Mispriced Guarantees from Government Backstops

Since the creation of the Federal Reserve in 1914 and the Federal Deposit Insurance in 1935, the official sector has attempted to minimize the risk of runs in the banking system risk through the use of its own balance sheet by providing credit guarantees via deposit insurance and contingent liquidity via lending of last resort. However, the risk-insensitive provision of credit guarantees and liquidity backstops creates well-known incentives for excessive risk-taking, leverage, and maturity transformation, motivating the need for supervision and prudential regulation. The traditional form of financial intermediation, with credit being intermediated through banks and insurance companies, but with the public sector standing close by to prevent destabilizing runs, dominated other forms of financial intermediation from the Great Depression well into the 1990s.

Pozsar, Adrian, Ashcraft, and Boesky (2013) define shadow banking as credit intermediation without explicitly guaranteed liabilities. Credit intermediation outside of backstopped commercial banks grew significantly, as illustrated in Figure 1. Outside of commercial banks, institutions have varying degrees of connectedness to government backstops. For example, uninsured liabilities outside of commercial banks are part of the shadow banking system since they do not benefit from access to official sector liquidity, thus making them vulnerable to concerns about credit as well as runs by investors. However, some shadow banking liabilities have indirect access to backstops via credit lines of commercial banks. The pricing of credit lines, which benefit from the government backstops, therefore influences the pricing of such uninsured liabilities. As the distortionary impact from official backstops is primarily contained via constraints on risk taking (e.g. via capital requirements), the pricing of the credit line to the shadow banking institution can benefit from the government backstop of the commercial bank. Examples of distorted pricing of shadow banking activities due to the closeness to government backstops are widespread and include the pricing of intraday credit in the triparty repo market, the implicit guarantees of various shadow banking institutions under the umbrella of bank holding companies due to reputational reasons (for example structured investment vehicles and money market funds), or credit guarantees written by insurance companies that benefit from superior credit ratings due to state insurance funds.

iii) Regulatory Arbitrage

Among the motivations for shadow credit intermediation are regulatory and tax arbitrage. Regulation typically constrains institutions to behave in ways that they would privately not choose: pay taxes to the official sector, disclose additional information to investors, or hold more capital against financial exposures. The re-structuring of financial activity that aims at avoiding taxes, disclosure, and/or capital requirements, is referred to as regulatory arbitrage. While arbitrage generally refers to the simultaneous buying and selling of instruments for a riskless profit, regulatory arbitrage is generally a change in structure of activity which does not change the risk profile of that activity, but increases the net cash flows to the sponsor by reducing the costs of regulation.

An example of regulatory arbitrage is documented by Acharya, Schnabl, and Suarez (2011). The authors show that the rapid expansion of ABCP since 2004 was, at least in part, attributable to regulatory arbitrage triggered by a change in capital rules. In particular, Financial Accounting Standards Board issued a directive in January 2003 (FIN 46) and updated the directive in December 2003 (FIN 46A) suggesting that sponsoring banks should consolidate assets in ABCP conduits onto their balanced sheets.[1] However, U.S. banking regulators clarified that assets consolidated onto balance sheets from conduits would not need to be included in the measurement of risk-based capital and instead used a 10 percent credit conversion factor for the amount covered by a liquidity guarantee. Acharya, Schnabl, and Suarez (2011) documented that the majority of guarantees were structured as liquidity-enhancing guarantees aimed at minimizing regulatory capital, instead of credit guarantees, and that the majority of conduits were supported by commercial banks subject to the most stringent capital requirements.

There is also a literature investigating the impact of taxes and tax avoidance activity on the recent financial boom and bust. Alworth and Arachi (2012) provide a broad discussion of the role of the tax advantages of home ownership, the use of debt in mergers and acquisitions by private equity, the use of hybrid debt instruments as capital by financial institutions, and the use of tax havens to structure securitization vehicles. Mooij, Keen, and Orihara (2013) documents an empirical link between corporate tax rates and the probability of crises. Finally, Davis and Stone (2004) document that the severity of crises is larger when pre-crisis leverage is higher, suggesting that tax policy could have effects both on incidence and severity of financial stress.

iv) Neglected Risk

Another economic role of shadow banking activity is related to aggregate tail risk. Because shadow banks are tailored to take advantage of mispriced tail risk, they accumulate assets that are particularly sensitive to tail events. Academic literature argues that such tail risk might be mis-priced ex-ante, either due to irrational or due to rational reasons. This literature is broadly referred to as "neglected risk."

The behavioral literature on neglected risk is rooted in the psychological observation that market participants are fundamentally biased against the rational assessment of tail risk. Gennaioli, Shleifer, and Vishny (2012) develop a theory of individual decision making based on the behavioral evidence, positing that actors neglect risk. Gennaioli, Shleifer, and Vishny (2013) apply this theory to the economics of the shadow banking system. They model a world where investors systematically ignore the worst state of the world, generating overinvestment and overpricing during the boom and excessive collapse of real activity and the financial sector during the bust. An early paper warning of the financial system's exposure to such tail risk was presented by Rajan (2005) who asked whether financial innovation had made the world riskier. Coval, Jurek, and Stafford (2009) point out that the AAA tranches of private label asset backed securities behave like catastrophe bonds that load on a systemic risk state. Neglected risk also manifests itself through over-reliance on credit ratings by investors. For example, Ashcraft, Goldsmith-Pinkham, Hull, Vickery (2011) document that subprime MBS prices are more sensitive to ratings than ex post performance, suggesting that funding is excessively sensitive to credit ratings relative to informational content.

[1] See http://www.fasb.org/summary/finsum46.shtml.

Dang, Gorton, and Holmström (2009) present an alternative theory that generates neglected risk within a rational setting. Their theory is one of information opacity that can serve as a rationalization of excessive risk taking in the shadow banking system. According to this theory, debt contracts are optimal because they generate opacity. Opacity, in turn, minimizes adverse selection and provides the least possible incentives to collect information. This insight justifies the growth of relatively opaque securitized products in the run-up to the crisis. Mortgages and loans were packaged into MBS and ABS and funded by CDOs, SIVs, and MMMFs that had relatively little information about the underlying credit quality. However, Dang, Gorton, and Holmström show that systemic risk is exacerbated once a bad shock hits informationally opaque, debt-funded economies. The intuition is that a bad shock leads to an increase in private information collection, which exacerbates the incorporation of adverse information in market prices. As a result, adverse selection starts to accumulate as systemic crises deepen.

v) Agency Problems

Ashcraft and Schuermann (2008) describe seven informational frictions in the securitization of subprime mortgage credit prior to the financial crisis, although these frictions can be generalized to all securitization transactions. They include asymmetric information problems between lenders and originators (predatory lending and borrowing), between lenders and investors, between servicers and investors, between servicers and borrowers, between beneficiaries of invested funds and asset managers, and between beneficiaries of invested funds and credit rating agencies. In addition, asymmetric information between investors and issuers results in risk-insensitive cost of funding. For example, Keys et al. (2010) document that mortgage borrowers with FICO scores just above a threshold of 620 perform significantly worse than borrowers with FICO scores just below 620. As it is more difficult to securitize loans below that threshold, the authors argue that this result is consistent with issuers exploiting asymmetric information, disrupting the otherwise monotone relationship between borrower credit scores and performance. Although securitization has a relatively short history, it is a troubled one. The first known securitization transactions in the United States occurred in the 1920s, when commercial real estate (CRE) bond houses sold loans to finance CRE to retail investors through a vehicle known as CRE bonds. Wiggers and Ashcraft (2012) document the performance of these bonds, which defaulted in large numbers following the onset of the Great Depression. Although the sharp deterioration in economic conditions played an important part in explaining their poor performance, so did aggressive underwriting and sales of the bonds in small denominations to unsophisticated retail investors. Over-reliance on credit ratings can create problems when the rating agencies face their own agency problems. For example, Mathis, McAndrews, Rochet (2009) analyze a dynamic model of ratings where reputation is endogenous and the market environment may vary over time. The authors' model predicts that a rating agency is likely to issue less accurate ratings in boom times than it would during recessionary periods. Moreover, the authors demonstrate that competition among rating agencies yields similar qualitative results. Xia and Strobl (2012) document that the conflict of interest caused by the issuer-pays rating model leads to inflated corporate credit ratings. Cohen (2011) documents significant relationships between variables that should not affect a CRA's view of the credit risk of conduit/fusion CMBS transactions issued during 2001-07, but that would affect issuers' and CRAs' incentives in an environment where rating shopping was present.

vi) Private Money Creation

Gorton and Metrick (2011, 2012) argue that an important aspect of shadow credit intermediation is its role in money creation. The creation of money like shadow bank liabilities complement traditional forms of money creation. High powered money can only be created by central banks. Commercial banks create broader forms of money, such as checking accounts and savings accounts. Treasury bills also have money like features due to their liquidity and safety. Shadow bank money creation occurs primarily in the commercial paper market and the repo market, and is funded by money market funds and short term investment funds. Money plays a crucial role in the economy, acting not only as a store of value, but also as a unit of account and means of exchange.

The role of shadow liabilities in the overall money supply is explored by Sunderam (2012), who analyses the extent to which shadow banking liabilities constitute substitutes for high-powered money. He shows in a simple model that shadow bank liabilities should constitute substitutes for money in the private sector's asset allocation. Empirically, Sunderam shows that shadow banking liabilities respond to money demand, extrapolating that heightened money demand can explain about half of the growth of ABCP in the mid-2000s. He also confirms that regulatory changes to ABCP played a significant role in the growth of the shadow banking system. Moreira and Savov (2012) study the impact of shadow money creation on macroeconomic fluctuations. Intermediaries create liquidity in the shadow banking system by levering up the collateral value of their assets. However, the liquidity creation comes at the cost of financial fragility as fluctuations in uncertainty cause a flight to quality from shadow liabilities to safe assets. The collapse of shadow banking liquidity has real effects via the pricing of credit and generates prolonged slumps after adverse shocks.

vii) Short-term Funding and Runs

The financial frictions that lead to excessive risk taking and exacerbated credit losses during downturns also interact with the fragility of funding. Per definition, funding sources for shadow banking activities are uninsured and thus runnable. In many ways, the fragility of shadow banks due to the run-ability of liabilities resembles the banking system of the 19th century, prior to the creation of the Federal Reserve and the FDIC. During that time, bank runs were common, and they often had severe consequences for the real economy.

The shadow banking system's vulnerability to runs bears resemblance to bank runs as modeled by Diamond and Dybvig (1983). Shadow banks are subject to runs because assets have longer maturities than liabilities and tend to be less liquid as well. While the fundamental reason for commercial bank runs is the sequential servicing constraint, for shadow banks the effective constraint is the presence of fire sale externalities. In a run, shadow banking entities have to sell assets at a discount, which depresses market pricing. This provides incentives to withdraw funding—before other shadow banking depositors arrive. However, the analogy between bank runs and shadow bank runs goes only so far. The reason is that shadow bank entities do not offer demand deposits, but instead obtain funding in wholesale money markets such as commercial paper or repo. Martin, Skeie, and von Thadden (2011) provide a model for a run in repo markets that takes the empirical facts of the Bear Stearns and Lehman crises as a starting point. In their model, repo borrowers face constraints due to the scarcity of collateral and the liquidity of collateral. Under sufficiently adverse conditions, self-fulfilling runs can occur. The model focuses in particular on the differences between the tri-party repo market and the bilateral repo market (see Adrian, Begalle, Copeland, and Martin (2013) for an overview of both markets). Arguably, runs occurred in both markets, but they were of very different natures. While the run in the bilateral market was characterized by a sharp increase in haircuts (as documented by Gorton and Metrick (2012)), the run in the tri-party repo market materialized as a simple withdrawal of funding with a rather limited impact on the level of haircuts (see Copeland, Martin, and Walker (2011)). Runs in the ABCP market were equally characterized by a withdrawal of funding (see Covitz, Liang, and Suarez (2012)). Gallin (2013) provides a comprehensive map of the amount of short term funding from the shadow banking system to the real economy, based on the flow of funds statistics. Gallin's framework shows that much of the decline in credit supply in the crisis was due to the decline of short term shadow bank funding. Gallin's work can be used to quantify fragility in shadow bank funding over time.

3. Shadow Bank Policies

The discussion of the economics of shadow banking in the previous section has demonstrated that some shadow banking activities are just market based credit intermediation with specialized financial institutions, while others are regulatory arbitrage responses to particular regulations, and yet others are outcomes of market failures. Shadow banking activities are generally vulnerable due to the absence of government backstops, and such vulnerabilities can create externalities for other parts of the financial sector. The regulation of shadow banking activities aims to correct market failures, government failures, and other distortions. Of particular concern is the systemic nature of certain shadow banking activities, i.e. the potential of distress in the shadow banking system to cause distress in other parts of the financial system, and ultimately the real economy.

While the case studies in sections 4., 5., and 6. present specific policy options in three shadow credit intermediation examples, the current section will discuss general principals that are motivated from the previous discussion on the economics of shadow banking. I discuss policy options for each of the seven economic mechanisms that were presented in Section 2.

i) Specialization

Specialization has many economic benefits, and in well functioning markets, specialized intermediaries are likely to increase economic efficiency. However, credit intermediation chains in specialized institutions can be subject to externalities along the chain. While credit intermediation within one and the same bank internalizes some of these externalities, credit intermediation along a chain of intermediaries can pass market failures on from one part of the chain to the next. Financial stability policies thus have to aim at internalizing such externalities, which depends on specific forms of the externality at each step of the chain. Externalities in shadow banking can be generated by network externalities, runs, leverage cycles due to risk management constraints, among other. Policies to address such externalities are specific to each shadow banking activity. The case studies in sections 4-6 discuss specific examples.

ii) Mispriced Guarantees from Government Backstops

Government guarantees consist primarily of the liquidity backstop by the Federal Reserve, and the credit backstop by the Federal Deposit insurance. The backstops are created to ensure the stability of the traditional commercial banking system, particularly due to bank runs. The regulation of depository institutions by the Federal Reserve and the Federal Deposit Insurance Corporation is motivated by the moral hazard that is created by the backstops. Many shadow banking activities benefit indirectly from the backstops, via the pricing of tail risk for both liquidity and credit. To the extent that shadow banking institutions benefit indirectly from government backstops, without, however, being subject to the same prudential regulation as depository institutions, policies have to aim at either expanding the regulatory reach, or else at adjusting the pricing of government backstops.

In the aftermath of the financial crisis, both routes have been undertaken. The prudential regulatory reach has been expanded by the creation of the Financial Stability Oversight Council, as well as fundamental reforms to the regulation of banks, bank holding companies, and other credit intermediaries. In addition, the pricing of government guarantees has been adjusted. For example, the assessment fee of the Federal Deposit Insurance Corporation has been changed to better reflect the systemic footprint of member banks. Capital regulations have been tightened to reflect the size, interconnectedness, and complexity of financial institutions, leading to an increase in the pricing of government backstops that are passed to shadow banking activities.

iii) Regulatory Arbitrage

A number of shadow banking activities consist of regulatory arbitrage, primarily with the aim of minimizing capital requirements of core regulated institutions such as banks, dealers, or insurance companies. In the banking sector, capital requirements represent the primary regulatory tool, and much regulatory arbitrage activity aims at circumventing such requirements. The first order policy response to such regulatory arbitrage activity is, of course, to change capital requirements in such a way that the arbitrage will be prevented. Indeed, the Basel III capital regulation has closed many loopholes in capital regulation, preventing regulatory capital arbitrage. However, it is too early to tell to what extent new regulatory arbitrage activities will emerge in the future. In addition, new regulations such as liquidity rules might be arbitraged once fully implemented. The case study on shadow insurance in section 6 provides a discussion of policy actions that can mitigate a particular form of capital arbitrage in the insurance sector.

iv) Neglected Risk

Neglected risks can arise due to behavioral reasons, or as an equilibrium phenomenon due to adverse selection. In general, the excessive buildup of risk due to neglected risk can be mitigated with reporting requirements and shadow bank risk monitoring systems. Indeed, after the financial crisis, much effort has been put into better reporting systems. For the banking system, stress tests have become the primary tool to assess forward looking risks. The tests include, at least to some extent, stresses due to balance sheet exposures to the shadow banking system. For the broader financial system, the Office of Financial Research has as goal to collect and analyze data in order to assess system wide risk, including in the shadow banking system. Furthermore, the Dodd-Frank Act provides regulatory agencies in the

U.S. with a broad mandate to regulate risk in the system as a whole, not just the risk of individual financial institutions. Internationally, the Financial Stability Board (2013a) is leading a global effort to analyze and collect data on shadow banking activity, and to propose regulations to mitigate risks emanating from such activities. Of course, risk reporting systems only go so far in being able to mitigate systemic shadow banking risks: risk negligence might be an equilibrium outcome, either due to behavioral biases or due to adverse selection. A first order question is to what extent regulators are subject to the same behavioral biases as market participants.

Adverse selection can be an equilibrium outcome in response to market frictions, generating informational insensitivity. Intuitively, funding liquidity in good times is only possible when funding arrangements are informationally insensitive. However, adverse shocks can lead to an unraveling of theses arrangement, leading to information sensitivity. Such unraveling can be excessive, justifying public liquidity injections. Hence optimal policies relative to information insensitivity are ex-post backstops that mitigate market breakdowns due to adverse selection. Of course, the challenge of such policies are the information asymmetries that central bank faces. Gorton (2009) argues that the collapse of securitization activity was triggered by the emergence of synthetic products that allowed the shorting of the housing market. In particular, the ABX, a synthetic index of subprime mortgage-backed securities, was created shortly before the financial crisis. The ABX allowed market participants to take short positions in subprime mortgages, and lead to an unraveling of information opacity in securitized credit markets. One of the policy responses of the Federal Reserve to the collapse of securitization activity was the creation of the Term Asset-backed Securities Loan Facility (TALF) as described by Ashcraft, Malz, and Pozsar (2011). Under the program, the Federal Reserve extended term loans collateralized by securities to buyers of certain high-quality ABS and CMBS, with the intent of reopening the new-issue ABS market. Through the TALF program, the Federal Reserve was able to prevent the shutdown of lending to consumers and small businesses, while limiting the public sector's risk. While such backstops might be optimal ex-post, from an ex-ante perspective, tighter regulation is likely optimal (Farhi and Tirole 2012).

v) Agency Problems

Many reform efforts since the financial crisis have aimed at mitigating agency problems in the shadow banking system, particularly in the securitization process, and for credit rating agencies. The Dodd-Frank Act requires credit risk retention by securitizers (see Adrian, 2011). The risk retention is designed to reduce the moral hazard problem arising from the fact that mortgages and loans that are securitized are sold in the market place, and the underwriter thus generally does not have the right incentives to monitor underwriting standards. The risk retention provisions of the Dodd-Frank Act aims at investor protections and improvements to the regulation of securities. Securitizers are forced to retain not less than five percent of the credit risk of any asset that they sell through the issuance of an ABS, and prohibit securitizers from directly or indirectly hedging or otherwise transferring the retained credit risk. The issuer must disclose the amount and form of retention to investors, and must provide material assumptions which justify the aggregate face amount of liabilities. A menu approach to risk retention is offered where vertical, horizontal, or a mix of vertical and horizontal tranches can be retained. "Vertical" retention refers to holding a portion of all tranches, while under "horizontal" retention the securitizer retains a first-loss tranche restricted to receive only scheduled principal. The rule also includes a “premium capture mechanism” that disallows securitizers from structuring interest only securities which transfer the full cash value to the equity tranche holder at the time of issuance. The premium capture mechanism prevents the structuring of the equity tranche in such a way that the incentive alignment is removed as cash flows are no longer sensitive to the credit quality of the underlying securities. If the issuer of the security is a bank, the capital requirement applied to the retained risk is a key consideration for the economic rationale of securitization.

The reform of credit rating agencies has aimed at lowering conflicts of interest. The Securities and Exchange Commission, which gained oversight of the credit rating agencies in 2006, has started to implement rules that aim at removing conflicts of interest since 2009 (see Adrian and Ashcraft 2012a for a discussion). For example, agencies are prohibited from structuring the same product that they rate, and analysts are not allowed to receive gifts exceeding $25 from companies that they rate. Furthermore, agencies are required to publish statistics about the performance of their ratings after 1, 3, and 10 years. Furthermore, the Dodd-Frank Act provided the Commission with greater authority over credit rating agencies with respect to disclosure, governance, and conflicts of interest. Credit rating agencies have to provide more granular information about their ratings methodology, and the assumptions underlying particular ratings. Material changes to ratings methodology need board approval. Furthermore, sales and analysis within credit rating agencies has been separated. Changes to the rating agency compensation model could furthermore have significant consequences. Investors are too small to have a meaningful influence over issuers to generate appropriately risk-sensitive funding, which suggests the need to either coordinate to have market power or have an agent negotiate with only their interests in mind. As coordination between investors might raise antitrust issue, hence making rating agencies effective representatives of investors is likely an important part of mitigating conflicts of interest. However, as long as agencies are chosen and paid by the issuer, it seems difficult to imagine them working exclusively as a fiduciary of investors. While a number of solutions are being discussed, the right conceptual model would appear to be rating agency risk retention. This might involve rating agencies being compensated for their services by the sponsor in the form of a vertical slice of securities rated. Alternatively, this might involve rating agencies having balance sheets, and only being permitted to disclose ratings to investors if they hold a vertical share of a security outstanding.

vi) Private Money Creation

One role of the shadow banking system, emphasized by Gorton and Metrick (2012), is the creation of safe collateral that can be used in money markets. In particular, AAA tranches of securitized products were used as collateral in repo markets, and ABCP funded conduits of long term, risky mortgage pools prior to securitization. The first order policy response to a shortage of risk free collateral is the regulation of aggregate liquidity through the management of the maturity structure of government debt, and the management of aggregate liquidity in the banking system. Stein (2012) develops a conceptual framework to assess these issues in the context of an equilibrium model. Stein argues that the central bank can regulate aggregate financial stability risk via the amount of reserves in the banking system. Shortages of collateral are met by the creation of short term wholesale shadow funding, which are subject to run risk, leading to inefficient fire sales. Demand pressures for short term debt can be measured via the spread between the interest on excess reserves, and the federal funds rate. By supplying liquidity in the federal fund market, and setting the interest on excess reserves, the central bank can influence the availability of liquidity in the banking system and thus regulate incentives for shadow bank money creation. Stein, Hansen, and Greenwood (2010) investigate the role of the maturity structure of government debt for incentives of the private sector to generate risk free collateral. They document that corporations tend to issue risk free debt at times when there is a shortage of Treasury collateral. Sunderam (2012) uncovers a similar mechanism for asset-backed commercial paper issuers, who respond to shortages in money markets. Krishnamurthy and Vissing-Jorgensen (2012) show an explicit link between the shortage of money like assets and financial crises. Financial stability considerations in the creation of risk free collateral by the Treasury and the central bank to regulate the extent to which the shadow banking system creates potentially vulnerable substitutes thus seems to be a goal for shadow bank policies.

vii) Short-term Funding and Runs

Policy efforts with respect to runs in wholesale funding markets have been primarily concentrated on money market funds, and the triparty repo market. While some progress has been achieved since the financial crisis, the risk of runs has not been eliminated. A 2010 reform of the money market fund sector by the Securities and Exchange Commission has tightened liquidity risk and credit risk constraints. Currently, three main reform proposals are under discussion. The first consists of the abolishment of the stable net asset value. Purchases and redemptions in money market fund shares are rounded to the nearest penny, and are not marked to market, except when asset values fall below $0.995, at which point the fund breaks the buck. Due to this stable net asset value rule, investors treat money market funds like demand deposits. However, once a fund breaks the buck, there is no public backstop, making the funds vulnerable to runs. While the abolishment of the net stable asset rule is likely to reduce run risk, it is important to note, however, that money market funds in countries with floating net asset values have also experienced runs. The second reform proposal is to institute capital requirements for money market funds, similar to the capital requirements imposed on banks (see McCabe, 2011). Capital requirements move the default barrier of the funds, allowing some losses in their portfolios without triggering bankruptcy. The equity tranche of the funds could be publicly traded at different prices than the safe money market shares. While a capital requirement can make default less likely, it certainly does not rule it out, and thus does not eliminate run risk entirely. A third proposal consists of a liquidity requirement called “minimum balance at risk”, which consists of a liquidity buffer that minimizes incentives for runs (see McCabe, Cipriani, Holscher, Martin, 2012).

The triparty repo market reform addresses three shortcomings in the triparty repo market: 1) the heavy reliance of market participants on intraday credit extension, 2) the weaknesses in credit and liquidity risk management practices by market participants, and 3) the lack of a mechanism to ensure that tri-party repo investors do not conduct disorderly fire sales immediately following a dealer default. The reliance of market participants on intraday credit is addressed via technological changes by the tri-party repo clearing banks, which is expected to lead to an elimination of this type of credit by late 2014. Risk management practices of dealers have improved due to heightened supervision of the largest dealers, leading to a decline in the fraction of overnight repo funding. The risk of fire sales in the event of a dealer failure remains an open issue, without any obvious solution.

4. Case Study 1: Agency Mortgage REITS

A) Economics of Agency REITs

Real estate investment trusts (REITs) are investment vehicles that primarily invest in real estate related assets. Agency mortgage REITs (agency REITs) are specialized REITs that invest in mortgage backed securities (MBS) issued by U.S. government sponsored agencies (Fannie Mae, Freddie Mac, and Ginnie Mae). While there are hundreds of publicly listed REITs in the U.S., the publicly listed agency REIT market consists of only a handful of companies, the majority of which were created since the financial crisis (see Figure 2). In 2013, there were 14 publicly traded agency REITs in the U.S., owning over $350 billion of agency MBS. While the latter only represents around seven percent of the total outstanding agency MBS, the ownership share of agency REITs in that market has grown rapidly in recent years, as can be seen in Figure 3.

U.S. REITs are exempt from specific provisions of the Investment Company Act due to the large fraction of their assets invested in real estate related assets. In particular, the SEC requires REITs to invest at least 55 percent of their assets in mortgages or qualifying real estate interests, and at least 80 percent of assets in qualifying real estate interests and assets. Due to the exemption from the Investment Company Act, REITs in general, and agency REITs in particular, are exempt from limits of leverage and other SEC regulations though, as publicly listed entities, they are subject to the SEC's investor protection rules and have to file reports such as 10Qs. However, agency REITs aren't subject to prudential regulation.

REITs are also special with respect to their tax status. As long as REITs distribute at least 90 percent of their taxable net income annually, they avoid paying corporate taxes. To the extent that those distributions are done in the form of dividends, they are taxed at the shareholders' income tax rate, thus avoiding double taxation. The dividend yield of REITS in general, and agency REITs in particular, tend to be relatively high due to the high level of distributions required to avoid corporate taxation.

The business model of agency REITs relies on liquidity and leverage, but not credit transformation. Mortgage REITs obtain leverage in the bilateral repo market, from the broker-dealer sector. The repo contracts limit the amount of leverage that REITs can obtain. Since the financial crisis, haircuts for agency MBS have increased. The current level of leverage is between 6 and 10, down from 10 to 16 pre-crisis, according to the 10K filings of the largest agency REITs. There is no credit transformation, as agency MBS only contain interest rate, prepayment, and liquidity risk, but no credit risk. The rapid growth of assets under management in the agency REIT sector since the financial crisis can be primarily attributed to the interest rate environment. As expansionary monetary policy has resulted in low yields across the maturity spectrum, investors have been reaching for yield by allocating funds to levered investments. As a result, agency REITs, bond mutual funds (and particularly high yield mutual funds) as well as collateralized loan obligations have grown rapidly. The high degree of leverage and the above mentioned requirement to pay out at least 90 percent of net income in order to achieve tax exemption results allows agency REITs to generate dividend yields that are among the highest among traded stocks. For example, in recent years, the largest agency REITs have achieved dividend yields around 20 percent in recent years, despite longer term interest rates that are only around two to three percent.

B) Risks of Agency Mortgage REITs

Agency REITs are exposed to two main sources of risk, duration risk and liquidity risk. Duration risk arises as their assets are longer term MBS, while liabilities are repos. Hence when the slope of the yield curve steepens, agency REITs experience mark to market looses on their mortgage holdings. This can be seen from the historically tight relationship between return on assets and the slope of the yield curve (see Figure 4). A steeper yield curve thus generates losses, translating into a fall of the REITs' equity value. In addition to slope risk, agency REITs hold convexity risk. Convexity risk arises also in a rising yield environment. As agency mortgage pools consist of mortgages that can be prepaid, rising interest rates makes prepayment less likely, extending the duration of mortgages. The duration extension in a rising yield environment generates "negative convexity", meaning that the price of MBS is more and more sensitive to increasing rates, the higher rates are. Negative convexity has been linked to past bond market selloffs, particularly in 1994 and 2003.

Agency REITs are exposed to market liquidity and funding liquidity risks. Market liquidity risks arise in the agency MBS market during selloffs, as witnessed during the financial crisis in 2008 and the selloff in 2013. In selloffs, prices on agency MBS can be depressed due to fire sale externalities, leading to mark-to-market losses by agency REITs, and a corresponding decline in their book equity. The leveraged nature of agency REITs means that adverse price movements of agency MBS due to illiquidity have a magnified impact on their equity cushion: when leverage is 10, a one percent loss of agency MBS prices leads to a 10 percent loss of book equity.

Funding liquidity risk arises for agency REITs because their repo funding is short term, typically with either an overnight or a month long maturity. If money market investors suddenly withdraw funding to dealers, those can no longer pass funding onto agency REITs, exposing the REITs to liquidity risk. In addition, dealers might increase haircuts when liquidity and rate risk of agency MBS is judged higher, exposing REITs to the possibility of forced deleveraging. In fact, during the financial crisis, repo funding of agency MBS became severely distorted, leading the Federal Reserve to start a special financing program called "Term Securities Lending Facility." In addition, distress of the securities broker-dealer sector, as experienced in 2008, can further impact the funding liquidity of agency REITs.

Agency REITs can contribute to systemic risk during times of sharply increasing longer term interest rates by magnifying rates selloffs. Rising interest rates can force REITs to fire sale agency MBS, as agency REITs tend to manage their leverage ratio. Rising rates lead to market-to-market losses and hence a decline in their equity cushion, thus involuntarily increasing their leverage ratio. In order to restore target leverage, REITs have to sell MBS, thus contributing to market illiquidity and rising rates. The adverse rate and liquidity effects might spill over to other institutions, such as mutual funds, money market funds, insurance companies, and pension funds. Indeed, during the sharp rise in interest rates in the summer of 2013, agency REITs did sell significant amounts of agency MBS.

If the sector grows significantly larger in coming years, the high leverage and dependence on repo market funding might increase the systemic footprint of agency REITs. Endogenous adverse feedback loops in the agency MBS market might be exacerbated by the presence of leveraged investment vehicles that do not have access to lender of last resort facilities. The concern that risk management by REITs via selloffs in a rising rate environment is further magnified by the relative size of their agency holdings in comparison to the dealer broker sector. Figure 5 illustrates that the size of agency MBS holdings by REITs has become very large relative to the agency MBS holdings of the securities broker-dealer sector.

C) Financial Stability Policies

Financial stability policies to address the systemic risks emanating from agency REITs can consist of policies aimed at improving the resilience of the repo market, enhanced disclosure requirements for REITs, and indirect regulation via supervised bank holding companies (BHCs).

A recent study by the Financial Stability Board (2013b) has explored policy options to ensure the stability of shadow bank intermediation in relation to repo and securities lending markets. The recommendations of the FSB include the collection of more granular data on such activities, regulatory regimes for securities lenders and their agents, limits on the rehypothecation of client collateral, minimum standards for collateral valuation, and the review of the law governing bankruptcies that involve repo contracts. All of these recommendations aim at making repo and the (closely intertwined) securities lending market more resilient, which in turn helps to solidify funding liquidity of agency REITs, among other repo market borrowers. Of course, policies that enhance the resiliency of the broker-dealer sector, the triparty repo market, and the money market fund sector will also enhance the funding liquidity of agency REITs. While such improvements of the repo market infrastructure benefit all repo market participants, agency REITs are likely beneficiaries due to their highly leveraged nature, and singular dependence on repo funding.

The second set of policies to mitigate systemic risks emanating from the agency REIT sector consists in data reporting and disclosure requirements. One of the cornerstones of regulations is the disclosure of data to investors, which allows market forces to constrain the behavior of financial institutions. The exemption of REITs from the Investment Company Act also implies exemption from more granular disclosure requirements that other investment vehicles are subjected to, such as disclosure of securities holdings and hedges. The Office of Financial Research, created by the Dodd-Frank Act, has an explicit mandate to collect data for institutions and activities that can potentially endanger the financial system, and whose data is not adequately collected by other agencies. The OFR has broad subpoena power that ensures its ability to collect data, even though it does not have any supervisory or regulatory authority.

A third avenue to address systemic risks emanating from the agency REIT sector is via the supervision of the counterparty credit risk management of the dealers that provide leverage via the bilateral repo market. As agency REITs rely on the dealers to obtain leverage, they are closely monitored by the counterparty risk management functions of dealers. This is putting constraints on the amount of interest rate risk, prepayment risk, and liquidity risk that the REITs can obtain. As most major dealers are now part of BHCs, Federal Reserve supervision has some indirect lever over the risk taking of the REIT sector. However, the constraint on this policy option is that there are major dealers that are not part of bank holding companies, as well as foreign dealers through which REITs can trade. Hence the effectiveness of the indirect supervision channel is limited at best.

5. Case Study 2: Leveraged Lending

A) The Economics of Leveraged Lending

Leveraged loans are loans extended to firms with credit ratings below investment grade. Leveraged loans are used to fund ongoing investments such as capital expenditures and working capital, and also to finance corporate events. The latter category includes leveraged buyouts of publicly listed firms. Leveraged loans are typically structured as floating rate balloon loans with limited amortization, making their performance highly dependent on refinancing conditions. The term of leveraged loans is usually between five and seven years. Defaults on leveraged loans is sensitive to macroeconomic conditions, varying between one and twelve percent annually depending on the state of the credit cycle. Leveraged loans are typically collateralized and senior to other debt instruments, yielding high recovery rates of 70 percent on average, which is higher than recovery rages for corporate bonds.

The shadow credit intermediation chain of the leveraged loan market is represented in Figure 6. Issuers consist of speculative grade corporations. Issuance is facilitated by the syndication desks of investment banks which also provide warehouse funding for loans that are securitized. Securitization of leveraged loans is via collateralized loan obligations (CLOs), which are portfolios of loans that are structured into different tranches according to their riskiness. The AAA tranche of a CLO makes up around 70 percent of total face value and is typically sold to banks. The mezzanine tranche makes up around 22 percent of the CLO and tends to be sold to insurance companies, pension funds, and asset managers. The equity tranche is around eight percent of the CLO and tends to be sold to hedge funds, private equity firms, or independent CLO managers. CLOs are leveraged structures that perform some maturity transformation, and can be used for risk arbitrage. Around 55 percent of leveraged loans were securitized by CLOs in 2013, while the remaining 45 percent were sold outright to insurance companies, asset managers, mutual funds, and exchange traded funds.

B) Risks in Leveraged Lending

Leveraged lending collapsed in 2008 after peaking in 2007 of $680 billion. In the aftermath of the financial crisis, leveraged lending rebounded quickly, reaching nearly $1 trillion in 2013 (see Figure 7). While issuance has been at record levels, part of that has been for purposes of refinancing. While the total amount of outstanding leveraged loans has been growing rapidly in the pat two years, the change from year to year is less than total issuance volumes (compare Figures 7 and 8). Refinancing activity reflects the low interest rates in recent years, as well as the rolling over of maturing loans. Leveraged buyouts are low by historical standards, and corporate events more generally have not been a primary source of leveraged lending activity. Credit metrics of leveraged buyouts have not deteriorated, with average Debt-to-EBITA and EBITA-to-debt service within historical norms to date. However, there is some evidence of increasing leverage as Debt-to-EBITA for the high yield sector that requires further monitoring.

The fraction of covenant lite loans has increased significantly from zero in 2010 to 60 percent in 2013, raising financial stability concerns. This deterioration in loan underwriting has come hand-in-hand with an increased presence of retail investors in the leveraged loan market primarily through mutual funds and exchange traded funds (see Figure 9). Such investors are relatively less sophisticated than banks and hedge funds whose share in leveraged loan ownership is declining (though not necessarily their overall amount of holdings). The funding of leveraged loans by mutual and exchange traded funds represents a financial stability risk, as the loans have long maturities, are opaque and are inherently risky. Mutual and exchange traded fund shares, on the other hand, are demandable on a daily basis. These funds thus engage in maturity and credit transformation. The funding of leveraged loans on balance sheets that perform maturity and credit transformation makes the activity classifiable as shadow credit intermediation. While leveraged loan funds do use risk management techniques such as minimum liquidity holdings and backup lines of credit, such hedges are inherently expensive, and unlikely to withstand a major selloff of leveraged loans.

In the leverage lending intermediation chain presented in Figure 6, the largest leverage risk is found in hedge funds and in CLOs' equity tranches, exposing these investors to high losses. However, in both cases the maturity transformation is not high, as the liabilities are not of a short-term nature, so forced unwinding is generally not a concern. The largest liquidity transformation is found in mutual funds and ETFs, which have grown significantly. As liquidity is normally robust, investors expect to be able to sell out of positions in market downturns, but may find liquidity is absent when they most need it. CLOs engage in risk arbitrage to secure equity returns. CLO AAA spreads are materially wider than corporate AAA bonds, but also experienced significant spread widening during the crisis.

C) Leveraged Loan Policies

Banking agencies have recently issued new regulatory guidance on leveraged lending (supervisory rule 13-03[2]). The rule is important as it takes a macroprudential approach to the supervision of underwriting standards for leveraged lending. While supervision is historically concerned with the safety and soundness of individual institutions, the Dodd-Frank Act of 2010 has given regulatory agencies an explicit mandate to ensure the safety and soundness of the financial system as a whole. The way in which SR 13-03 implements that mandate is by requiring examiners of banks that underwrite leveraged loans to enforce underwriting standards even if those loans are not intended to be held by the bank in question. This is in contrast to some of the supervisory rules prior to the financial crisis, when poor underwriting of loans (or mortgages, for that matter) was not prevented as long as the loans under question were resold in the market place.

The rule provides specific guidance to examiners when reviewing leveraged lending, including standards for underwriting of specific loans, as well as overall risk management. The underwriting guidelines will raise scrutiny in the face of excessive leverage, limited amortization, and over-reliance on refinancing. As explained above, these underwriting standards apply both to loans intended for distribution as well as for the bank's own portfolio. Guidance related to risk management requires institutions to have a clearly articulated risk appetite, limits for pipeline and commitments, as well as for the aggregate book and individual borrower concentration. Banks must stress test both the pipeline and retained portfolio, and hold adequate capital against all positions.

[2] See http://www.federalreserve.gov/bankinforeg/srletters/sr1303.htm.

6. Case Study 3: Captive Reinsurance Affiliates

A) Economics of Reinsurance

Reinsurance is the sale of risk from an insurance company to a reinsurance company. There are several motivations for reinsurance. First, reinsurance helps an insurer avoid concentrations in its own portfolio, permitting it to underwrite larger insurance policies by relaxing regulatory and economic capital constraints. Second, solicitation of third-party evaluation and pricing of risk can supplement the insurer's own evaluation and pricing, reducing uncertainty about the risk. Third, when markets are segmented, the insurer can earn arbitrage profits. Segmentation can be driven by reinsurers who have more expertise, are better able to diversify, or have different funding sources. The usage of reinsurance by insurance companies can thus enhance their efficiency and competitiveness. While the usage of reinsurance can be advantageous from the point of view of individual insurers, it might be costly from society's point of view. In particular, the usage of reinsurance can lead to laxer regulation, excessive risk taking, and a potentially higher burden for taxpayers in the case of insurance company distress.

One particular form of reinsurance is captive reinsurance, where an insurance company purchases reinsurance from an affiliate, reducing the cost of regulation of the insurer. Captives are subject to different accounting rules that facilitate lower reserves. In addition, captives do not face regulatory capital requirements, thus offering a regulatory arbitrage opportunity for insurers. While insurance company regulation imposes restrictions on liquidity and credit risk taking, captives are generally not subject to these rules. Captives also face weaker transparency requirements limiting market discipline. Unlike insurance companies, captives are able to back reinsurance with low cost letters of credit or parental guarantees instead of more expensive capital. In a typical captive insurance arrangement, risk is transferred from the insurance company to the parent, which reduces the insurance company's regulatory capital requirements. The arrangement permits the consolidated organization to lower capital requirements, thus enhancing return on equity. Many captive reinsurance agreements are backed by letters of credit from the holding company to the captive reinsurer (see Figure 10). Alternatively, the captive reinsurer can be guaranteed with a letter of credit from a bank, which is in turn guaranteed by the holding company. The bottom line is that while risk is transferred out of insurance subsidiaries, it is still part of the holding company, i.e. it is not transferred out of the holding company. However, the required capital is lower for the captive.

Insurance company regulators have the authority to reject transactions with a captive. However, insurance companies are regulated at the state level, and not the holding company level. From the state's point of view, risk transfer to captives represents a reduction in the risk at the subsidiary, even though the risk at the holding company level might not experience a decline of risk, and typically experiences increased risk due to the lower capital requirement at the captive. Insurance companies argue that captive insurance is used to reduce the cost of excessively conservative regulation, which require them to hold reserves above the actuarial risk of their insurance policies. Moreover, captive reinsurance helps to protect the insurance company from the capital market volatility of variable-rate annuities. As the insurer provides a guaranty on the principal value of these investments, they are required to increase reserves when the market value of those investments declines in value, which reduces earnings and capital of the insurance company. The use of a captive insurance reduces volatility in regulatory capital ratios of the regulated entity. Furthermore, insurer provides guaranty on the principal value of these investments, they are required to increase reserves when the market value of those investments declines in value, which reduces earnings and capital of the insurance company.

B) Risks of Captive Reinsurance

Life insurers' reinsurance to captives has grown significantly in recent years, from $11 billion in 2002 to an estimated $364 billion in 2012 according to Koijen and Yogo (2013), see Figure 11. Koijen and Yogo further document that captive reinsurance is primarily used by the largest insurance companies which are estimated to cede one quarter of all insured dollars to shadow reinsurers in 2012. Koijen and Yogo further estimate that risk based capital is reduced by 53 percentage points due to the usage of captives. They estimate that that the total amount of this risk transfer corresponds to a three notch ratings downgrade. The authors argue that the cost of life insurance is significantly impacted by the usage of captives, as is the risk of the companies who are using them. The usage of shadow insurance is thus quantitatively large, and has a potentially significant impact on the risks in the insurance sector.

The growth of captive reinsurers has been attracting the attention of regulators. For example, the New York State Department of Financial Services recently issued a report highlighting findings from a study of reinsurance captives.[3] The New York state regulators refer to the activity as "shadow insurance," noting broader financial stability concerns, and calling for a moratorium on new activity. In the report, the regulators note significant volume of activity, significant reductions in regulatory capital ratios, inconsistent and incomplete disclosure to the market and regulators, and evidence of a regulatory race to the bottom.

A December 2013 study by the Federal Insurance Office of the U.S. Treasury on the modernization and improvement of insurance regulation in the U.S. pursuant to the Dodd-Frank Act argues that reinsurance captives for life insurance companies represent two risks.[4] Reinsurance captives allow an insurer to receive credit against its reserve and capital requirements by transferring risk to the captive even though the captive is not bound by consistent capital rules across the states. Reinsurance captives can be established with a small percentage of the capital required to establish a commercial insurance license in the same state. In particular, the standards that govern the quality of capital that reinsurance captives must hold are not sufficiently robust. For example, some state laws currently allow intra-company letters of credit, parental guaranties, or intra-company guaranties to constitute capital for captives. These instruments may not be sufficiently loss-absorbing if a significant adverse event were to occur. In many cases, a significant adverse event would cause a captive to fail and spread losses retained within the holding company or to another affiliate within the group, thereby accentuating group risk.

[3] See http://www.dfs.ny.gov/reportpub/shadow_insurance_report_2013.pdf.

[4] See http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf.

The Federal Insurance Office also points to the lack of transparency regarding the risk transfer to captives. The lack of transparency is not just vis-a-vis investors and the public, but also with regard to regulators. While financial statements of traditional insurers are made publicly available, the financial statements of captives are kept confidential between the captive manager and the domestic state. This is particularly troublesome in light of the limits on state regulatory authority, as state regulators must rely on information from another state in which a reinsurance captive is domiciled.

C) Financial Stability Policies for Insurance Captives

Insurance company regulators have the authority to reject transactions with a captive. However, the fragmented nature of insurance regulation in the U.S. represents a high hurdle. Disclosure requirements limit regulators ability to assess the extent to which insurance companies transfer risks to captives in other states. Furthermore, as captives tend to make the insurance subsidiary in a given state less risky, they tend to be approved, even if the holding company risk has not declined.

The Federal Insurance Office recommends for states to develop a uniform and transparent solvency and oversight regime for the transfer of risk to reinsurance captives. The oversight of captives should not only cover the liabilities transferred to a reinsurance captive, but also of the nature of the assets that support a reinsurance captive's financial status. In addition, the Office recommends for states to develop and adopt a uniform capital requirement for reinsurance captives, including a prohibition on those types of transactions that do not constitute a legitimate transfer of risk.

The National Association of Insurance Commissioners has put out a white paper with recommendations regarding the treatment of captives and other special purpose vehicles that includes accounting, confidentiality and reinsurance regulatory matters. However, the paper notes that state insurance regulators disagree about the regulation of captives, with some arguing for a nationwide level playing field, while others prefer the current regime of incomplete opacity and differential capital treatment.

Among the state regulator, the New York State Department of Financial Services has aggressively argues for a change in the regulation of life insurance captives by recommending disclosure requirements for captives of New York based insurers and their affiliates, by pressing the National Association of Insurance Commissioners to develop enhanced disclosure requirements for all jurisdictions. The New York regulator has also called for an immediate national moratorium on approvals of shadow insurance transactions until investigations are complete.

One avenue of regulation that is relevant for the captives of the largest, most systemically important insurance companies is the designation by the Financial Stability Oversight Council as systemically important financial institutions (nonbank SIFIs). Some of the largest insurance companies have recently been designated by the Financial Stability Oversight Council as systemically important, and will thus be subject to Federal Reserve supervision at the consolidated level. The designation of nonbank firms as systemically important is an important method of the Dodd-Frank Act to address the risk of so called "too big to fail" financial institutions.

The Dodd-Frank Act explicitly mandates that designated systemically important financial institutions have to be subject to *enhanced prudential standards*, which include enhanced risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, risk-management requirements, an early remediation regime, and resolution-planning requirements. Sections 165 and 166 of the Act also require that these prudential standards become more stringent as the systemic footprint of the firm increases. The Federal Reserve's proposed rules apply the same set of enhanced prudential standards to covered companies that are bank holding companies and covered companies that are nonbank financial companies designated by the Council.

In SR letter 12-23, issued on December 20, 2013, the Federal Reserve sets forth supplemental guidance regarding risk transfer considerations when assessing capital adequacy of large financial institutions. While the Federal Reserve generally recognizes that risk reducing transactions can represent sound risk management practices, the Fed points out that certain risk transfers to unconsolidated, sponsored affiliate entities give rise to supervisory concern as such transactions may result in a significant reduction of the capital requirements without a significant reduction of the firms' risk. To the extent that captive reinsurance affiliates lead to a reduction in regulatory capital for insurance holding companies, the Federal Reserve's treatment might become a binding constraint on the size of such affiliates.

7. Conclusion

Shadow banking activities evolve in response to changing regulations and market conditions. As a result of this evolution, policies towards financial stability for the shadow banking system need to adapt. While some of the risks that were relevant in the run-up to the financial crisis remain risks today, new shadow banking activities have emerged, requiring new policy approaches. For example, run and funding risks emanating from the triparty repo market and the money market fund sector remain current, while risks from ABCP conduits, SIVs, and CDOs have receded, in part due to regulatory and accounting changes. The discussions and case studies in this article also underline that shadow bank policies are highly specific to the particular activity under consideration. Policies cover areas as diverse as capital regulation, wholesale money market funding, insurance company structure, disclosure policies, underwriting standards, among many others.

Policies aimed at mitigating risks from shadow credit intermediation have to start with an analysis of the economic mechanism that motivates the particular activity. We have listed seven motivations for shadow credit intermediation. A major challenge for financial stability policies for shadow banking is the fragmented nature of the regulatory system in the U.S. The creation of the Financial Stability Oversight Council by the Dodd-Frank Act provides some additional scope for regulators to address threats from shadow banking, primarily via designation of nonbank financial institutions as systemically important. Policies will need to react dynamically to the changing financial landscape to contain threats effectively. Importantly, shadow bank policies need to take a system wide, macroprudential view, due to the tight interconnections and potentially powerful spillovers among shadow banking entities, and between shadow banks and core regulated financial institutions.

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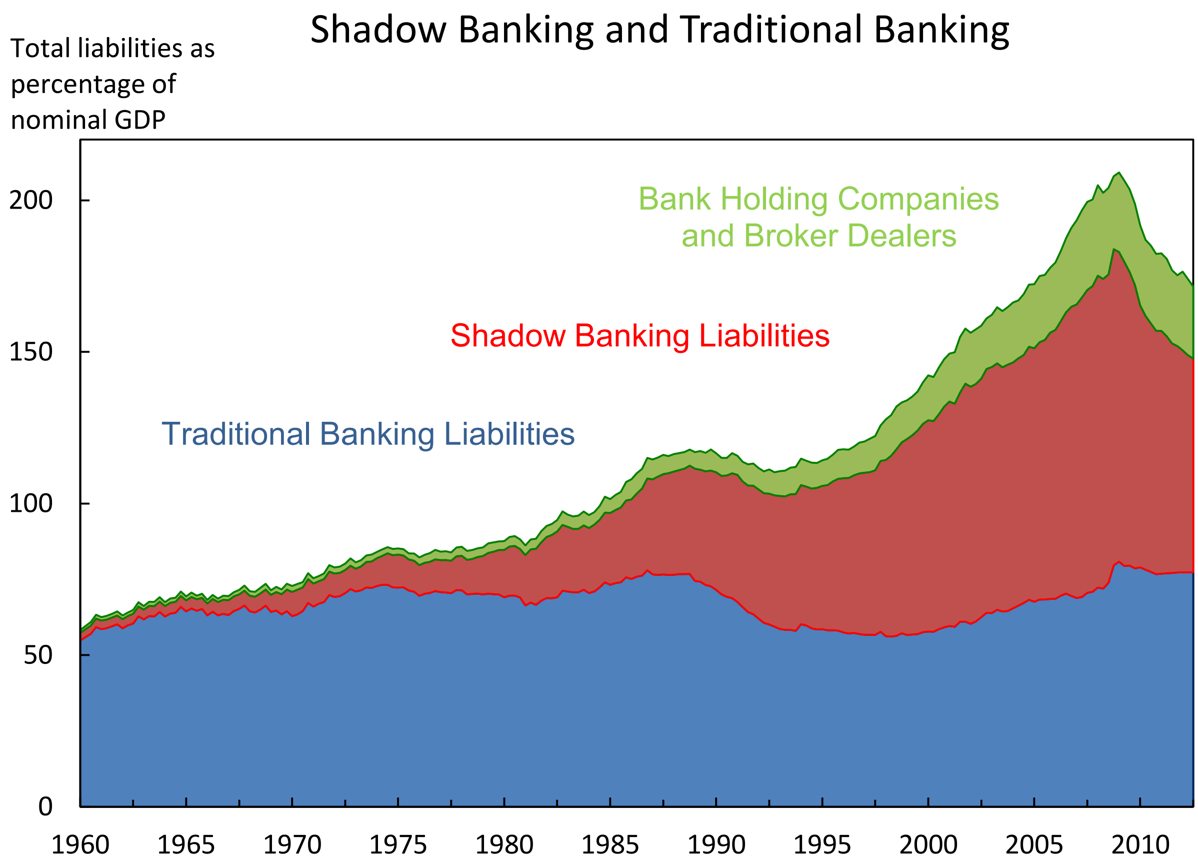
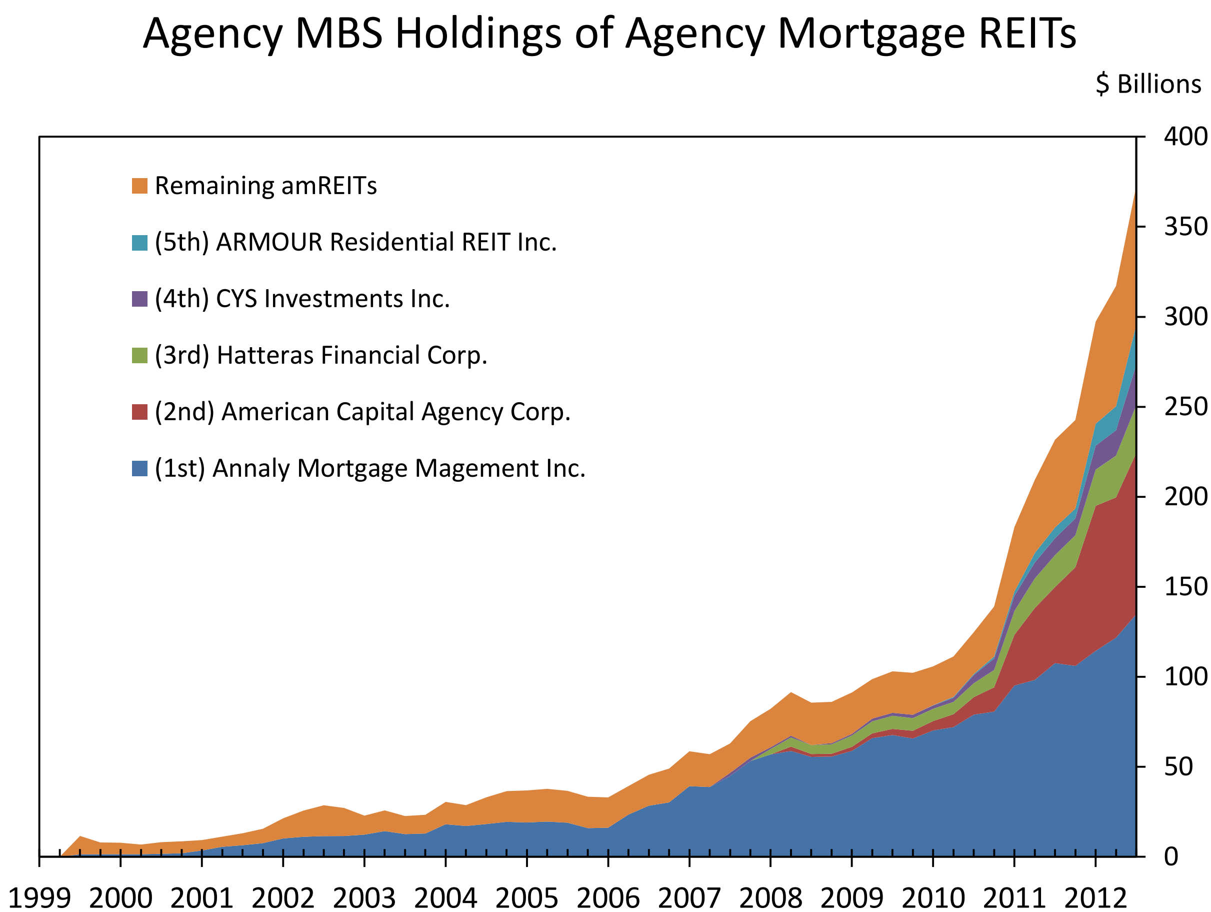
Figures and Tables

Figure 1



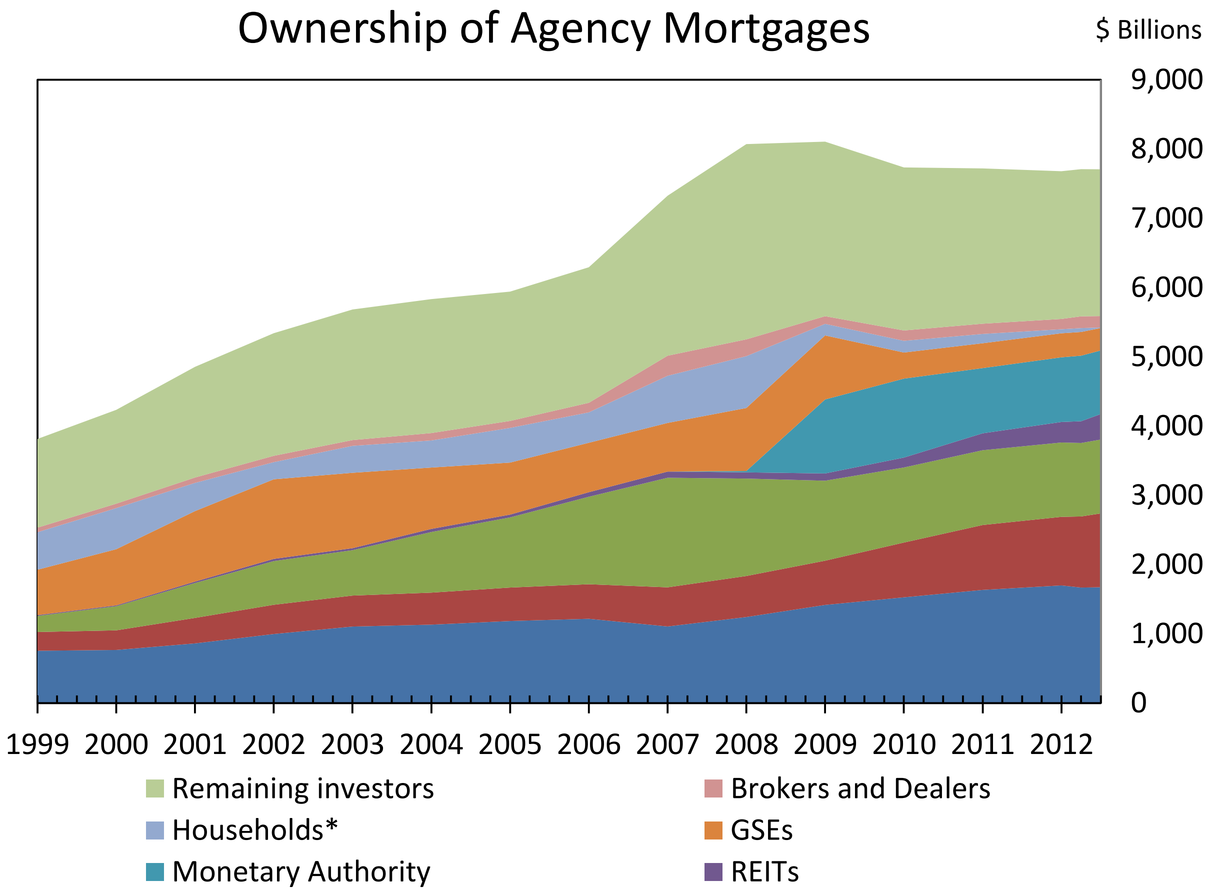
Note: The figure shows the evolution of total liabilities by shadow banks, traditional banks, and bank holding companies and broker-dealers, based on data from the U.S. Flow of Funds by the Board of Governors of the Federal Reserve, and the U.S. National Accounts by the Bureau of Economic Analysis. The figure illustrates the stability of the size of traditional bank liabilities relative to GDP around 70 percent since the 1960s, and the rapidly increasing size of the shadow banking system over the past fifty years. The collapse of shadow banking after the financial crisis of 2007-09 is also clearly visible. The plot is from Adrian, Covitz, Liang (2012).

Figure 2



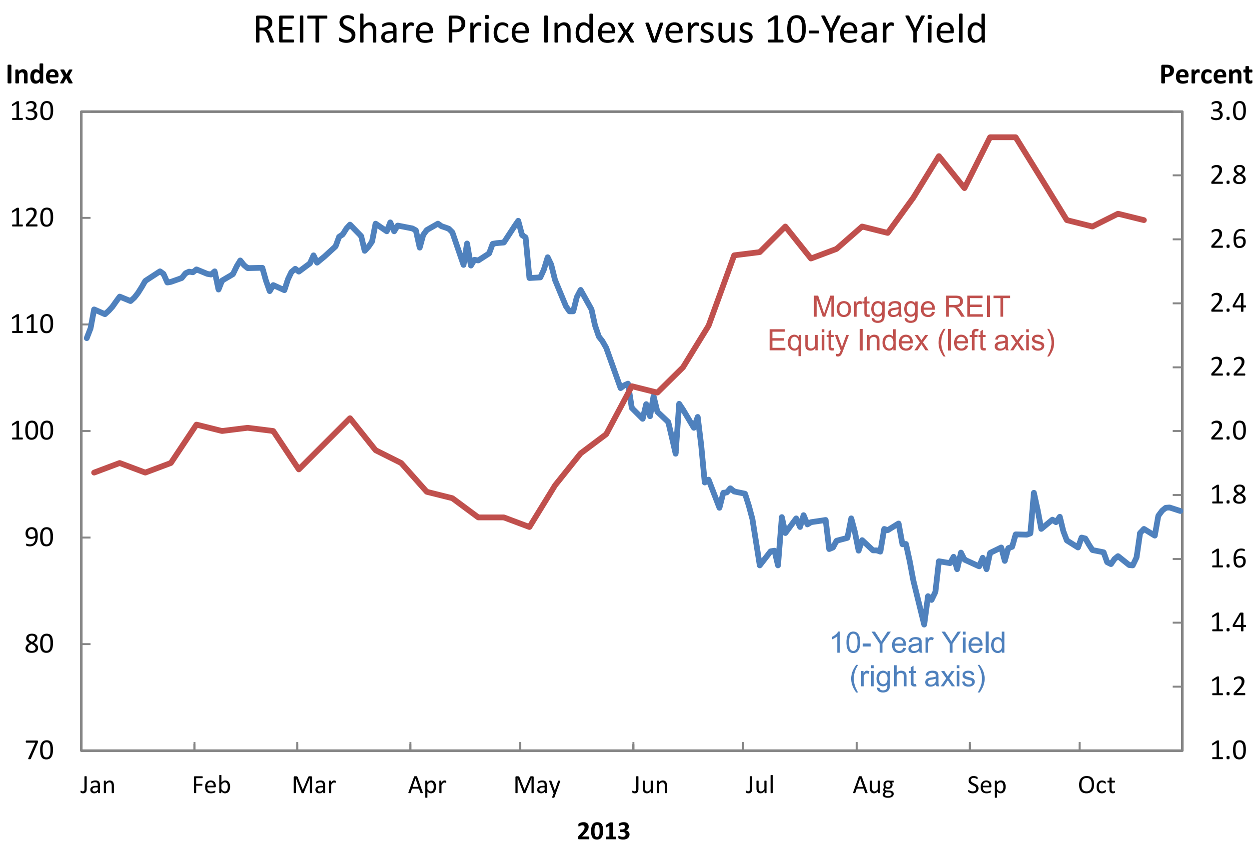
Note: The figure plots agency mortgage holdings by publicly listed agency mortgage REITs, based on 10K and 10Q filings with the Securities and Exchange Commission. The figure shows the rapid increase in the size of agency mortgage holdings by REITs, as well as the high degree of concentration in holdings by the top two firms.

Figure 3



Note: The figure plots ownership of agency mortgages by type of investors, based on data by the Board of Governors of the Federal Reserve. The chart illustrates that holdings by REITs have increased rapidly in recent years, but remain small in comparison to agency mortgage holdings by other investors.

Figure 4



Note: The chart shows the level of the 10-year Treasury yield, together with the share price of the agency mortgage REIT index based on data from the Board of Governors of the Federal Reserve and Bloomberg. The negative relationship between the yield and the REIT index reflects the mechanism through which agency REITs generate earnings: they borrow short (at low rates close to zero) and invest in longer term assets. When interest rates rise, REITs experience mark-to-market losses on their agency mortgage holdings, leading to lower earnings and a declining share price.

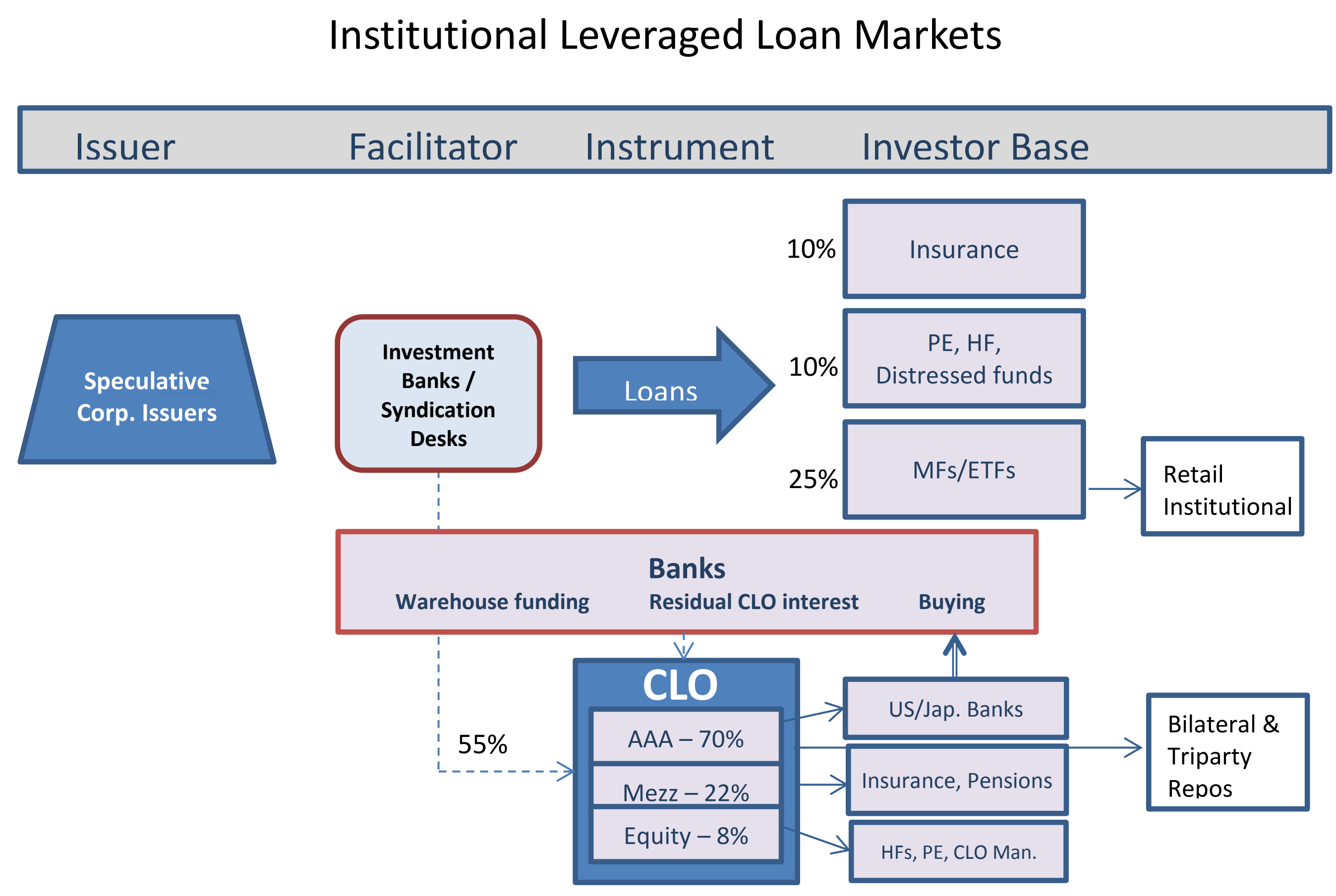
Figure 5

Agency Mortgage Holdings: Inventories of REITs and Broker-Dealers

	2007	2008	2009	2010	2011	2012
REITs	88.9	89.6	105.1	143.3	239.1	368.2
Broker-Dealers	290.2	242.6	110.9	149.8	166.8	165.5
Ratio	0.3	0.4	0.9	1	1.4	2.2

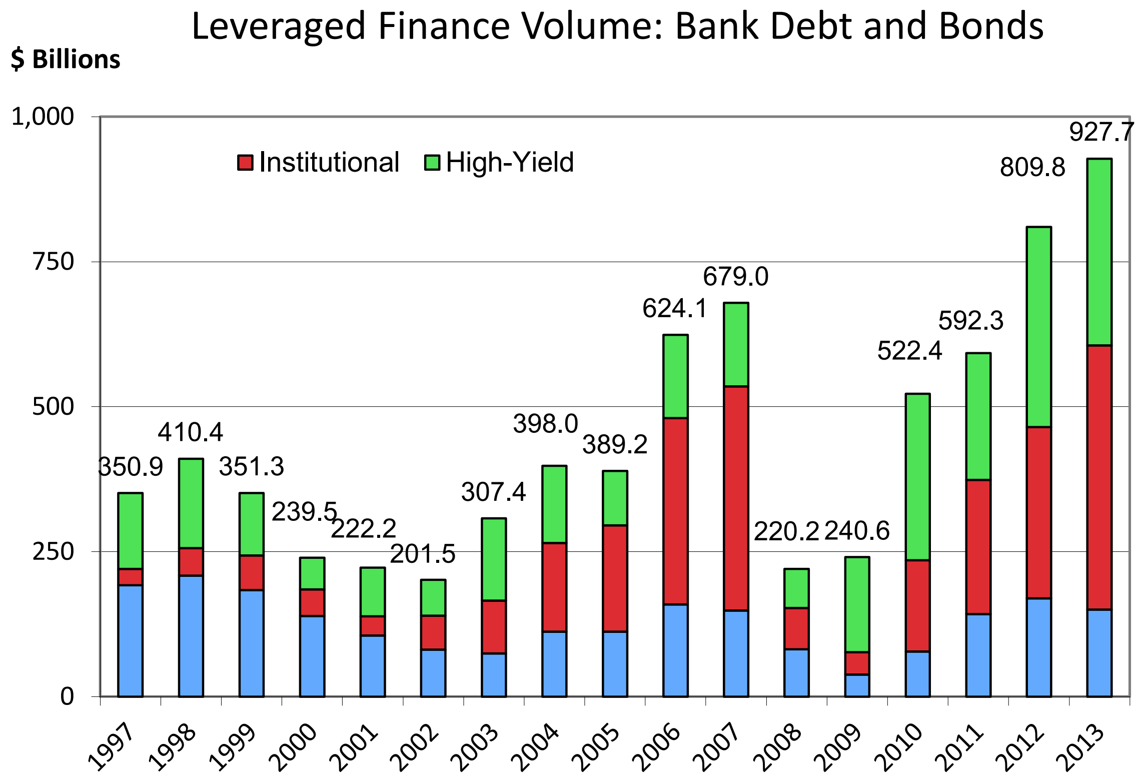
Note: The table shows the agency mortgage holdings by REITs and by security broker-dealers, based on data form the U.S. Flow of Funds of the Board of Governors of the Federal Reserve. The table documents that the fraction of agency bonds owned by REITs relative to broker dealers increased from one third to more than two between 2007 and 2013.

Figure 6



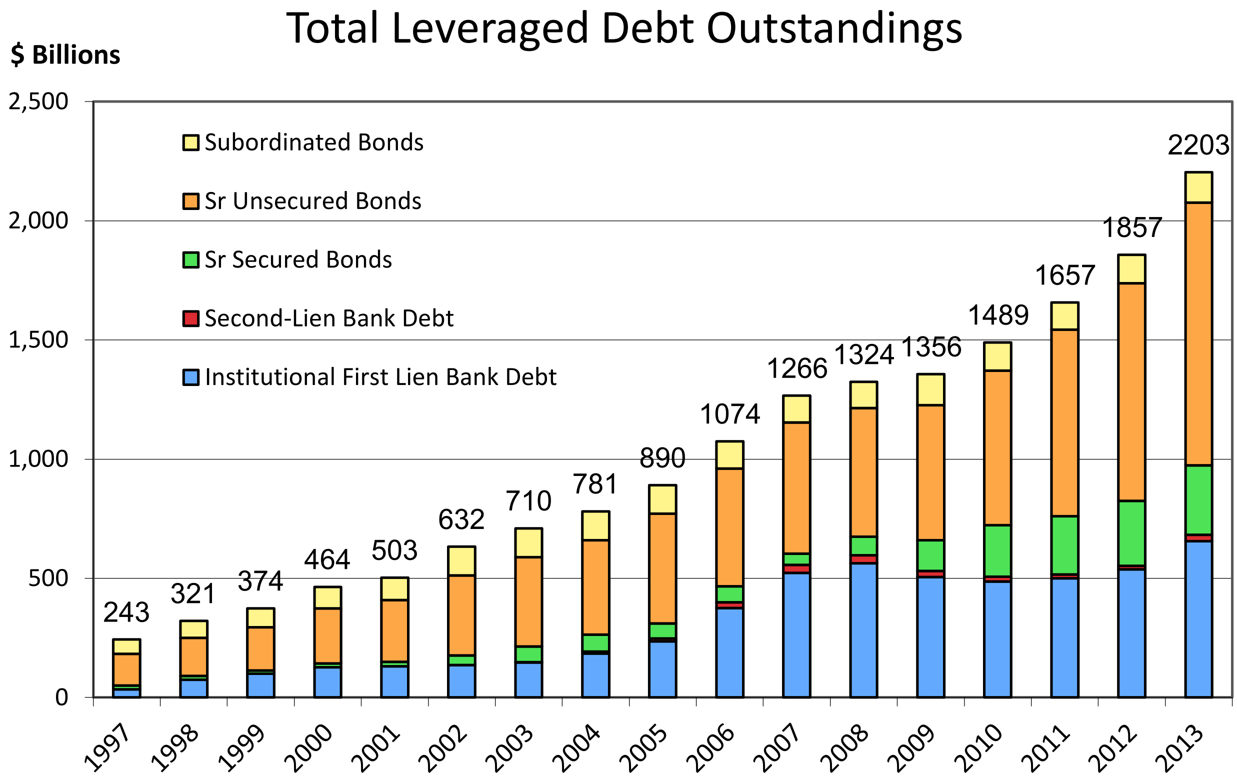
Note: The institutional leveraged loan market is comprised of bank syndicated loans distributed to institutional investors. CLOs represent the predominant investor in leveraged loans. Large US banks are at the heart of the originate-to-distribute model. They fund loan warehouses, take residual risk in CLOs, and buy AAA or AA tranches. The largest leverage risk is found in hedge funds and CLOs' equity tranches, exposing these investors to high losses. However, in both cases the maturity transformation is not high, as the liabilities are not of a short-term nature. The largest liquidity transformation is found in mutual funds and ETFs, which have grown significantly. As liquidity is normally robust, investors expect to be able to sell out of positions in market downturns, but may find liquidity is absent when they most need it. CLOs engage in risk arbitrage to secure equity returns. CLO AAA spreads are materially wider than corporate AAA bonds, but also experienced significant spread widening during the crisis.

Figure 7



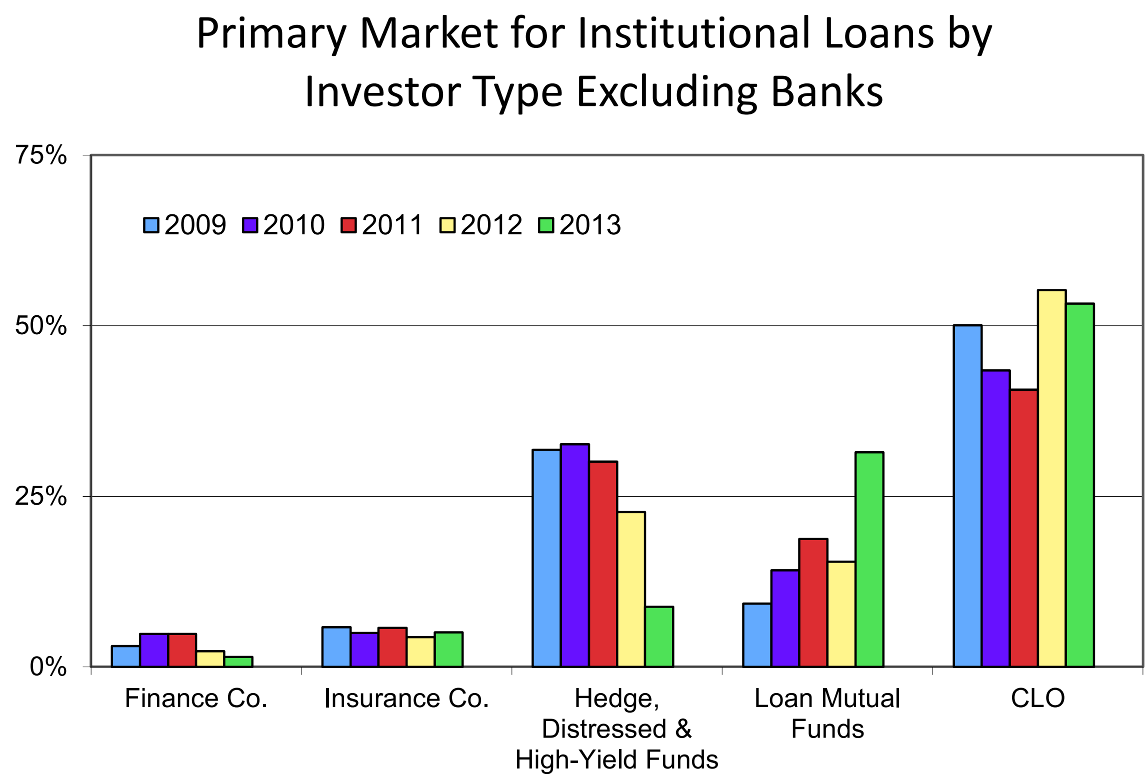
Note: The chart plots the leveraged finance issuance volume for leveraged loans (red), high yield, bonds (green), and pro-rata (blue), based on data from Standard & Poor's Capital IQ LCD. Issuance volume in 2012 and 2013 was at historical highs, exceeding volumes of 2006 and 2007, particularly in the high yield bond market.

Figure 8



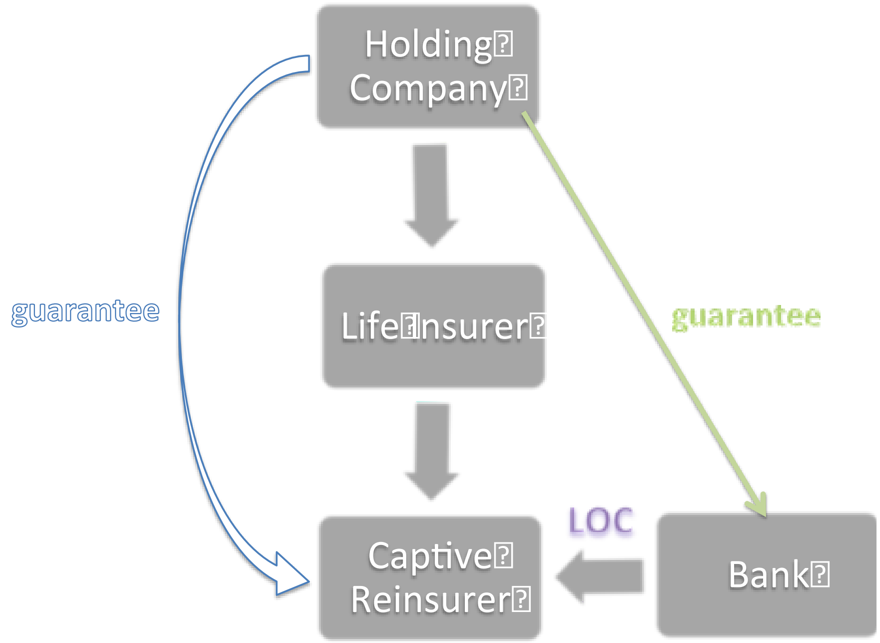
Note: The chart plots total leveraged debt outstandings, based on data from Bank of America/Merrill Lynch Global High-Yield Strategy and Standard & Poor's Capital IQ LCD. Total outstandings grew substantially in 2012 and 2013, reaching 2.2 trillion by the end of 2013.

Figure 9



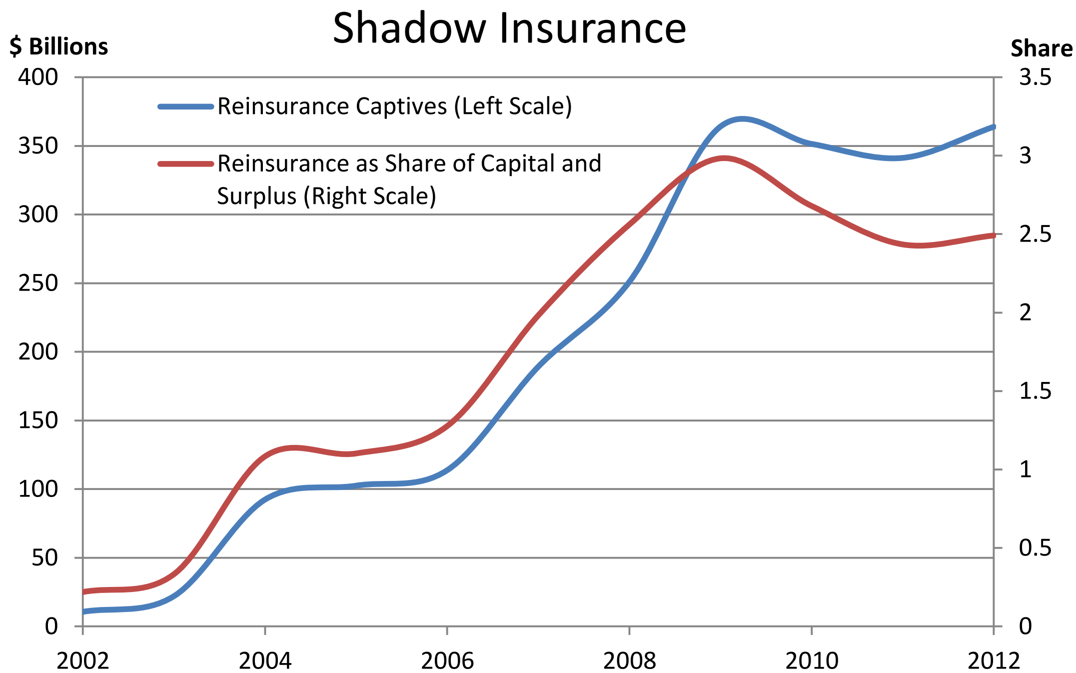
Note: The figure plots the share of investments in the institutional loan market by investor type since 2009, based on data by Standard & Poor's Capital IQ LCD. The chart shows the rapid growth of loan mutual funds among primary loan market investors. The growth of mutual fund investors is primarily offset by declining investments of hedge, distressed, and high yield funds.

Figure 10



Note: This figure shows the functioning of reinsurance captives for life insurance companies. Life insurance assets and liabilities are moved from the life insurance subsidiary to an affiliated captive reinsurer that typically resides in a different state with lower or no capital requirements. The holding company provides a guarantee either directly to the captive reinsurer, or to a bank that provides a letter of credit (LOC) to the captive. Hence risk is not transferred out of the insurance holding company, but total capital held by the holding company is lowered due to this capital arbitrage.

Figure 11



Note: This figure reports life and annuity reinsurance ceded by U.S. life insurers to shadow reinsurers, both in total dollars and as a share of the capital and surplus of the ceding companies, based on data from Koijen and Yogo (2013). Reinsurance ceded is the sum of reserve credit taken and modified coinsurance reserve ceded. Shadow reinsurers are affiliated and unauthorized reinsurers without an A.M. best rating.

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News Release

FHFA Proposes Revisions to Federal Home Loan Bank Membership Eligibility Requirements

FOR IMMEDIATE RELEASE

9/2/2014

Washington, DC – The Federal Housing Finance Agency (FHFA) today proposed a rule that would revise the requirements for financial institutions to apply for and retain membership in one of the 12 Federal Home Loan Banks (Banks). The proposed rule would revise FHFA's existing Bank membership regulation to ensure that members maintain a commitment to housing finance and that only eligible entities can gain access to Bank advances and the benefits of membership.

FHFA Director Mel Watt in May delivered a **speech** before the Federal Home Loan Bank Director's Conference where he described a number of issues, including ensuring that the Banks remain focused on their housing finance mission.

The proposed rule would:

- Establish a new quantitative test requiring all members to hold one percent of their assets in home mortgage loans (HML) and to do so on an ongoing basis. Currently, applicants for membership need only demonstrate a nominal amount of HML on their balance sheet at the time of their application, but not thereafter.

- Require certain members that are subject to the 10 percent residential mortgage loans (RML) requirement to adhere to this requirement on an ongoing basis. Currently, these members are subject to the 10 percent RML requirement only when they initially apply for membership in a Bank, but not thereafter.

- Define "insurance company" to mean a company that has as its primary business the underwriting of insurance for nonaffiliated persons. This would continue to include traditional insurance companies but would effectively exclude captive insurers from membership and prevent entities not eligible for membership from gaining access to Bank advances through a captive insurer. Membership of existing captive insurers would be "sunset" over five years with defined limits on advances.

- Clarify the standards by which an insurance company's "principal place of business" is to be identified in determining the appropriate Bank district for membership.

Interested parties are invited to submit comments on this proposed rule within 60 days after the rule is published in the Federal Register. Comments should be submitted to the Federal Housing Finance Agency, Division of Bank Regulation, 400 7th Street, S.W., Washington, DC 20024 or via FHFA.gov.

Link to proposed rule [Note: the proposed rule will also be published in the Federal Register].

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The Federal Housing Finance Agency regulates Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks. These government-sponsored enterprises provide more than $5.6 trillion in funding for the U.S. mortgage markets and financial institutions.

Contacts:
Stefanie Johnson (202) 649-3030 / Corinne Russell (202) 649-3032

Criteria for Rating U.S. Mortgage REITs and Similar Finance Companies

Sector-Specific Criteria

This report updates and replaces the criteria report of the same title dated Feb. 25, 2014.

Criteria Update: This sector-specific criteria report updates Fitch Ratings' methodology on analyzing the credit risk of U.S.-based mortgage real estate investment trusts (REITs) and similar finance companies. Fitch's master criteria for non-bank financial institutions are outlined in Fitch Research on "Global Financial Institutions Rating Criteria," dated January 2014, available on Fitch's website at www.fitchratings.com. Fitch's rating methodology for U.S. mortgage REITs and similar finance companies also takes into consideration various cross-sector criteria reports noted to the left.

Impacted Credit Ratings: This report addresses forward-looking opinions on the creditworthiness of mortgage REITs — companies that own direct or indirect interests in mortgages on real estate or other interests in real property — including long-term issuer default ratings (IDRs) as well as credit ratings for revolving credit facilities, long-term debt obligations and preferred stock of these issuers.

REIT Tax Election: The vast majority of issuers to which Fitch applies these rating criteria have elected REIT status under the U.S. Internal Revenue Service tax code. Additionally, these criteria apply to finance companies that have not elected REIT status but whose asset compositions and financial and operational strategies are similar to those of mortgage REITs.

Qualitative and Quantitative Factors: Fitch's credit ratings for mortgage REITs are based on qualitative factors such as the company's business model, asset quality, funding diversity, financing strategy, servicing platform, management and governance, staffing, track record and competitive position. Quantitative factors include leverage, unencumbered asset coverage, access to capital and liquidity management and operating performance.

Credit Ratings Spectrum: The vast majority of mortgage REITs have IDRs or other forms of credit opinions that are below investment grade. Mortgage REITs typically have a soft cap of the 'BBB' rating category. Funding diversity and financing strategy, liquidity and unencumbered asset quality are typically major obstacles in a company's evolution toward achieving investment-grade ratings. Business model and management discipline may also be differentiating factors in the ability of mortgage REITs to achieve investment-grade ratings.

REIT Rating Constraints: Mortgage REITs would likely be considered less attractive stock investments if they utilized minimal levels of leverage commensurate with higher rating levels, given the dividend yield and return expectations of equity investors. The long-term cash retention limitations placed on REITs, given the tax code requirement for a REIT to distribute at least 90% of its taxable income, may also limit the extent to which mortgage REITs could achieve higher rating levels, as mortgage REITs consistently rely on access to the capital markets.

Relevance of Analytical Factors: Depending on the mortgage REIT, certain analytical factors may carry more significance than others. For instance, Fitch would place less emphasis on asset quality for a mortgage REIT that owns low credit risk assets than for a mortgage REIT that owns high credit risk assets. Fitch would place less emphasis on funding for a mortgage REIT that primarily utilizes long-term unsecured bonds than for a mortgage REIT that primarily utilizes short-term reverse repurchase agreement financing.

Related Criteria

Global Financial Institutions Rating Criteria (January 2014)

Treatment and Notching of Hybrids in Nonfinancial Corporate and REIT Credit Analysis (November 2014)

Analysts

Steven Marks
+1 212 908-9161
steven.marks@fitchratings.com

Sean Pattap
+1 212 908-0642
sean.pattap@fitchratings.com

Mortgage REIT Industry

There are three types of companies within the mortgage REIT sector to which this criteria report applies: commercial mortgage REITs (CM-REITs), residential mortgage REITs (RM-REITs) and hybrid REITs.

Commercial Mortgage REITs

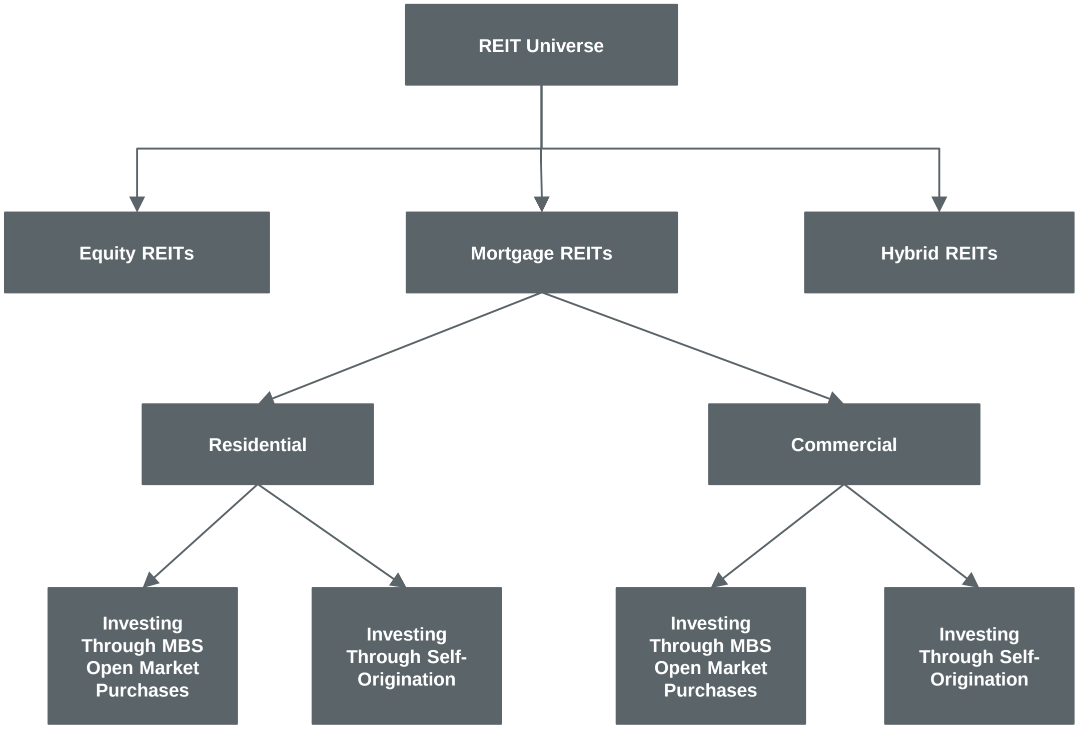
CM-REITs generally invest in first and mezzanine commercial mortgages, commercial mortgage-backed securities (CMBS) and/or other interests in commercial mortgages. Certain CM-REITs originate loans, while others purchase third-party-originated whole loans, CMBS and other real estate-related loans and securities.

Certain CM-REITs have real estate servicing platforms. These servicing platforms enable the generation of fee income and may provide opportunities to expand investments in residual interests. Additionally, servicing often helps CM-REITs identify new business opportunities with existing portfolio borrowers.

Residential Mortgage REITs

RM-REITs generally invest in residential mortgage whole loans and residential mortgage-backed securities (RMBS). Asset quality varies from lower credit risk assets, such as U.S. government-guaranteed securities, to higher credit risk assets, such as subprime mortgages. Like CM-REITs, RM-REITs may either originate and service their owned portfolios or rely on the origination and servicing capabilities of third parties.

Overview of REIT Industry Universe



Hybrid REITs

Hybrid REITs constitute some combination of mortgage real estate and equity real estate assets. Hybrid REITs typically invest in loans and mortgage-backed securities (MBS) and have direct equity ownership interests in real estate properties.

Qualitative Analytical Factors

Business Model

Fitch focuses on the company's value proposition and relative position in its markets. There are various models and combinations of models in the mortgage REIT universe, including whole loan/MBS buyers, servicers and special servicers and originators.

Whole Loan and MBS Buyers

Certain mortgage REITs utilize mathematical modeling in an effort to maximize the efficiency of spread lending. Such companies do not generally service commercial or residential-based assets or provide other asset management services. Nevertheless, pure-play whole loan/MBS buyers may add liquidity to the mortgage markets and, when capital markets are accommodative, may add value by distributing risk as a financial intermediary by utilizing the secured debt markets to finance their portfolios.

Originators

Mortgage REITs with comprehensive origination platforms grow their portfolios from opportunities created by their service-based franchises. Such REITs may be more selective in pursuing investment opportunities than servicers, have the ability to build a base of repeat borrowers and tend to have more control of the assets they own than servicers or whole loan/MBS buyers. However, an origination and surveillance capability can entail substantial costs due to the need for a regional or national sales and marketing platform.

Servicing Capabilities

Mortgage REITs engaged in servicing or special servicing are more transaction-oriented and, therefore, require heavier labor and technology infrastructures. By managing underlying assets such as residential and commercial mortgages, such mortgage REITs generate recurring fee income and may strive to reposition underperforming assets. These companies may also benefit from a hands-on approach to asset management, particularly during weaker points in a real estate cycle.

Fitch views mortgage REITs that make servicing decisions internally more favorably than those that delegate major servicing decisions to third parties. The closer an issuer is to controlling its origination and servicing, the better insights its management will have on asset quality.

Asset Quality

Factors affecting asset quality include the number of properties, property types, tenants, stability of asset cash flow, underlying credit quality of the borrower from the REIT's perspective, tenor, geography and loan origination vintage.

Nonperforming or Delinquent Assets

The level of nonperforming and delinquent assets is central to assessing asset quality. The terms and amount of any modified loans, which would typically not initially be included in nonperforming or delinquent asset categories, also affects asset quality. Fitch generally focuses on nonperforming and delinquent assets as a percentage of total assets for both commercial and residential issuers (see Appendix B, page 14, for additional details).

Underlying Real Estate Quality

Beyond reviewing asset quality of the mortgage REIT's portfolio, Fitch will endeavor to monitor the asset quality of the underlying real estate that collateralizes loans held by the REIT or, in the case of REITs with a focus on MBS, the quality of underlying loans against which securities have been originated.

Asset Quality Disclosure

Mortgage REITs have various ways of disclosing asset quality metrics. Regardless of the mortgage REIT's disclosure, Fitch will not assign or maintain ratings or other forms of opinion in cases where data on both the mortgage REIT's portfolio and the underlying real estate are not sufficiently robust relative to the ratings or credit opinions.

Style Drift

Mortgage REITs may change their investment focus through cycles. Fitch does not necessarily view style drift negatively; however, in such cases, Fitch focuses on the rationale and appropriate staffing and/or experience when migrating into different investments.

Cash Flow Stress

In reviewing asset quality, Fitch may stress cash flows generated by assets in a mortgage REIT's portfolio to determine the ability of the REIT to service corporate obligations.

Management and Governance

In analyzing corporate governance, Fitch applies "Evaluating Corporate Governance," dated December 2012, available on Fitch's website at www.fitchratings.com. Issuer credit ratings will not be negatively affected by country-specific characteristics, given that issuers operate in the U.S. When looking at issuer-specific governance characteristics, Fitch focuses on systemic corporate governance characteristics as well as issuer-specific corporate governance characteristics. Issuer-specific characteristics include:

- Board effectiveness.
- Management effectiveness.
- Transparency of financial information.
- Related-party transactions.

Key Man Risk

Key man risk is the potential overreliance on one or a few individuals within the management team. Key man risk is not unusual for mortgage REITs or similar finance companies. For mortgage REITs or similar finance companies with key man risk, Fitch reviews key management members that could replace top executives for succession-planning purposes.

External Management

Externally managed mortgage REITs are typically managed by affiliated companies that, through a management agreement, provide all managerial and operational services for the REIT. As a result, the mortgage REIT itself is an externally managed company and does not have any employees of its own. Fitch judges the linkage between an externally managed mortgage REIT and its manager on a case-by-case basis. While managers receive fees from externally managed REITs, there have been instances where managers do not support externally managed REITs in distress.

Management Agreements

When reviewing the management agreement, Fitch reviews whether the incentives of the REIT are aligned with the manager; this includes whether the REIT is required to pay manager fees should the board elect to terminate the management contract or should the board decide to internalize management. Fitch generally has a more favorable view toward internal management teams than external management teams because internal management teams are dedicated solely to the REIT, minimizing conflicts of interest. External management may have several investment vehicles under management, with potentially overlapping investment objectives. In reviewing whether management is a shared service, Fitch reviews the mortgage REIT's operations, such as the outsourcing of accounting staff.

Unconsolidated Entities

In analyzing management, Fitch also reviews the exposure of mortgage REITs to unconsolidated entities such as joint ventures. Fitch reviews the extent to which the mortgage REIT's incentives are aligned with those of the unconsolidated entity, including joint-venture terms and conditions for recourse to the REIT.

Track Record and Operating History

Mortgage REITs and similar finance companies with longer operating histories of greater than three years — particularly during periods of market stress — have more operating credibility and experience than mortgage REITs with limited operating histories. Fitch places an IDR or credit opinion ceiling of 'B+' for mortgage REITs and similar finance companies that have less than three years of operating history. More seasoned REITs may also have stronger access to a variety of capital sources.

Many mortgage REITs take a significant amount of time to generate a core portfolio of assets, particularly in periods of limited long-term financing availability. Conversely, rapid growth may place stress on underwriting and surveillance functions. Rapid growth may also create uncertainties regarding the mortgage REIT's targeted or optimal operating leverage and scale, potentially increasing credit risk.

Competitive Position

Servicing functions typically have high barriers to entry given the degree of relationships, track record and industry expertise required. Therefore, certain special servicers and master servicers of both residential and commercial assets possess a stronger competitive position compared with smaller players or those that do not service assets. Conversely, mortgage REITs that do not own any servicing operations, while potentially benefiting the issuer from a cost standpoint, may be forgoing significant market knowledge that could help the issuer manage through cyclical downturns. When reviewing a mortgage REIT's market position, Fitch does not rely on league tables. A mortgage REIT may try to climb league tables by making risky business decisions or seeking business volumes not commensurate with staffing levels.

Impact of REIT Tax Election on Liquidity

All else being equal, Fitch typically views REITs as having weaker liquidity positions than similar finance companies that have not elected REIT status, as these finance companies can have stronger capital retention flexibility than REITs. However, REITs that address required dividend distributions through the issuance of new shares as opposed to cash dividend payments may have stronger liquidity than REITs that issue the majority of taxable income as cash dividends to shareholders.

Quantitative Analytical Factors

Developing Funding Options

Obtaining a diverse funding base is one of the greatest challenges that a mortgage REIT faces. Many mortgage REITs typically begin with a reliance on reverse repurchase agreements and/or secured warehouse funding lines with strict covenant features, provided predominantly by a limited universe of financial institutions. This funding concentration magnifies event risk across the industry, as several lenders exiting the market at once could have a significant negative impact, particularly during times of liquidity reductions similar to the financial crisis of 2008–2009. Additionally, these lending facilities are often short term, not committed and are subject to market valuation requirements, requiring the REIT to maintain unencumbered assets for contingent liquidity to meet margin calls. Margin call risk is elevated during periods of capital market stress.

Funding Diversity

Fitch views positively mortgage REITs with demonstrated access to multiple forms of capital. Prior to the capital markets crisis in 2008–2009, certain mortgage REITs broadened their funding to include commercial paper conduit facilities, collateralized debt obligations (CDOs), secured and unsecured committed credit facilities, unsecured term debt, MBS, loan syndication facilities and unsecured trust preferred securities. These financing options provide liquidity diversity as well as favorable interest rate and term characteristics and open mortgage REITs up to a much wider array of potential investors, including pension funds, insurance companies, hedge funds, mutual funds and even other mortgage and equity REITs. However, even U.S. mortgage REITs and similar finance companies that have diverse funding sources may encounter increased default risk if they hold risky assets, and thus, Fitch places greater emphasis on an issuer's asset quality than its ability to access various funding sources.

Committed Funding

A robust funding profile within a REIT or similar finance company typically includes reliable sources of contingent funding, both for financing new asset originations and refinancing maturing debt obligations. Fitch looks favorably on issuers that have access to committed, unsecured revolving liquidity facilities with terms of one year or more. In addition to the funding ratios in Appendix B, Fitch reviews the financial and qualitative covenants embedded in mortgage REITs' financing agreements to monitor the flexibility to withstand market fluctuations.

Other Funding Risks

Repricing Gap

For highly leveraged mortgage REITs, a rapid change in interest rates on a rapidly resetting liability structure relative to a largely fixed-rate asset base could make such entity vulnerable to refinance risk. To measure this risk, Fitch reviews the average repricing gap.

Pipeline Risk

Fluctuations in a mortgage REIT's new investment pipeline can be significantly influenced by the interest rate environment. Additionally, an unhedged pipeline can lead to challenges in terms of securing long-term financing for new assets in volatile interest rate circumstances and may negatively affect ratings if significant interest volatility results.

Margin Call Risk

In instances where the collateral for a borrowing arrangement is subject to mark-to-market valuation adjustments, Fitch applies a valuation stress scenario to determine portfolio pricing in a more adverse environment. For REITs that utilize short-term funding, such as reverse repurchase agreement facilities with prescribed advance rates, Fitch's more conservative range will gauge the REIT's ability to withstand margin calls that would require the REIT to post additional collateral in the event that portfolio values deteriorate rapidly.

Valuation

Issuers with large concentrations of purchased MBS are vulnerable to market value volatility, as changing credit quality and/or interest rates may have an effect on holdings due to changes in interest income, prepayments or defaults.

Cash Traps

For mortgage REITs with significant on-balance sheet CDO funding, Fitch reviews whether cash traps are imbedded in the CDO structure. In the event of a CDO covenant violation, cash interest income from assets collateralizing the CDO may be trapped in the CDO and would be unavailable to the REIT to fund corporate-level debt, which Fitch would view negatively.

Leverage and Capitalization

Fitch's analysis of a mortgage REIT's leverage and capitalization includes the calculation of leverage ratios shown in Appendix B. Fitch also reviews the leverage utilized across a mortgage REIT's portfolio based on the ability of the REIT's various assets to withstand declines in value. Two mortgage REITs with the same leverage ratios may have different credit ratings if one mortgage REIT owns lower credit risk assets and another owns higher credit risk assets.

Unencumbered Asset Coverage

For REITs issuing unsecured debt, Fitch reviews the extent to which unencumbered assets cover unsecured debt. Unsecured debt is commonly issued by higher rated mortgage REITs. Fitch views unencumbered asset coverage in concert with its review of the mortgage REIT's investment focus. For example, all else being equal, a mezzanine commercial mortgage owner would need stronger unencumbered asset coverage than would a senior commercial mortgage owner for the same rating.

Mortgage REIT Funding Summary

Funding Type	Strengths	Weaknesses
Reverse Repurchase Borrowing	Low cost	Short term and rate duration Limited providers Susceptible to pullback in adverse liquidity environment Margin requirements
Commercial Paper Conduit	Low cost Diverse investors	Short term and rate duration Margin requirements
Mortgage-Backed Securities	Matched rate and duration Diverse investors	Less control of assets Requires shorter term if not sold Leaves higher risk residuals if sold
Collateralized Debt Obligations	Matched rate and duration Diverse investors	Less control of assets Leaves higher risk residuals if sold Limited transparency and/or esoteric structure
Mortgages	Long-term commitment No margin call Moderate cost	Asset-specific structuring sometimes required Can make repositioning property a challenge
Unsecured Notes	Long term Increases financial flexibility Unsecured capital	Higher cost Restrictive covenants
Secured Revolving Credit	Additional source of liquidity Lower cost than unsecured revolving credit	Often have high advance rates Margin call risk Not a source of corporate liquidity
Unsecured Revolving Credit	Increases financial flexibility Unsecured capital	Higher cost than secured revolving credit Entails commitment costs regardless of usage levels
Preferred Stock	Long term Unsecured, subordinated capital	Higher cost

Relative quantity and quality of unencumbered assets is also important. A larger, diversified pool of unencumbered assets may help insulate unsecured bond and preferred stock investors from concentration issues within the unencumbered asset pool. Cash flow coverage also plays a significant role in the assessment of unencumbered assets. Fitch reviews a mortgage REIT’s unencumbered asset net operating income relative to unsecured interest expense in measuring the cash flow-generating ability of unencumbered assets.

Access to Capital

Mortgage REITs typically rely on the equity capital markets for capital formation because most of these issuers pay out the vast majority of their taxable income as cash dividends to shareholders. They may seek contingent sources of liquidity, such as reverse repurchase facilities or readily accessible liquidity, including committed revolving credit facilities.

Regular Capital Markets Access

Repeated capital markets offerings can help issuers maintain familiarity with their investor base and add new investors. Such offerings give companies an opportunity to keep the markets informed of their story and can potentially help make issuances in more challenging times slightly easier.

Funds from Operations and Adjusted Funds from Operations

Based on guidelines established by the National Association of Real Estate Investment Trusts, funds from operations (FFO) consist of net income excluding gains (or losses) from property sales, plus depreciation and amortization, plus adjustments for unconsolidated partnerships and joint ventures. Fitch compares dividends paid to stockholders with FFO. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect FFO on the same basis.

Fitch subtracts capital expenditures and excludes noncash items included in FFO to arrive at adjusted funds from operations (AFFO) and compares dividends paid to stockholders with AFFO. Although FFO and AFFO are after-interest expense measures, these measures are relevant to bondholders and preferred stockholders. Namely, if FFO or AFFO payout ratios are close to or exceed 100%, it indicates the REIT is not retaining cash flow for future liquidity to meet its fixed-charge obligations and is accessing other forms of cash flow to pay its dividends, which Fitch views negatively.

Liquidity Management

Crucial areas within which mortgage REITs manage their liquidity are through bank commitments and liquidity coverage.

Bank Commitments

Unsecured committed bank agreements with maturity dates out at least one year represent a liquidity cushion for mortgage REITs. Fitch will consider the facilities that also have a one-year term-out provision as a positive factor. Additionally, REITs with meaningful operating flexibility under any covenants included in the facility will also be viewed as stronger from a credit perspective. Fitch rarely views reverse repurchase facilities as beneficial from a liquidity management standpoint, as they are secured, often not committed, or, in many cases, are only committed when funded. However, reverse repurchase facilities may be one way in which mortgage REITs demonstrate access to capital.

Liquidity Coverage

Fitch compares a mortgage REIT’s sources of liquidity (measured as unrestricted cash, availability under unsecured committed revolving lines of credit and projected retained cash flows from operating activities after dividend payments) with uses of liquidity (secured and unsecured debt maturities and other projected expenditures) over an 18- to 24-month horizon. If sources exceed uses, a liquidity surplus is generated. If uses exceed sources, a liquidity shortfall is generated. Additionally, Fitch divides sources by uses in calculating a base case liquidity coverage ratio, which assumes no external access to capital raises or asset sales. If a REIT’s liquidity coverage ratio is below 1.0x, Fitch typically scrutinizes the extent to which the issuer’s access to capital and contingent sources of liquidity may mitigate such a liquidity shortfall.

Fitch supplements this base case liquidity methodology with calculations assuming various levels of access to the capital markets. For example, Fitch may assume a range of secured debt refinancing activities (e.g. between 80% and 100% of secured debt will be refinanced on maturity). See the table on page 10 for an illustrative example of liquidity sources and uses and liquidity coverage, including a sensitivity analysis assuming 90% of secured debt is refinanced on maturity.

Fitch further supplements the base case liquidity methodology with an asset portfolio stress case that reflects margin call risk limits availability under revolving credit facilities. Such mark-to-market adjustments are applicable to mortgage REITs that hold liquid assets such as so-called agency mortgage REITs (i.e. mortgage REITs that invest in mortgage bonds issued by government-sponsored enterprises such as Ginnie Mae, Freddie Mac and Fannie Mae).

Liquidity Coverage Example

($ Mil)

	Base Case Assuming No Asset Sales or Refinancing Activity in the Capital Markets	Sensitivity Analysis Assuming 90% Refinance Rate on Secured Debt	Stress Case Assuming Margin Call Risk Limits Availability Under Revolving Credit Facilities
Sources of Liquidity			
Cash	20	20	20
Availability Under Revolving Credit Facilities	500	500	300
Projected Retained Cash Flows from Operating Activities	25	25	25
Total Sources of Liquidity	**545**	**545**	**345**
Uses of Liquidity			
Upcoming Secured Debt Maturities (Next 18-24 Months)	150	15	15
Upcoming Unsecured Debt Maturities (Next 18-24 Months)	330	330	330
Other Recurring Capital Uses	160	160	160
Total Uses of Liquidity	**640**	**505**	**505**
Total Sources of Liquidity Less Total Uses of Liquidity	**(95)**	**40**	**(160)**
Liquidity Coverage (Total Sources of Liquidity Divided by Total Uses of Liquidity) (x)	0.9	1.1	0.7

Unencumbered Assets

For mortgage REITs with unencumbered assets, Fitch measures contingent liquidity by stressing the value of unencumbered assets and comparing those values to outstanding unsecured debt.

Asset Sales

Asset sales may be a supplementary source of liquidity. However, mortgage REITs that fail to remain active or at least familiar to investors in the securitization or whole loan markets risk facing additional hurdles if they should need to raise liquidity from these markets quickly. Fitch views mortgage REITs that are less reliant on asset sales to generate liquidity more positively, given the execution risks inherent in disposing of assets during periods of limited capital markets access for potential acquirers.

Operating Performance

Fitch generally looks for mortgage REITs to have a solid component of recurring contractual cash income from their investment portfolio. Fee income may fluctuate during market cycles. Income from gain-on-sale and gain-on-securitization of assets are often noncash based or nonrecurring. Therefore, Fitch excludes gains-on-sale and gains-on-securitization income from operating performance credit ratios.

Given the various qualities of a mortgage REIT’s earnings, Fitch supplements its review of earnings with a cash flow analysis when analyzing a mortgage REIT’s operating performance. See Appendix B for an overview of operating performance metrics.

Rating Outlooks

Base Case Projections

Base case adjustments to a mortgage REIT’s earnings reflect what Fitch believes the most likely case of earnings generated by a REIT over the next 12–24 months to correspond with the typical outlook time frame. In determining the base case, Fitch utilizes a combination of company projections that Fitch reviews, historical data, peer comparisons, volatility relative to peers and Fitch's view on the performance cycle. Base case adjustments may be positive, negative or flat. Fitch compares its base case with third-party perspectives. Fitch places greater emphasis on its base case projections during its rating process than other REIT projections, including the stress case.

Stress Case Projections

Stress case projections incorporate a view of a potential deterioration in earnings tailored to the specific REIT. In determining the stress case, Fitch reviews factors such as the company's worst performance to date and other risks.

Limitations

General Limitations

See Fitch research on "Global Financial Institutions Rating Criteria," dated January 2014, available on Fitch's website at www.fitchratings.com, for limitations to credit ratings, including credit ratings for U.S. mortgage REITs and similar finance companies.

U.S. Tax Legislation

U.S. mortgage REITs benefit from favorable tax treatment, as they do not pay income taxes on the portion of taxable income paid as dividends to shareholders. Credit ratings could change if federal tax legislation affects U.S. REITs changes.

Appendix A: Hypothetical Examples

Attributes of a Mortgage REIT with a 'BB' Issuer Default Rating

Company A is a commercial mortgage REIT that primarily originates commercial real estate loans and finances those originations by issuing senior unsecured notes and preferred stock. To a limited extent, Company A packages its loans into on-balance-sheet securitizations.

Qualitative Credit Strengths

- Company A's management team is solid. Many management team members have numerous years of experience in the commercial real estate mortgage industry, and the company has existed through various cycles, including periods of challenging capital markets conditions.
- Company A's underwriting process is robust, and the systems that it uses to monitor the loan portfolio are efficient.
- Company A receives explicit financial support from a large, diversified financial institution with which it is affiliated.

Qualitative Credit Weaknesses

- Commercial properties backing Company A's loan portfolio are geographically diversified throughout the U.S., although certain of these markets have experienced weakening fundamentals. Collateral backing Company A's portfolio includes office buildings as well as shopping centers that have underperformed relative to their markets.
- A small portion of the commercial real estate landlords that borrow from Company A are not creditworthy.

Quantitative Credit Strengths

- Company A's leverage levels, measured as debt to tangible equity and net debt to recurring operating EBITDA, are 3.0x and 5.0x, respectively, and Fitch anticipates these leverage ratios will remain at these levels over the near term. These levels are appropriate for the 'BB' rating category given the credit risk of Company A's portfolio.
- Company A's liquidity position is good, with sources exceeding uses of liquidity. Additionally, Company A's portfolio consists of a modest pool of unencumbered assets covering unsecured debt by 1.5x, providing further financial flexibility.
- Company A's recurring operating EBITDA-to-interest incurred ratio is 2.0x, which is appropriate for the rating category. Fitch anticipates coverage will remain between 1.8x and 2.2x over the near term.

Quantitative Credit Weaknesses

- Company A recently paid dividends to stockholders in excess of the company's core funds from operations and has not signaled an intention to reduce dividend payout ratios over the near term.
- More than 25% of Company A's debt obligations are short-term, floating-rate obligations, exposing Company A to funding rollover risk and interest rate movement risk.
- Company A's on-balance-sheet securitizations may be its ability to sell assets, although they provide long-term match funding.

Fitch assigns a 'BB' IDR to Company A based on its credit profile. Company A's senior unsecured debt ratings are also 'BB'. Company A's preferred stock ratings are 'B+', which is consistent with Fitch Research on "Treatment and Notching of Hybrids in Nonfinancial

Corporate and REIT Credit Analysis," dated November 2014, available on Fitch's website at www.fitchratings.com.

The following factors may have a positive impact on Company A's ratings and/or Rating Outlook:

- Debt to tangible equity maintained below 2.0x.
- Recurring operating EBITDA to interest incurred remaining above 2.5x.
- Improved credit profile of Company A's borrowers.

The following factors may have a negative impact on Company A's ratings and/or Rating Outlook:

- Debt-to-tangible equity maintained above 4.0x.
- Recurring operating EBITDA to interest incurred remaining below 1.5x.
- A liquidity shortfall.

Attributes of a Mortgage REIT with a 'B' Issuer Default Rating

Company B is a mortgage REIT that originates, acquires and retains an interest in fixed-rate, one-to-four-family prime and jumbo residential mortgage assets. Company B principally utilizes reverse repurchase facilities to fund originations and acquisitions. In the long term, Company B packages its loans into on-balance-sheet RMBS transactions and issues senior unsecured notes and trust preferred securities.

Qualitative Credit Strengths

- Company B's loan portfolio is collateralized by assets owned by individuals with strong and well-documented credit histories.
- Company B's management team has worked together through various capital market cycles, including periods of extremely limited liquidity.

Qualitative Credit Weaknesses

- Company B's master servicer platform has been in business for only two years.
- Sustained adverse conditions in the U.S. housing market could significantly impair the value of Company B's portfolio.
- Company B has a small balance sheet of just more than $1 billion.

Quantitative Credit Strengths

- Company B's leverage ratio, measured as debt-to-tangible equity, is 4.0x, which is strong for the rating category, although the majority of Company B's borrowing base consists of short-term reverse repurchase funding.
- Unencumbered assets cover unsecured notes and trust preferred securities by 1.5x, a respectable margin above covenant requirements. Fitch anticipates unencumbered asset coverage will remain consistent over the near term.

Quantitative Credit Weaknesses

- Company B has a liquidity shortfall over the next 24 months, requiring that it has access to the external capital markets for liquidity funding.
- Company B's recurring operating EBITDA-to-interest incurred ratio is 1.2x, which is weak for the rating category.

Fitch assigns a 'B' IDR to Company B based on its credit profile. Company B's senior unsecured debt ratings are rated 'B/RR4', as recoveries are expected to be average. Company B's preferred stock is rated 'CCC/RR6', as recoveries are expected to be weak.

The following factors may have a positive impact on Company B's ratings and/or Rating Outlook:

- A decreased reliance on reverse repurchase agreement funding to below 25% of overall borrowings.
- Recurring operating EBITDA to interest incurred remaining above 1.5x.
- Increased balance sheet size.

The following factors may have a negative impact on Company B's ratings and/or Rating Outlook:

- Unencumbered asset coverage remaining below 1.5x.
- A covenant violation.
- A long-term decline in housing prices throughout the U.S. from current levels.

Appendix B: Selected Financial Ratios

Fitch typically utilizes the ratios noted below in its analysis of mortgage REITs, but disclosures vary by company. Regardless of the mortgage REIT's disclosure, Fitch will not assign or maintain ratings in cases where data on the mortgage REIT's portfolio and the underlying real estate are not sufficiently robust.

Asset Quality

Key Metric	Definition
Delinquent Assets/Period-End Assets	Assets classified as past due at least 30 days relative to period-end gross assets.
Modified Assets/Period-End Assets	Assets that have been modified such as modified loans to period-end gross assets.
Impaired or Nonperforming Assets/Period-End Assets	Assets where income has either stopped accruing to period-end gross assets.
Gross Chargeoffs/Average Assets	Gross chargeoffs to average assets during the period.
Net Chargeoffs/Average Assets	Gross principal losses less recoveries to average assets during the period.
Reserves/Nonperforming Assets	Asset reserves to nonperforming assets.
Impairment Charges/Average Assets	Impairment charges on loans/average assets.

Assets may include residential or commercial whole loans, mortgage-backed securities, securities referencing loans or mortgage-backed securities or other interests in residential or commercial real estate.

Funding

Key Metric	Definition
Short-Term Debt/Total Interest-Bearing Liabilities	Debt with an original maturity of less than one year to total interest-bearing liabilities.
Short-Term Debt plus CPLTD/Total Interest-Bearing Liabilities	Short-term debt plus current portion of long-term debt to total interest-bearing liabilities.
Secured Debt/Total Interest-Bearing Liabilities	Debt secured by corporate assets to total interest-bearing liabilities.
Committed Funding Facilities/Total Funding	Committed and undrawn funding facilities to total interest-bearing liabilities.
Drawn Credit Facilities/Total Credit Facilities	Drawn funding facilities to total credit facilities.
Unencumbered Assets/Unsecured Debt	Amount of assets free and clear of any encumbrance relative to unsecured debt.

Leverage

Key Metric	Definition
Tangible Equity/Managed Assets	Total shareholders' equity less goodwill and intangibles to managed assets.
Core Capital/Tangible Assets	Core capital to period-end assets less goodwill and intangibles.
Debt/Core Capital	Reported interest bearing liabilities plus off-balance-sheet funding to core capital.
Debt/Tangible Equity	Reported interest bearing liabilities to tangible equity.
Combined Payout Ratio	Dividends plus net share repurchases as a percentage of reported funds from operations.
Net Debt/Recurring Operating EBITDA	Debt less cash divided by recurring operating earnings before interest, taxes, depreciation and amortization.

Operating Performance

Key Metric	Definition
Return on Average Assets	Reported net income to average assets.
Return on Average Equity	Reported net income to average common equity.
Net Interest Margin	Net interest income to average interest earning assets.
Efficiency Ratio	Operating expenses to net operating income.
Fixed-Charge Coverage	Pretax income plus interest expense and other fixed charges divided by fixed charges.
Recurring Operating EBITDA/Interest	Earnings before interest, tax, depreciation and amortization to interest expense incurred.

Appendix C: Industry Profile and Operating Environment

Industry Profile

In 1960, the U.S. Congress created the REIT designation to facilitate investment in real estate by a diverse range of investors, hence the requirement that REITs have at least 100 common shareholders. The legislation offered real estate companies the opportunity to adopt a REIT status for tax purposes, allowing the companies to offset taxable income with the payment of dividends. However, the original act did not allow REITs to generate meaningful income from the sales of assets, which is an important characteristic of the business model for many commercial and residential mortgage originators.

The current REIT structure was established under the Internal Revenue Service Code of 1986, whereby, to maintain tax status as a REIT, a company must distribute at least 90% of its taxable income in the form of qualifying distributions to shareholders. The REIT Modernization Act of 1998 built on the 1986 code and expanded REITs' flexibility to sell assets by allowing for the creation of taxable REIT subsidiary entities. These entities may contribute to a portion of REIT earnings and typically derive much of their income from sales of assets owned less than four years and other nonrent, non-interest-income-generating real estate-related activities.

As U.S. REIT legislation has evolved, mortgage REITs have faced various challenges related to their business models and access to the capital markets. Traditionally, mortgage REITs initially fund the acquisition of investments with short-term secured indebtedness, such as reverse repurchase obligations, wherein the REIT sells securities to a counterparty under an agreement to repurchase them after a short time frame of from 30 days–360 days. These investments are then financed via CDO financing or other types of long-term financing. Availability of both short- and long-term financing contracted sharply on certain occasions, including during credit market disruptions in 1998 and during the financial crisis of 2008.

Operating Environment

In the period leading to the current operating environment, mortgage REITs' investment strategies have been tested, and various companies that elected REIT status failed. Several mortgage REITs that had significant exposure to subprime mortgage-related assets filed for bankruptcy protection after the subprime housing market collapsed in 2007 and the years that followed.

Several RM-REITs that were not primarily exposed to subprime loans were adversely affected by the overall decline in housing prices beginning in 2006. These RM-REITs had increased reliance on short-term financing and exposure to margin calls and filed for bankruptcy, as did several CM-REITs that were unable to refinance short-term funding agreements. In contrast, certain mortgage REITs have been tested and have thrived through real estate and capital market cycles due to a focus on low credit risk investments and/or reliance on long-term match-funded on-balance-sheet securitization financing.

Fitch's rating criteria for mortgage REITs and similar finance companies take into consideration the inconsistent performance of companies in this sector during real estate and capital market cycles. Various qualitative and quantitative factors are incorporated into Fitch's forward-looking views regarding the credit risk of these companies through such cycles.

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REITS: BUILDING DIVIDENDS

August 8, 2014

David G. Clunie
Executive Secretary
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, D.C. 20220

Re: TREAS-DO-2014-0005 Comment on the Development of Responsible Private Label Securities (PLS) Market

Dear Mr. Clunie,

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 which operate in all facets of the real estate economy in the U.S.

NAREIT's Mortgage REIT (MREIT) Council (Council) is comprised of both residential and commercial mortgage REITs (MREITs), and the mission of the Council is to advise NAREIT's leadership on matters of interest to mortgage REITs, in part through the input of the Council's Residential and Commercial MREIT Committees.

MREITs today provide a significant amount of capital and liquidity to the residential and commercial real estate markets. MREITs have, directly or indirectly, funded millions of residential and commercial properties, including single family homes, multifamily units, office buildings, hotels, shopping malls, and other properties. Their presence has facilitated efficient capital raising during the recent financial crisis and provided significant support to the residential and commercial mortgage markets and to the housing market as a whole. Since the beginning of 2008, MREITs have raised $65.3 billion in IPOs and secondary equity offerings.

The MREIT Council welcomes the opportunity to comment on the "appropriate role for new issue PLS in the current and future of the housing finance system." Today MREITs play a small but highly consequential role in the U.S. Agency RMBS markets, and have been an especially important source of private sector capital in the aftermath of the financial crisis, a period when many other market

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players withdrew. We believe that MREITs are ideally poised to play a similar role in the PLS market, which historically has served an important niche in U.S. residential finance. We feel confident the PLS market will revive and prosper, and we fully support the Department of Treasury's initiative to stimulate this important housing finance sector.

This comment letter is organized in two parts. Because MREITs present many distinctive features, which are often not well understood, in Part I we set forth some background on the MREIT sector. Part II sets forth some observations the PLS market and the current state of the overall RMBS market that we hope will be of use to the Department of Treasury as it pursues its PLS initiative.

I. Mortgage REITs

REITs were established by Congress in 1960 to enable Americans from all walks of life to gain the benefits of investment in real estate. There are two main types of REITs, generally referred to as equity REITs and MREITs. Equity REITs invest in real estate by acquiring leasing space in properties, such as shopping malls, office buildings, apartments and other properties, and collecting rents from their tenants. At least 30 countries around the world currently have enacted laws supporting equity REIT structures, which own and operate real estate assets. But the U.S. MREIT sector is distinctive in its role in supporting residential and commercial real estate debt finance.

MREITs, the focus in this comment, typically concentrate on either the residential or commercial mortgage markets, although some do both, through investments in the debt required to finance real estate. Some MREITs also originate mortgages and mortgage-related loans. Most MREITs are listed on the NYSE or NASDAQ, allowing a wide range of investors, including individual investors as well as institutions, to purchase shares of their equity securities. However, some MREITs have shares that are registered with the SEC but are not listed on any stock exchange. These public, non-listed MREITs typically are sold to investors by a broker or financial advisor. MREITs also can be privately held.[1]

Residential MREITs

Since 2009, Agency RMBS has overwhelmingly dominated U.S. single family mortgage securitization, and mirroring this development, most residential MREITs today focus on Agency RMBS. However, even today, some residential MREITs invest in PLS, securities financing residential real estate that are issued by private institutions, such as subsidiaries of investment banks, financial institutions and home builders. At the end of 2013, Agency MREITs held under five percent of Agency RMBS, with 26 percent held in banks and other depository institutions, 26 percent for the Federal Reserve, nine percent by mutual funds and the remainder held by insurance firms, pensions and other entities.

[1] For more information about MREITs, see http://www.reit.com/investing/reit-basics/guide-mortgage-reits .

Commercial MREITs

Commercial MREITs provide financing for many types of commercial real estate, including office buildings and office parks, apartment buildings, retail establishments, malls, restaurants, data centers and industrial facilities. They may invest in commercial mortgages and commercial real estate loans, as well as both rated and unrated CMBS, mezzanine loans, subordinated securities or construction loans, and may participate in loan securitizations. Commercial MREITs traditionally have proprietary origination platforms and provide financing solutions to various buyers and owners of commercial real estate.

MREITs Have a Proven Track Record of Attracting Investors

Because of their regular access to public capital markets, residential MREITs have been able to provide an important channel for private-sector capital to help sustain and finance home mortgage markets in the aftermath of the Great Financial Crisis.

As of July 31, 2014, there were 27 residential MREITs in the FTSE NAREIT All REITs index with an equity market capitalization of $48.3 billion, and 13 Commercial MREITs with an equity market capitalization of $18.1 billion. There have been 21 Mortgage REIT IPOs since the end of 2007, and listed MREITs encompassed a total of $492.4 billion in assets at the end of the first quarter of 2014.

Over time, investors have been well served by publicly traded REITs, typically earning total returns built on dividends and the potential for capital appreciation. Moreover, investor returns on MREITs generally, as measured by the FTSE NAREIT Mortgage REIT Index, have been competitive with investor returns in broad stock indexes.

MREITs Have Deep Expertise in Mortgage Debt Markets

The success of MREITs today reflects years of developed expertise in the fundamentals of real estate debt markets, expertise combining rigorous research, valuation, data collection and technical analytics, together with a deep understanding of the fiscal, legal and regulatory frameworks within which RMBS and CMBS markets operate. MREITs make use of proprietary models to assess loan characteristics and likely performance, factoring in prepayment risk, structural risks, servicing risks, and other risks under a variety of scenarios. MREITs employ both quantitative and qualitative tools to further test performance projections against multiple scenarios of changing regulation, interest rate shifts and changing real estate market conditions.

Moreover, MREITs deploy quantitative and qualitative risk management techniques, continuously assessing relevant risk parameters, including changes in market, macro-economic and policy conditions. Today MREIT risk-management practices incorporate a range of proven strategies and tools to address interest rate fluctuations, currency fluctuations, counterparty credit risk, prepayment risk and liquidity risks. These include continuous balance sheet stress-testing, active and disciplined liability management, and well-tested hedging strategies, such as the use of interest rate swaps; swaptions; interest rate collars, caps or floors; and other financial derivatives contracts.

<u>MREITs Have the Potential to Play a Larger Role in PLS Markets</u>

MREITs have the potential to play an expanded role in PLS markets. They can and do attract capital successfully; they have deep experience in RMBS research, acquisition and valuation; and, they have developed and successfully made use of sophisticated models and protocols to evaluate real estate, mortgage and mortgage securities' fundamentals and to manage the risks presented by RMBS acquisition and management.

Today MREITs play a small but highly consequential role in the U.S. Agency RMBS markets. They have been important source of private sector capital in the aftermath of the financial crisis, a period when many other market players withdrew. MREITs are ideally poised to participate in PLS markets now and in the future.

II. Growing the PLS Market

The MREIT Council applauds the Department of Treasury's initiative to assess ways to support private sector development of an equitable and responsible PLS market serving borrowers, lenders and investors alike. The Council believes that, ultimately, however, it will be investors who drive the course and scale of the PLS market. The MREIT Council respectfully suggests that future investors in PLS would benefit from greater clarity and definition in a number areas, discussed below.

The MREIT Council also notes that the full potential of the PLS market is not likely to be realized until the future status of the GSE conservatorships is either resolved or on a certain path towards resolution. Only then will private capital that has been "sitting on the sidelines," feel fully comfortable committing to the PLS sector.

We group our comments around five observations:

- Transparency and Standardization are Critical to PLS Investors
- PLS Investors Deserve Confidence in their Remedies
- PLS Investors Must Have Confidence in Ratings
- Political and Regulatory Uncertainties are an Obstacle to PLS Market Growth
- Public Sector Coordination, Accountability and Transparency are Key to Transitioning the U.S. Housing Finance Sector

<u>Transparency and Standardization are Critical to Investors</u>

Publicly traded MREITs today are able to attract investors because their holdings and operations are transparent and their disclosure practices are elaborate and thorough. Similar transparency principles, applied more uniformly across the PLS market, would likewise serve to attract additional investment. There is considerable room to standardize documentation practices associated with aggregation and securitization practices.

In this regard, several bills pending before the 113th Congress, including the *Protecting American Taxpayers and Homeowners Act* (HR 2767 the *PATH* Act)[2] and the *Housing Finance Reform and Taxpayer Protection Act of 2013* (S. 1217, the *Johnson-Crapo* bill)[3], include provisions intended to encourage standardized agreements, standardized representations and warranties and pool level disclosures for PLS. The Department of Treasury's assistance and encouragement of these and other similar efforts to standardize practices and documentation across the PLS market could provide beneficial momentum.

PLS Investors Deserve Confidence in their Remedies

Investors are not likely to return to the PLS market if they are uncertain about how liability will be apportioned if their investments go sour. Litigation that followed RMBS defaults in the Financial Crisis have suggested to market participants and experts that the roles and responsibilities of mortgage pool trustees, largely understood to be exempt from the 1939 Trust Indenture Act, should be better defined and possibly expanded. Some academics[4] and investor groups[5] have recently urged Congress to enact legislation to impose a clear fiduciary duty on mortgage pool trustees, or to otherwise set forth a clear delineation of duties of trustees, servicers and investors. The *Path Act* stipulates that the securitization utility would specify the duties of mortgage pool trustees.[6] Amendments to the *Crapo-Johnson* bill pending in the 113th Congress would have gone further and imposed a fiduciary duty on PLS mortgage pool trustees.[7] Moreover, both the *Crapo-Johnson* bill and the House *Path Act* included provisions to address successor liability and indemnification, both important to attracting new investors.

The MREIT Council understands that expanding the role and responsibilities of PLS mortgage pool trustees is not costless, but also notes that these costs may be outweighed by the benefits accrued by attracting new investors who would feel confident that trustees are acting in their best interests. We believe the Department of Treasury could play a constructive role in evaluating the cost-benefit trade-offs presented by these proposals.

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[2] HR 2767, § 322(b).
[3] S.1217, § 223.
[4] See, e.g., *Testimony before the Senate Banking Committee, Adam J. Levitin, Professor of Law, Georgetown Law Centre* (October 1, 2013) (the *Trust Indenture Act* of 1939 should be updated to provide clear basic minimum standards for the duties of trustees and servicers in PLS and investors rights).
[5] *Testimony before the Senate Banking Committee, John Gidman on Behalf of the Association of Institutional Investors* (October 1, 2013); and Douglas M Hodge, *How to Make Housing Safe for Private Capital*, Barron's April 11, 2014.
[6] HR 2767, § 322(b).
[7] Amendment numbers 19 and 20 to S. 1217 would have created a fiduciary duty for trustees of PLS issued both off and on the common securitization platform to investors. Similar provisions were included in the *Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011* (S. 824) in the 112th Congress.

Confidence in Ratings is Essential to Attracting PLS Investors

Investor trust in ratings is a critical element to entice investors back into PLS. Counter-party trust in these ratings is equally important to ensure that rated PLS are accepted as collateral in repo and securities lending markets. The *Dodd-Frank Act*, and subsequent SEC regulations, has required credit rating agencies (NRSROs) to disclose their methodologies, a positive step. But it is clear that some potential PLS investors still do not feel entirely confident of the ratings of PLS securities.

While the ultimate development and adoption of a PLS ratings methodology will fall on the private sector, the MREIT Council believes that this is an area that could benefit from guidance and leadership from government regulatory experts. Several promising proposals have been advanced recently, including the implementation of a *single, numerical, public structured credit scale* for certain structured credit instruments, such as PLS.[8] These, together with others, should be evaluated.

Political and Regulatory Uncertainties are an Obstacle to PLS Market Growth

Since they were placed into conservatorship in 2008, the two U.S. housing government sponsored entities (GSEs), Fannie Mae and Freddie Mac, have continued to play a key role in the U.S. housing market recovery, which has deterred private capital from entering the market. There is additional uncertainty surrounding the future direction, if any, of congressional action to address the GSE conservatorships, further deterring PLS market development. Recently some investors have filed lawsuits challenging the terms of the GSE conservatorships, contributing another level of complexity to the outlook.

This uncertainty has practical consequences that are impossible to overstate. Current and future market participants do not know whether the federal government will continue to play a role in housing finance, and if so, what the size and scope of the federal role will be, how it might be structured, regulated and supervised. Will the concept of the conforming loan survive? If so, will the loan limit be lower, higher or the same? Will securitization markets be dominated by a few large players? If so, on what terms? Who will regulate this market? How?

Compounding this unsettled state of affairs, even today, the post- Dodd-Frank Act regulatory environment is also far from fixed. The ultimate, cumulative effect of the implementation of the final risk retention rules, the multiple consumer protection regulations and the Basel III bank capital and liquidity rules is still unknown.

Recognizing that no single governmental or market player can unilaterally transform this situation, the MREIT Council wishes to encourage the Treasury Department to continue its leadership in seeking a resolution of the status of the conservatorship of the GSEs.

[8] Ann Rutledge and Robert E. Litan, A Real Fix for Credit Ratings (Brookings, July 9, 2014).

<u>Coordination and Accountability are Critical to Transitioning the Housing Finance Market</u>

Understanding that the transition from the conservatorships of Fannie Mae and Freddie Mac is likely to take time, the MREIT Council respectfully suggests that the Department of Treasury could play a constructive role in coordinating transitional activity—including transitional activity already underway—and in ensuring that key players from both the public and private sectors execute on the various regulatory, supervisory and market infrastructure initiatives that will be required to move U.S. housing finance onto appropriate footing for the 21st Century.

* * *

NAREIT and its Mortgage REIT Council look forward working with the Department of Treasury and other governmental and private sector stakeholders on issues related to the development of the PLS marketplace and other important issues related to reform of the U.S. housing finance sector. Please feel free to contact me at swechsler@nareit.com or at (202) 739-9406 or Victoria Rostow, NAREIT's Senior Vice President of Regulation and Policy at vrostow@nareit.com or 202) 739-9431 if you would like to discuss this letter in greater detail.

Respectfully submitted on behalf of the MREIT Council,

Steven A. Wechsler
NAREIT President & CEO

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January 12, 2015

Via Email:

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, D.C. 20024

Re: *RIN 2590-AA39 – Notice of Proposed Rulemaking regarding membership requirements in the Federal Home Loan Bank System*

Dear Mr. Pollard:

The National Association of Real Estate Investment Trusts (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 residential and commercial real estate. NAREIT's Mortgage REIT (MREIT) Council ("MREIT Council" or "Council"), which includes both residential and commercial MREITs, advises NAREIT's leadership on MREIT matters.

NAREIT and its MREIT Council welcome the opportunity to comment on the provisions of the Federal Housing Finance Agency's (FHFA) *Notice of Proposed Rulemaking (NPRM) to amend its rules governing membership in the Federal Home Loan Banks (FHLBs).*[1] For the past several months, NAREIT's MREIT Council has engaged in a careful review and analysis of the NPRM and has developed the attached comment letter for consideration by the FHFA.[2]

At the outset, NAREIT's Council wishes to register its support for the FHFA's goal, set forth in the NPRM, of ensuring that the core mission of the FHLB system — financing U.S. residential housing — is honored and its support for the FHFA's efforts, some described in the NPRM, to ensure that the FHLB rules reflect current developments in the mortgage marketplace. In this very same spirit,

[1] 79 Fed. Reg. 54848 (September 12, 2014) (hereinafter the NPRM).
[2] As of the date the NPRM was issued, three NAREIT MREIT Council members had become members of FHLBs, through wholly-owned, state-chartered and -regulated captive insurance subsidiaries, and several other MREIT Council members were exploring possible FHLB membership.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
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however, the Council disagrees with the provisions of the NPRM that would effectively render captive insurance subsidiaries of MREITs — real estate finance businesses that are highly aligned with the housing mission of the FHLBs — ineligible for FHLB membership.

To the contrary, NAREIT and the Council strongly believe that, as members of FHLBs, captive insurance subsidiaries of MREITs have and will continue to bring benefits to the FHLBs and enhance the ability of the FHLB system to fulfill its mission in today's housing finance sector. Moreover, as federal government support for residential finance inevitably diminishes, with the contraction of GSE activity and diminishing Federal Reserve support for residential MBS, the benefits of responsible MREIT captive FHLB membership are even greater.

Please feel free to contact me if you would like to discuss our positions in greater detail.

Respectfully submitted,

Steven A. Wechsler
President & CEO

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

♦ ♦ ♦

REITS: BUILDING DIVIDENDS

January 12, 2015

Alfred. M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Re: *RIN 2590-AA39 – Notice of Proposed Rulemaking regarding membership requirements in the Federal Home Loan Bank System*

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NAREIT and its MREIT Council welcome the opportunity to comment on the provisions of the Federal Housing Finance Agency's (FHFA) *Notice of Proposed Rulemaking (NPRM) to amend its rules governing membership in the Federal Home Loan Banks (FHLBs).*[1] As of the date the NPRM was issued, three NAREIT MREIT Council members had become members of FHLBs, through wholly-owned, state-chartered and regulated captive insurance subsidiaries, and several other MREIT Council members were exploring possible FHLB membership.

Each of these MREIT captive insurance subsidiary members of FHLBs is chartered, domiciled and supervised in a state within the district of the FHLB of which it is member, and is in full compliance with all relevant laws and regulations. Importantly, each of NAREIT's MREIT members whose subsidiaries are currently FHLB members or are exploring membership is also an SEC-registered, U.S. stock exchange-listed real estate business dedicated to funding mortgages and/or providing mortgage-related finance for single- and multi-family

[1] 79 Fed. Reg. 54848 (September 12, 2014) (hereinafter the NPRM).

residences in the United States. As such, each of these MREIT parents is an operating business whose purpose – financing single and/or multi-family mortgages – is wholly consistent with the historic mission of the FHLB system. Moreover, to maintain their REIT status, MREITs must comply with regulatory requirements that effectively ensure that their mission will remain consistent with the mission of the FHLB system.[2]

Today, publicly-traded MREITs perform an integral role in the U.S. real estate capital markets by providing financing and liquidity through funding and originating mortgage and mortgage-related loans for residential and commercial borrowers. MREITs have, directly or indirectly, funded millions of U.S. residential properties, including both single-family homes and multi-family units. MREITs have been an especially important source of private sector housing finance capital in the aftermath of the 2007-2008 financial crisis by being continuously active in the Agency Residential Mortgage Backed Securities (RMBS) market, and they have been increasingly involved in the recovering Private Label Security (PLS) sector, which is critical to expanding credit to borrowers who otherwise may not have access to home loan financing.

Because certain distinct features of MREITs may not be broadly understood, Section I of this comment provides background on MREITs and describes how MREITs have become an integral part of the housing finance architecture in the United States. Section II discusses why real estate firms, such as residential MREITs and their subsidiaries, are mission-aligned with the FHLB system. Section III sets forth the Council's observations regarding the administration of the FHLBs' membership and lending procedures. In Section IV, the MREIT Council voices its concerns that the NPRM is likely to constrain access to residential single- and multi-family housing finance at an especially inopportune and important time. Section V sets forth the Council's conclusions and its suggestions of areas that might lead to more tailored amendments to the FHLB membership rules, which it believes would better serve the goals of the FHLB system, without the costs of discouraging the beneficial participation of MREIT captives and similar mission-aligned captives in the FHLB system, which can bring stable private capital to the benefit of the FHLB system.

I. Background on MREITs

REITs were established by Congress in 1960 to enable all American investors to enjoy the benefits of investment in real estate. There are two main types of REITs, generally referred to as equity REITs and MREITs. Equity REITs invest in "bricks and mortar" real estate by acquiring leasable space in properties, such as apartments, shopping malls, office buildings, and other properties, and collecting rents from their tenants. At least 34 countries around the world currently have enacted laws supporting equity REIT structures, which own and operate real estate assets.[3] However, the U.S. MREIT sector is wholly distinctive in its role in supporting

[2] To maintain their REIT status, MREITs must satisfy certain rules set forth under the Internal Revenue Code of 1986, as amended, including rules that (i) require that at least 75 percent of the value of a REIT's total assets be represented by real estate assets, cash and cash items and government securities (so-called "qualifying assets"); and (ii) require that no less than 75 percent of an MREIT's income be derived from such qualifying assets. Internal Revenue Code § 856 *et. seq*.

[3] *EPRA Global REIT Survey* (October 2014).

residential and commercial real estate debt finance. Nearly all of the MREITs that are members of NAREIT's MREIT Council are listed on the NYSE or NASDAQ, allowing a wide range of investors, including individual investors as well as institutions, to purchase shares of the equity securities of MREITs.

MREITs today typically concentrate on either the residential or commercial mortgage markets, although some "hybrid" MREITs operate in both markets and a few "hybrid" REITs own and operate real estate and hold mortgages. Residential MREITs serve the U.S. housing market by funding the acquisition and financing of mortgages and mortgage-related instruments, while some MREITs also originate mortgages and mortgage-related loans. When evaluating investment opportunities, MREITs employ rigorous quantitative and qualitative underwriting and credit evaluation methodologies. MREITs also make use of proprietary models to assess loan characteristics and likely performance under a variety or interest rate and market scenarios.

Risk management is a core function of the MREIT business model, allowing firms to proactively consider and address impacts from changes in economic and interest rate conditions, counterparty credit risk, prepayment risk and liquidity risk on an ongoing basis. MREITs regularly stress-test balance sheets, employing disciplined liability and liquidity risk management together with well-tested hedging strategies to mitigate various portfolio risks on an ongoing basis. Additionally, under new rules implemented pursuant to the Dodd-Frank Act, MREITs are required to clear certain derivative instruments used for hedging purposes through central clearinghouses, including interest rate swaps, further increasing the transparency of their trading operations and liquidity management and supporting broader financial stability.

Residential MREITs

Since 2009, Agency RMBS has overwhelmingly dominated U.S. single family mortgage securitization, and mirroring this development, most residential MREITs today focus on Agency RMBS. However, as noted above, a few MREITs also have significant investments in PLS and others are venturing back into this market as a complement to their Agency RMBS holdings.[4] While Agency MREITs have grown in size and number in recent years, today they hold less than four percent of outstanding Agency RMBS. By contrast banks and other depository institutions hold roughly 23 percent of Agency RMBS; the Federal Reserve holds another approximately 25 percent; mutual funds hold approximately14 percent, and the remainder are held by other governmental bodies, insurance firms, pension funds and other entities.[5]

Commercial MREITs

Commercial MREITs provide financing for many types of commercial real estate, including apartment buildings and other multi-family structures, office buildings and office parks, retail establishments, malls, restaurants, data centers and industrial facilities. They may invest in

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[4] NAREIT's MREIT Council commented on the U.S. Treasury Department's June 2014 Initiative to Promote Private Label Mortgage. *See*, Steve Wechsler, NAREIT Comment on the Development of Responsible Private Label Securities (PLS) Market (August 8, 2014).
[5] *Financial Stability Oversight Council Annual Report* (2014), p. 38.

commercial mortgages and commercial real estate loans, as well as both rated and unrated CMBS, mezzanine loans, subordinated securities or construction loans, and may participate in loan securitizations. Commercial MREITs traditionally have proprietary origination platforms and provide financing solutions to various buyers and owners of commercial real estate.

MREITs are a Source of Private Capital for U.S. Housing Finance

Because of their regular access to public capital markets, residential MREITs have been able to serve as an important channel for private-sector capital to help sustain and finance home mortgage markets in the aftermath of the recent financial crisis. Since 2007, MREITs have raised more than $70 billion in permanent capital for deployment in the U.S mortgage markets.

As of July 31, 2014, there were 27 residential MREITs in the FTSE NAREIT All REITs index with an equity market capitalization of $48.3 billion and 13 commercial MREITs with an equity market capitalization of $18.1 billion. Exchange-listed MREITs held a total of $492.4 billion in assets at the end of the first quarter of 2014. Of that amount, $258.8 billion was comprised of Agency assets and debentures.[6] Through their investments in real estate-related assets, MREITs have helped to finance more than an estimated 1.4 million homes in the United States.[7]

The success of MREITs today reflects years of developed expertise in the fundamentals of real estate debt markets: expertise combining rigorous research, valuation, data collection, underwriting and technical analytics, together with a deep understanding of the fiscal, legal and regulatory frameworks within which RMBS and CMBS markets operate.

II. Captive Insurance Subsidiaries of MREITs Can Further the FHLB Housing Mission

Members of the MREIT Council believe that the admission of captive insurance subsidiaries of real estate businesses that are aligned with the mission of the FHLBs will continue to strengthen the FHLB system and thereby expand housing finance credit. In this respect, the Council notes that the concerns set forth in the NPRM, although not fully elaborated or documented, appear to arise more from "form" than "substance." For example, while acknowledging that MREITs "are involved in the residential housing finance markets,"[8] the primary concern expressed in the NPRM is that MREITs are among "certain institutions that are ineligible for Bank membership" and are "using captives as vehicles through which they can obtain Bank advances to fund their business operations."[9]

In addition to noting that the FHLB rules do not prohibit members from accessing advances through subsidiaries or wholly-owned conduits (and indeed several do), the Council respectfully urges the FHFA not to overlook the "substance" here – *i.e.*, the strong mission alignment

[6] Federal Reserve Board, *Financial Accounts of the United States* (2014).
[7] *Id*., calculation derived by dividing REIT Agency asset holdings ($258.8 billion) by US Existing Home Sales Median Price ($208,300), utilizing a multiplier estimating an average down payment of 10 percent.
[8] NPRM at p.25.
[9] NPRM at 54853.

between MREITs and the FHLB system. Residential MREITs (as well as many commercial MREITs) are real estate finance businesses created and operated *for the very purpose* of funding residential real estate. Moreover, as public companies, their success in executing on this mission is evaluated by the U.S. capital markets daily.

While the NPRM does not document injury arising from MREIT captives accessing FHLB advances, it does suggest that somehow the captive structure could result in advances being used for purposes not related to the FHLB mission. Of course, such a concern (*i.e.*, that because money is fungible, advances might be supporting non-housing activities and be used like a working capital facility would apply to any FHLB member category), least applies to captives of residential MREITs, which are businesses *necessarily* devoted to residential housing finance. Indeed, insurance captives and their MREIT parents use FHLB advances to support the purchase of mortgage loans and securities that fund millions of single- and multi-family homes, which is an activity that is entirely consistent with the FHLB mission to "enable the Banks to provide low cost wholesale funding to their member institutions so that, in turn, those members could provide long-term home mortgage loans to consumers at a reasonable cost" and "to reserve the benefits of Bank membership…for institutions that are likely to use those benefits to fulfill the primary purposes of the Bank Act."[10]

It is also worth noting that Congress has never considered eliminating captive insurance members of the FHLBs, nor has it ever considered distinguishing among insurance structures or curtailing insurance members in any other way, despite multiple opportunities at those times when the Federal Home Loan Bank Act (the FHLB Act) has been amended.[11] Congress has, however, at times, recognized the need to conform FHLB rules to accommodate certain new housing finance products and businesses that have emerged in the decades since the FHLB Act's enactment and support the FHLB mission. But in doing so, Congress has always expanded, rather than contracted, the system's membership opportunities, adding, for example, Community Development Financial Institutions (CDFIs) and thrifts to reflect the evolution in housing finance in the decades since the enactment of the FHLB Act.

III. FHLBs Prudently Administer Membership and Lending Practices Related to Captive Members

The FHLB System and its regulator currently employ stringent, well-designed vetting and control processes for applicants. The MREIT captives that have explored or been granted admission to the FHLB System have found the thoroughness of FHLB credit analysis, underwriting and other activities to be on par with that of the most exacting investors and outside auditors.

[10] *Id*.
[11] *Housing and Economic Recovery Act of 2008 (*"*HERA*") Pub. L. 110-289 § 1201, 122 Stat. 2654 (2008), codified at 12 U.S.C. § 4513. *Financial Institutions Reform, Recovery, and Enforcement Act of 1989* (Pub. L 101-73 § 709, 013 Stat. 183, 12 U.S.C. § 1424 (1989)) and Gramm-Leach-Bliley Act of 1999 (Pub. L. 106-102 § 604, 113 Stat. 1338, 12 U.S.C. § 1430 (1999)).

FHLB Credit and Collateral Due Diligence

The FHLB membership admission process begins with extensive due diligence screenings performed according to the specific requirements of the FHLB Act and the rules implementing it. The applicant captive's financial data is then subjected to additional credit analysis, consistent with credit underwriting standards in the financial sector. Even in the preliminary stages of the process, the FHLB credit departments analyze and evaluate the management, business activities, historical performance, leverage, capital base and overall stability of each FHLB applicant, and, where applicable, its parent firm.

The FHLBs additionally set strict collateral eligibility requirements to protect each FHLB Bank and the FHLB system as a whole against risk. Moreover, these requirements are rigorously applied and reviewed.

Monthly, Quarterly, and Annual Reporting Requirements

The diligence performed by FHLB credit departments does not stop once an eligible institution is granted membership. Ongoing monitoring and credit review processes continue to confer multiple layers of protection to the FHLBs and their members. Captive insurance members are required to provide monthly, quarterly and annual information relating to both the captive entity and its parent. Reports include, but are not limited to, audited and unaudited financial statements of the parent entity, portfolio details, funding structures and counterparty information and REIT testing results.

Additionally, the structure of the FHLBs, a grouping of member cooperatives, provides additional protection. Upon admission to one of the FHLBs all members, including captives, are required to purchase shares conferring a vested interest in the welfare of the Bank. Members are also required to purchase "activity" stock that is directly correlated to the dollar volume of their borrowings. Activity stock effectively provides an incremental safety tool (on top of collateral haircuts) to align incentives between borrowing and managing system-wide risk by effectively requiring more "skin in the game" as borrowings increase.

The Council fully supports the FHFA's goal of ensuring responsible administration of the statutory membership requirements of the FHLB system. However, after studying the NPRM, and reviewing the recent experiences of Council members and others, the Council notes the thoroughness and competence of current standards and their consistency with credit review performed by other private sector lenders.

IV. If Adopted, the NPRM Would Exacerbate Tightness in U.S. Mortgage Markets

Today, in the aftermath of the financial crisis, there are many differing views as to the proper role of the federal government in a post-GSE conservatorship world. However, there is nearly universal agreement among policy experts, academics and government officials from both political parties that "… there is too little private capital available for housing finance and too few private sector firms with the ability, expertise, experience and capital to effectively stabilize and expand the sector,"[12] and that federal government policy must "encourage private capital to take a bigger role in the mortgage market."[13] Treasury Secretary Jack Lew recently reaffirmed this consensus observing that "[t]he fact is, we need to attract more private capital to the housing market."[14]

Current market conditions have exacerbated the need to expand private capital funding for housing finance. Housing credit remains very tight notwithstanding recent policy initiatives, limiting residential housing options and constraining the U.S. economy's overall growth trajectory. Fannie Mae and Freddie Mac (GSEs), although still in conservatorship status, are winding down their portfolios through amortization and asset sales, pursuant to the FHFA's strategic plans and goals. Additionally, the Federal Reserve has ended its purchases of RMBS under its quantitative easing program and is evaluating strategies for an eventual unwinding of these holdings. As a result, U.S. Government support for residential mortgage finance appears to be on a trajectory to shrink significantly for the first time in decades. Residential MREITs, many of which are specialists in Agency RMBS and in command of highly sophisticated models, analytics and long institutional expertise, stand ready to inject additional liquidity into this changing mortgage market.

MREITs emerged from the financial crisis as well-capitalized vehicles to access and deploy private capital into the single- and multi-family residential mortgage sectors. The sector has contributed broadly to housing affordability for consumers by originating mortgage loans, purchasing mortgage-backed securities, and providing first loss capital for new private label securitizations. MREITs have also purchased a large portion of the innovative credit risk transfer securities issued recently by the GSEs, a novel approach developed as part of the FHFA's initiative to reduce taxpayer risk in the residential mortgage market. Yet the NPRM, by ultimately barring MREIT captive insurance subsidiaries from FHLB membership, would serve to discourage this trend, and do so at a time when the need for more private housing finance capital is regarded by nearly all stakeholders as urgent.

Today, only a few MREITs may access FHLB funding through their captive insurance subsidiaries. However, the early experiences of these few convey the significant impact that FHLB membership could have, as well as the tangible costs of barring from membership MREIT captive insurance companies. FHLB advances have already provided MREIT captive insurance members and their parent firms with an optional, additional and complementary funding source, generally with longer durations and a different risk profile. This additional source of funding has enhanced the ability of these MREITs to manage their balance sheets responsibly through a

[12] House Financial Services Chairman Jeb Hensarling (R-TX), Press Conference introducing the *PATH Act to a Sustainable Housing Finance System for the 21st Century (August 7, 2013)*.
[13] Id.
[14] *Remarks of Secretary Lew at the Making Home Affordable Five-Year Anniversary Summit* (June 6, 2013). See also, *Remarks of Under Secretary Miller at the National Housing Conference Annual Policy Symposium* (June 13, 2014) ("[acknowledging the outsized role of government in the housing sector… the President called for a return of private capital to the center of the system;" and U.S. Treasury Department and U.S. Department of Housing and Urban Development *Reforming America's Housing Finance Market: A Report To Congress* (there is a need to "help bring private capital back to the market.").

range of market scenarios and has expanded their mortgage funding capacity. This is true even though FHLB advances now constitute a modest percentage of the liabilities of these MREITs and are likely to continue as such for the foreseeable future.

Indeed, the early experiences of the MREITS that have been able to access FHLB funding tell a relatively simple story: access to FHLB advances expands the current and future ability of MREITS and their captive insurance companies to fund U.S. single- and multi-family housing. Also, this pool – captive insurance subsidiaries – of potential FHLB members has the potential to enable the FHLBs to increase their earnings and expand their role in sponsoring affordable housing, as per their mandate.

The Council's members believe that the consequences of restricting FHLB membership by barring MREIT captive insurance companies – and by extension, captives of other potential members with the expertise, ability and capital to responsibly expand private sector housing finance – are likely to be negative, immediate and irreversible.

V. Conclusions and Recommendations

In preparing this comment, NAREIT's MREIT Council spent several months reviewing the NPRM, relevant sections of the FHLB Act and the FHLBs' current administration of the various rules governing the FHLB system and assessing the recent experiences that some Council members have had with the FHLB system. At the conclusion of this process, the MREIT Council did not agree with the FHFA that a valid public policy rationale had been established for the provisions of the NPRM that would effectively bar captive insurance subsidiaries of MREITs from membership consideration by FHLBs, nor that a compelling safety and soundness basis for such a radical change in FHLB membership rules had been established. To the contrary, the Council's conviction that MREITs are highly aligned with the housing mission of the FHLBs and that their participation in the system would benefit its membership and the system as a whole was even stronger.

At the same time, the Council wishes to express its strong support for the FHFA's goal, expressed in the NPRM, of ensuring that the core mission of the FHLB system – financing U.S. residential housing – is honored. The Council also strongly supports the FHFA's efforts to ensure that the FHLB rules reflect current developments in the mortgage marketplace, and endorses the suggestion set forth in the NPRM that the relevant regulatory definition of mortgages be updated to encompass new mortgage products.[15] In this same spirit, the Council urges the FHFA to recognize that MREITs, residential finance businesses that also reflect

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[15] The Council would like to register its support of the FHFA's recommendation, also contained in the NPRM, "that it is appropriate to expand the definition of 'home mortgage loan'" to include "all types of MBS backed by qualifying assets and eliminate the current distinction that the rules draw between pass-through securities and other types of MBS," including "collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and other non-pass-through MBS ...[t]he economic interest of all such instruments is much the same, and the forms of the respective instruments are more of a legal technicality that is neither decisive as to the nature of the economic interest that the owner holds nor the level of support for the mortgage market that the securities provide." NPRM at pp. 28-29.

developments in the evolving housing finance landscape, have considerable potential to be strong contributing members of the FHLBs, via captive insurance subsidiaries.

The Council respectfully suggests that a variety of more targeted amendments to the FHLB membership rules could better accomplish the goals set forth in the NPRM without taking the radical step of discriminating among types of insurance firms and effectively proscribing the beneficial participation of mission-aligned MREIT captive insurance subsidiaries.

For example, if the FHFA's concern is that FHLB advances to captive members could be misdirected to purposes unrelated to FHLB mission, the Council suggests that the FHFA might consider developing various membership criteria applicable to the parent of a captive member to ensure that the parent firms are mission-aligned and demonstrate requisite links to the housing finance and community development mission of the FHLB system.

Alternatively (or additionally) if the FHFA wishes to ensure that the links between parent firms and their captive subsidiaries remain sufficiently robust to protect the FHLBs under a variety of scenarios, the FHFA could address this concern more directly and efficiently by developing standard guarantees for parent firms of captive FHLB members.

Finally, if the FHFA's concerns relate to risk management practices, there are a variety of specific reforms that might ensure that captive members and their parents remain focused on risk management at far lower cost, including possibly establishing or reinforcing FHLB institutional or system-wide risk management oversight.

*   *   *

The potential for residential MREITs and their captives to foster the FHLB mission has been acknowledged by prominent housing policy experts, including Dr. Michael Stegman, the Housing Counselor to Treasury Secretary Jack Lew, who recently observed that "many of the activities that REITs engage in appear to be aligned with the FHLB System's core mission, and represent an important source of private capital that should be at the core of the U.S. housing finance system."[16] The Council respectfully asks that the FHFA not overlook or underestimate the considerable opportunities that MREITs offer to the FHLB system and to private sector housing finance more broadly.

The members of NAREIT's MREIT Council appreciate the opportunity to express their views on the NPRM and their continued support for the FHLB system. If unimpeded by the prohibitions in the NPRM, the Council is confident that MREIT captive insurance members will continue to contribute additional capital, housing finance expertise and diversity to the FHLB membership base, helping to sustain the success of the FHLB system as it adapts, as it must, to an environment becoming progressively less reliant on the historic GSE infrastructure.

[16] *Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman before The North Carolina Bankers Association 2014 American Mortgage Conference* (September 9, 2014).

If you have any questions or you would like to discuss these matters further, please contact NAREIT's Senior Vice President, Policy & Regulatory Affairs, Victoria Rostow, at vrostow@nareit.com or (202) 739-9400.

Respectfully submitted,

Executive Committee
NAREIT MREIT Council

NAREIT MREIT Executive Committee Chair:
William S. Gorin
Chief Executive Officer
MFA Financial, Inc.

MREIT Council Executive Committee Members:

Wellington J. Denahan
Chairman & CEO
Annaly Capital Management, Inc.

Michael R. Hough
Chairman & CEO
Hatteras Financial Corporation

Andrew F. Jacobs
President & CEO
Capstead Mortgage Corporation

Gary D. Kain
President & CIO
American Capital Agency Corp.

Richard J. King
President & CEO
Invesco Mortgage Capital, Inc.

Stuart A. Rothstein
CEO & President
Apollo Commercial Real Estate Finance, Inc.

Richard B. Salzman
President & CEO
Colony Capital, Inc.

Thomas E. Siering
President & CEO
Two Harbors Investment Corp.

OFFICE OF FINANCIAL RESEARCH

2014 Annual Report

LETTER FROM THE DIRECTOR

I am pleased to present the Office of Financial Research 2014 Annual Report to Congress. This report — our third — analyzes potential threats to U.S. financial stability, documents our significant progress in meeting the mission of the Office, and reports on key research findings.

Over the past year, the U.S. financial system has continued to recover and strengthen. Compared with the period just before the financial crisis, threats to financial stability are moderate. But that relatively benign backdrop is no cause for complacency.

Rather, there is good reason to watch financial developments closely. Since our 2013 report, several financial stability risks have increased. The three most important are excessive risk-taking in some markets, vulnerabilities associated with declining market liquidity, and the migration of financial activities toward opaque and less resilient corners of the financial system.

The Financial Stability Oversight Council identified similar issues in its annual report six months ago and recommended steps to address them. Our report, as in 2013, builds on and complements the Council's comprehensive perspective and policy recommendations with a more in-depth look at specific issues and an evaluation of policy options.

Last year, we introduced our benchmark tool for assessing and monitoring threats — the OFR Financial Stability Monitor, which enables us uniquely to look across the financial system and spot threats wherever they arise. The further development of this monitor presented here is just one way we fulfill our mission to develop and maintain tools and metrics to assess and monitor vulnerabilities in the financial system.

Our ability to identify and assess vulnerabilities and the quality of our judgments do not hinge on tools alone. They also depend on the quality of our raw materials — that is, the data and information we employ. What makes the OFR unique is our mission to improve the quality and scope of financial data. Global data standards are essential for data quality, so efforts to improve data quality require the engagement and cooperation of financial regulators and market participants worldwide.

For example, the Office has led the global Legal Entity Identifier (LEI) initiative from the start. This signature project is now self-sustaining, yet realizing the full benefits of the LEI system requires ubiquitous adoption. Consequently, I continue to call for regulators around the world to require the use of the LEI — and other available standards — in regulatory reporting.

In a second data-quality project, we are helping the Commodity Futures Trading Commission to improve the quality of derivatives data reported to swap data repositories. Those data are essential for assessing exposures and interconnections across the financial system.

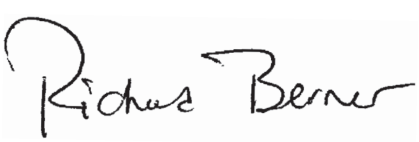
Collaboration on efforts to fill data gaps is also necessary. We have just launched a landmark pilot project with the Federal Reserve to collect previously unavailable data for bilateral repurchase agreements, or repos. This project marks the first time the Office will collect data directly from financial companies. This collection and subsequent analysis of this key segment of short-term, wholesale funding markets will inform our future data collection initiatives.

Four years have passed since the signing of Dodd-Frank, and a great deal has been accomplished. But the challenges of providing data and analysis for use by financial stability policymakers, and of evaluating financial stability policies and tools, remain consequential. Moreover, financial innovation and migration of financial activity to different markets, institutions, and jurisdictions will always tax our capacity to measure and analyze financial activity.

World-class thinking is required to meet these challenges. For our part, the OFR needs the independence, the flexibility, and the resources to attract and retain the core, superior talent required to achieve our mission. At the same time, our approach to our work is collaborative by necessity. The breadth and scope of our mission exceed our stand-alone capacity, regardless of our talent and resources. That is why we view the OFR as part of a virtual research-and-data community that extends the analytical capability of the Office, expands our capacity to meet urgent needs, and complements the work of others in this community.

The vision that we all share is of a transparent, efficient, and stable financial system. Our work so far has given us a strong sense of what success looks like. That perspective has informed a soon-to-be-published strategic plan that articulates our mission and goals for the next five years, and a roadmap to achieve them. First, we plan to be an essential source of data and analysis for monitoring threats to financial stability. Second, we will promote the identification and adoption of standards that improve the quality and utility of financial data. Third, our leading edge research will improve financial stability monitoring and the scope and quality of financial data, and inform policy and risk management.

I am deeply grateful for the opportunity to lead this extraordinary organization and our talented team of dedicated professionals for a fourth year. Our goals are ambitious but fulfilling our mission requires aiming high. I am more confident than ever that we are building a valuable institution that will help assure a stronger and safer financial system in the future.



Richard Berner
Director, Office of Financial Research

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EXECUTIVE SUMMARY 1

This third annual report of the Office of Financial Research (OFR) assesses threats to U.S. financial stability, outlines OFR research that supports the assessment, and describes the OFR's progress in meeting our mission. The report also evaluates policy initiatives for promoting financial stability and describes our work to improve the quality and scope of financial data and analysis.

The OFR, financial regulators, and other policy institutions have made significant progress since our last annual report in assessing the buildup of vulnerabilities in the financial system, improving the quality and scope of financial data, and developing and implementing new policy tools that — although largely untested — are designed to make the financial system stronger and more transparent.

However, several threats to financial stability have risen over the past year. This report highlights three specific risks. First, we see material evidence of excessive risk-taking during the extended period of low interest rates and low volatility. Second, markets have become more brittle because liquidity may be less available in a downturn and the risk of asset fire sales and runs in short-term wholesale funding markets remains unresolved. Third, we are concerned that financial activity is migrating toward areas of the financial system where threats are more difficult to assess because information is not available, and that activity may be consequential. Gaps in analysis, data, and policy also persist, despite progress in narrowing them. If left unaddressed, these threats could adversely affect financial stability.

This report fulfills the requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 for the OFR to report annually to Congress. As required, the report includes: (1) an analysis of any threats to the financial stability of the United States, (2) the status of our efforts in meeting the mission of the Office, and (3) key findings from our research and analysis of the financial system.

This annual report describes our:

- Financial Stability Monitor and other tools to help policymakers and market participants understand and assess vulnerabilities and potential threats to financial stability;
- analysis of the macroprudential policy toolkit regulators are developing, including key areas of progress and remaining issues, such as market liquidity risks, risks of runs and asset fire sales, and the need to address cyclical market excesses;
- work to make data standards in general and the Legal Entity Identifier in particular widespread in regulatory reporting and market practice, and OFR collaboration with the Commodity Futures Trading Commission (CFTC) to promote data standards across derivatives markets; and
- efforts to address data gaps, such as the OFR's new collaboration with the Federal Reserve to gather data about repurchase agreement (repo) markets.

Analyzing Threats to Financial Stability

Chapter 2 details where risks have increased over the past year. The focal point of this analysis is our Financial Stability Monitor, introduced last year, but refined, broadened, and deepened for this report. The monitor displays the buildup of vulnerabilities across five broad categories of risk — macroeconomic, market, credit, funding and liquidity, and contagion — based on a set of models, surveys, financial data, and other indicators.

The monitor shows that although overall risks to financial stability are not particularly elevated compared to the pre-crisis period, some have clearly intensified over the past year. One particular concern is market risk, which is the vulnerability of investor portfolios to large losses because of unanticipated adverse movements in interest rates, exchange rates, and other asset prices. The monitor also shows elevated risks among nonfinancial corporations in the United States because of relaxed lending standards, lower credit quality, higher debt levels in relation to total assets, and thinner cushions to counteract shocks. Market liquidity risks have also increased, in part reflecting structural changes in the way liquidity is provided.

Recent volatility in financial markets focused attention on some of the vulnerabilities that have been growing over the past several years. Although accommodative monetary policy has helped to foster economic recovery and promote bank balance-sheet repair, the prolonged period of low interest rates has also suppressed volatility and encouraged greater risk-taking by market participants.

We also remain concerned about structural vulnerabilities related to short-term wholesale funding markets because incentives still exist for fire sales of assets during periods of stress. Short-term funding markets are instrumental in providing liquidity to keep the global financial system operating.

Potential spillovers from an inevitable reversal in the stance of monetary policy are an additional cause of concern. The impending change in policy poses risks for market participants who have bet on sustained low volatility or low interest rates. The buildup of excesses is not unique to the United States. Emerging markets, for instance, show some parallels. Tighter global links mean that future shocks will be more quickly transmitted, likely resulting in broader disruptions.

Evaluating Macroprudential Policy Tools

Although the OFR is not a policymaking entity, the Dodd-Frank Act directed us to provide analysis and advice about policies designed to curb risks to the financial system.

In this country and overseas, regulators have made notable progress developing policies designed to make the financial system less vulnerable to shocks and less likely to be the source of shocks. For example, U.S. banking regulators have overhauled the requirements regarding the capital that banks must hold as a buffer to shocks, and they are beginning to introduce requirements on liquidity. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), they also now require the largest banks to undergo supervisory stress tests and to submit resolution plans, or "living wills," to help restore market discipline. The Financial Stability Oversight Council (Council) has begun to designate nonbank financial companies for enhanced prudential standards and supervision by the Federal Reserve under another Dodd-Frank Act mandate.

In Chapter 3 of this report, we explore the benefits and challenges of the new set of policies, most of which focus on the largest banks or nonbank financial companies. We also discuss risks in mortgage securitization markets and the steps that regulators have taken, or could take, to address them, focusing on the final risk retention or "skin in the game" rule released by regulators in October.

Most reforms so far have been aimed at structural vulnerabilities. We observe in Chapter 3 that tools are also needed to address cyclical excesses. The one new cyclical tool introduced in the United States is the countercyclical capital buffer. As agreed under the international Basel III accord, regulators can require banks to hold an additional buffer of capital during boom times as a cushion against potential future losses. We note that U.S. regulators have not said how the buffer will be used or what will trigger its use. In addition, the buffer is a blunt tool that may not be suitable for addressing excesses in specific credit markets.

The leveraged lending market provides a test case of the current approach to cyclical excesses. The response to these issues has been led by bank regulators, who regulate the largest institutions that originate leveraged loans, often for sale to asset managers through various instruments. Despite stronger supervisory guidance and other actions, excesses in this market show little evidence of easing.

Research on Financial Stability

In Chapter 4, we highlight three multiyear research projects at the OFR. The first uses agent-based models to simulate the spread of contagion across multiple channels for risk transmission in financial markets during crises. These models hold great promise for understanding the dynamics of fire sales and other chains of complex events. The models attempt to capture the behaviors and interactions of diverse market participants by considering the roles each agent plays in stress events as they unfold. The second project describes the OFR's exploration of visualization techniques that go beyond familiar line charts and bar charts to help analysts monitor financial stability. Effective and innovative visualizations reveal key patterns and connections in complex financial data. The OFR is also developing interactive visualizations for displaying these insights online.

The third section of Chapter 4 describes ongoing OFR research on credit default swap markets. Research is focused on the role of information flows on credit default swap activity and pricing and how transaction sizes affect prices and liquidity under different market conditions. In addition, the chapter discusses implications for financial stability posed by central counterparty clearing of credit default swaps.

Advancing Data Standards

In Chapter 5 of the report, we describe the OFR's work to promote and develop financial data standards, which are essential to make data suitable for financial stability analysis and for financial companies' internal risk management.

The global Legal Entity Identifier (LEI) project is the most advanced of these standards, and it took major strides forward in 2014 with the completion of the governing structure for the LEI system. The LEI is like a bar code for identifying entities that engage in financial market transactions. It is a linchpin for making connections in the massive volumes of financial data that course through the international economy every day. To date, about 300,000 LEIs have been issued to entities around the world and 19 utilities have been approved to issue LEIs for use in regulatory reporting. Regulations requiring the LEI are being issued at an accelerating pace across the world. The OFR's Chief Counsel chairs the international committee overseeing the system.

As momentum builds and the LEI system grows, the benefits are growing as well, including efficiencies for financial companies in internal reporting and in collecting, cleaning, and aggregating data. We also expect to reduce companies' reporting burdens by generating efficiencies in reporting data to regulators.

In 2014, the OFR began work to help the CFTC and other regulators improve data quality in swap data repositories. This is a critical initiative for market participants and regulators to make sense of the vast amounts of new market data that these repositories are beginning to collect.

The OFR also created plans in 2014 to prepare and publish reference databases for financial entities and companies and financial instruments, as required in Dodd-Frank. The LEI system will provide all needed inputs to create and maintain a financial entity database. As an outgrowth of projects such as the work with the CFTC, the OFR has also begun to develop formats and standards for reporting financial transaction and position data and for identifying financial instrument types. In addition, the OFR will develop a prototype of the financial instrument reference database.

Data sharing is critical to our mission. The Office continues to work with Council member organizations to develop protocols and procedures for securely sharing data for monitoring and analysis.

Addressing Data Gaps

In Chapter 6, we discuss our progress in filling gaps in the data available for monitoring and analyzing financial stability. In October, we announced a pilot project with the Federal Reserve to gather data about the market for bilateral repos. This project focuses on a critical gap in the data needed for financial stability analysis. A repo is essentially a collateralized loan, when one party sells a security to another party with an agreement to repurchase it later at an agreed price. Repos are an important source of short-term funding for the financial industry. The U.S. repo market provides more than $3 trillion in funding every day. The bilateral repo market, which constitutes half of the total market, is not only opaque, but also vulnerable to runs and fire sales.

Our ability to evaluate financial developments has benefited significantly as regulators introduced new data collections and expanded old ones in recent years. For example, the Securities and Exchange Commission's (SEC's) new Form PF has provided unprecedented insights about hedge funds and other private funds. Chapter 6 explains our analysis of hedge fund leverage using information from that form.

Outreach, Collaboration, and Infrastructure

Chapter 7 describes the OFR's progress in building its organization as a valued source of high-quality data and expert research and in collaborating with member agencies of the Council, outside researchers, and regulators overseas. This collaboration is central to the mission of the OFR.

In the 2014 fiscal year, we organized workshops and conferences in collaboration with the Council and its member agencies. This year, our Financial Research Advisory Committee met twice, and presented more than a dozen recommendations that span our work in research, risk management, and data standards. We awarded three grants to outside experts to promote financial stability research under a joint program with the National Science Foundation. OFR senior managers and research staff members participated in dozens of public events, both for general and technical audiences, increasing awareness of our activities and promoting further collaborations with outside organizations.

Our forthcoming strategic plan for FY 2015-19 describes our vision, mission, goals, and objectives, and discusses specific ways we will carry out that mission. The plan is a blueprint to guide our activities, set our priorities, and inform the public about our mission and how we work to achieve it. The plan also contains metrics required by law to evaluate our performance and hold us accountable to oversight and the public.

Information technology is critical to carry out our mission. In 2014, we completed installation of a world-class, analytic environment for collecting, storing, aggregating, and maintaining large volumes of data. We also installed computing tools to support complex financial models, cutting edge visualization, and analysis. The Office uses a wide range of security tools to assure protection of confidential, nonpublic information and has created a proprietary recovery site to assure business continuity.

We continue to hire highly qualified employees. In the past three years the staff has increased from 30 to nearly 225 employees. As detailed in our forthcoming 2014 Human Capital Report to Congress, we plan a steady-state total workforce of approximately 300.

Agenda Ahead

In Chapter 8, we describe our plans for 2015 and beyond. Our research priorities include:

- broadening our market monitoring framework, including the publication of a Financial Markets Monitor, a version of which is currently presented only to the Council;
- developing a suite of additional monitors and dashboards, focused on money market funds, hedge funds, and credit default swap markets;
- publishing working papers that describe in greater detail the methodology behind our Financial Stability Monitor and Financial Stress Index, as well as a series of short papers on significant threats to financial stability;
- expanding our analysis of stress tests and other macroprudential policy tools; and
- publishing research on financial stability, risk management, and related topics, including working papers on agent-based models, visualization techniques, and credit default swap markets, as described in Chapter 4.

Our data priorities include:

- advocating for the global implementation of the LEI in regulation and market practice;
- promoting data standards in derivatives markets, in collaboration with the CFTC;
- leading or contributing to the development and implementation of new standards, such as universal loan identifiers in the mortgage market;
- collecting data on the repo market, in collaboration with the Federal Reserve;
- filling the data gaps discussed in Chapter 6, particularly to help us understand risks in asset management activities and short-term wholesale funding markets; and
- creating a prototype financial instrument reference database to promote market transparency.

Our institutional priorities continue to focus on building our expert workforce and our technological capabilities, including a leading-edge intranet for the OFR staff and deployment of the new OFR public website.

In 2015, we will continue to collaborate with the Council and its member agencies and with our network of outside researchers, industry experts, and others. We will also continue to engage with our stakeholders in Congress and expand our grants program with the National Science Foundation.

ANALYZING THREATS TO FINANCIAL STABILITY 2

Financial markets came under pressure in September and October, exposing some of the vulnerabilities and risk-taking that have been promoted by several years of low interest rates and low volatility. In this chapter, we highlight concerns about: (1) excessive risk-taking and positioning, with a focus on interest rate risks, credit risks, and volatility risks; (2) market structure and liquidity issues, with a focus on the fragmentation of market liquidity and the persistent risks of asset fire sales and runs; and (3) the migration of activities due to financial innovation and regulatory arbitrage.

2.1 Analytic and Monitoring Framework

Seeking higher returns, market participants have taken significant duration, credit, and liquidity risk during six years of low interest rates, low volatility, and ample funding liquidity. Our analysis focuses on the risk that an unanticipated interest rate or volatility shock could reveal those vulnerabilities.

Since our last annual report, market excesses and consequent threats to financial stability have been increasingly evident across a number of dimensions. For example, throughout most of 2014, low volatility and compressed risk premia persisted across asset classes, while nonfinancial corporate credit fundamentals deteriorated. While an accommodative monetary policy helped support the economic recovery and promoted balance-sheet repair by lowering borrowing costs, it also created incentives for risk-taking, with potential consequences for financial stability.

Since our last annual report, market excesses and consequent threats to financial stability have been increasingly evident across a number of dimensions.

The decline in risky asset prices and increase in volatility that occurred in September and October 2014 exposed some of those excesses. That some markets proved to be surprisingly brittle under this modest stress strongly suggests that both cyclical and structural vulnerabilities have increased over the past year. Whether they turn out to be serious vulnerabilities will only be revealed in time by larger market shocks. In this chapter, we describe the framework and indicators we use to track and analyze vulnerabilities.

Market Developments and Financial Stability Monitoring. Section 2.2 describes our monitoring activities, focusing on our Financial Stability Monitor, which tracks and quantifies five categories of risk based on a host of underlying indicators, and our Financial Stress Index, which tracks risks on a real-time basis.

Potential Threats to Financial Stability. In Section 2.3, we highlight the key cyclical and structural vulnerabilities that concern us, based on the results of our Financial Stability Monitor, market intelligence gathered from a range of sources, and other surveillance tools. Financial stability risks have risen since our last report, centered in three areas:

- **Excessive risk-taking,** including: (1) interest rate risks and operational challenges posed by a normalization in monetary policy; (2) credit risks related to excessive risk-taking and a weakening in nonfinancial corporate credit fundamentals; (3) volatility risks, characterized by reaching-for-yield and herding behavior following a long period of low volatility; and (4) emerging market risks, as capital outflows may reveal underlying fundamental weaknesses.
- **Market structure and liquidity issues,** including: (1) market liquidity risks, caused by fragmentation and structural changes in various market segments; (2) run risks and asset fire sale risks in wholesale funding markets; and (3) market infrastructure vulnerabilities in equity markets, stemming from complexity and lack of transparency.
- **Financial innovation and migration of activities** from more tightly to less tightly regulated parts of the financial system, such as: (1) captive reinsurance companies, (2) mortgage servicing rights, and (3) single family rental securitization.

2.2 Market Developments and Financial Stability Monitoring

This section describes market developments over the past year and our monitoring activities, including an update of the Financial Stability Monitor, which we introduced in our 2013 annual report.

Review of 2014 Market Developments

Following a prolonged period of calm, investors' concerns about extended valuations and global economic growth triggered a broad-based reassessment of risk in September and October 2014. Global risky assets sold off, volatility spiked, and global sovereign bond yields fell amid a flight to safety. Measures of tail risk — the risk of extremely rare events — also increased, as demonstrated by demand for protection against adverse future moves in market prices. The dislocation was large and unexpected, but short-lived. Expectations for continued monetary policy accommodation helped asset prices stabilize and partially recover. But investor sentiment remains fragile.

The episode revealed a number of underlying vulnerabilities. First, during a protracted period of low interest rates and the Federal Reserve's quantitative easing, investors may have taken low volatility for granted and underestimated the potential for a reversal. While quantitative easing policies are intended to encourage investors to buy risky assets, there is also a risk that the perceived reversal of such policies will lead investors to turn the other way, triggering market instability.

Similarly, investors may have become too sanguine about the availability of market liquidity — the ability to transact in size without having a significant impact on price — during both good times and bad. While structural changes in the provision of market liquidity are not fully understood, financial stability analyses in recent years, including the OFR's previous annual reports, have noted the potential fragility of market liquidity during a market shock, due in part to the reduced willingness or capacity of broker-dealers to provide liquidity (see OFR, 2013a; IMF, 2014c; and **Market Liquidity Risks** in **Section 2.3**). The recent market dislocation showed those concerns to be valid, as market liquidity quickly vanished in traditionally liquid markets such as U.S. Treasuries, cash, and futures markets, leading to less market depth and further sharp price declines. (Reduced market depth increases the transaction cost of executing a trade in reasonable size.)

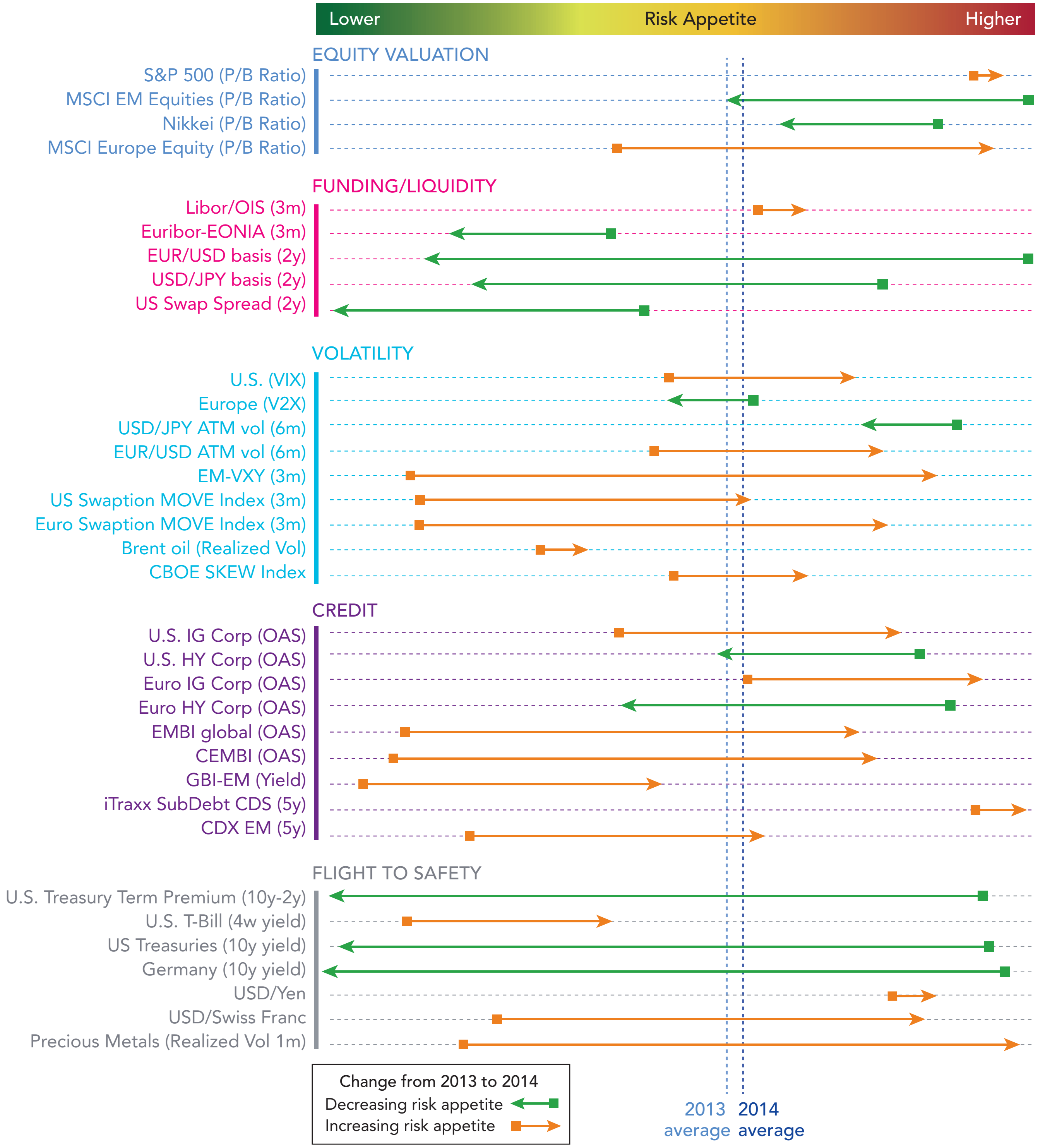
The liquidity strains in the U.S. Treasury market spread quickly to other markets, affecting related asset classes such as interest rate futures, swaps, and options to differing degrees. A liquidation of speculative short positions in interest rate markets also contributed to the instability. Anecdotally, some of the price movements appeared continuous, suggesting that a high volume of transactions was executed by algorithmic trading systems.

Although the dislocation that peaked in mid-October was fleeting, we believe there is a risk of a repeat occurrence, given the increased prevalence of algorithmic trading, a shift in risk preferences by broker-dealers, and the persistent incentives for risk-taking. The potential for a rapid and severe adjustment in prices followed by a reversal in derivatives markets or fixed-income markets — which are large, interconnected, and widely used for hedging and risk management — raises a host of financial stability concerns.

Despite the market gyrations, overall demand for risky assets has not abated (see **Figure 2-1**). Investors continue

Figure 2-1. Risk Tolerance Financial Market Heat Map

Overall risk appetite has firmed since our last annual report

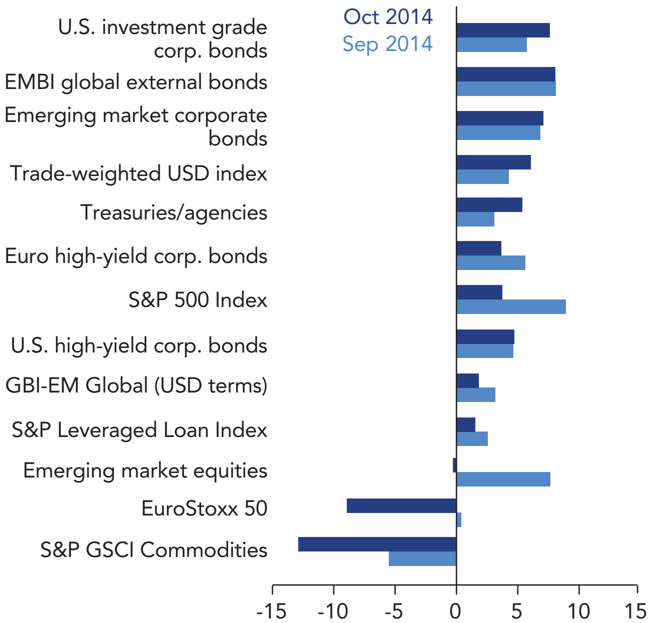


Note: Each indicator is scaled to a percentile range rank and compared to the levels prevailing over the past three years. The dotted vertical lines represent the average across all five asset classes for 2013 and 2014. The direction of the arrow displays the change in the risk appetite between the two years. P/B = Price-to-Book ratio (a ratio used to compare a stock's market value to its book value); EM = emerging market; LIBOR = London Interbank Offered Rate; OIS = Overnight Index Swap; EONIA = Euro Overnight Index Average (1-day interbank interest rate for the euro zone); V2X = European equivalent of VIX; ATM =at-the-money (for options, where the strike price is the same as the current spot price of the underlying security); vol = volatility; VXY = measure of volatility in a basket of currencies; MOVE = Merrill Option Volatility Estimate Index; IG = investment grade; HY = high-yield; EMBI = J.P. Morgan's Emerging Markets Bond Index; CEMBI = J.P. Morgan's Corporate Emerging Market Bond Index; GBI-EM = J.P. Morgan's Government Bond Index-Emerging Markets (an emerging market benchmark index that tracks local currency bonds); CDX EM = Markit's index of credit default swaps covering emerging market companies.

Sources: Bloomberg L.P., OFR analysis

Figure 2-2. Total Year-to-Date Returns (percent)

Most risky assets show positive returns this year, despite market stress in late September and October



Note: Data are year-to-date through September 15, 2014, just before a period of market stress began, and through October 17, 2014, when the stress event had largely subsided.

Sources: Bank of America Merrill Lynch, Bloomberg L.P., JPMorgan Chase & Co., OFR analysis

Although the dislocation that peaked in mid-October was fleeting, we believe there is a risk of a repeat occurrence, given the increased prevalence of algorithmic trading, a shift in risk preferences by broker-dealers, and the persistent incentives for risk-taking.

to be rewarded for taking credit, duration, and liquidity risk. Even after taking into account the broad-based market dislocation that occurred in September and October, higher risk assets such as eurozone peripheral bonds, emerging market sovereign and corporate debt, and U.S. corporate bonds remain among the better performing assets this year (see **Figure 2-2**).

Overall global financial and monetary conditions remain broadly accommodative, reflecting the outlook for slow economic growth and low inflation (see **Figure 2-3**). While the Federal Reserve and Bank of England have spelled out the circumstances that would entail future changes in their policy stances, currently they remain committed to accommodative policies. The Bank of Japan and the European Central Bank have taken additional measures to ease policy further.

Accommodative global monetary policy, coupled with the Federal Reserve's purchases of large amounts of low-risk assets and changes in risk sentiment, helped to compress volatility and risk premiums (the returns in excess of the return earned on a risk-free investment).

These conditions encouraged investors to increase their holdings of long-dated securities and products with riskier credit attributes in a search for higher returns. Over the past five years, investors moved out of money market instruments and into riskier assets such as leveraged loans, high-yield corporate credit, eurozone peripheral bonds, and emerging market equities. Investors moved into global equities more slowly (see **Figure 2-4**). For instance, cumulative flows from U.S.-domiciled mutual funds into bonds have increased by nearly $1 trillion since the end of 2008, while the flow into equities has been a mere trickle. As a result, some investors (particularly those with unhedged positions and duration mismatches) grew more heavily exposed to an abrupt correction in the fixed-income markets compared to the pre-crisis period.

During the recent bout of volatility, investors partly unwound their positions in eurozone peripheral credits, U.S. equities, and high-yield and leveraged loans. But the liquidation was not enough to offset the extended long positions that investors had built up over the past few years. On the contrary, the fleeting nature of the episode ultimately had the effect of reinforcing demand for duration, credit, and liquidity risk, and led many investors to reestablish such positions.

Unlike prior to the financial crisis, investors have not significantly increased balance-sheet leverage to boost returns. That's partly because of constraints on banks from increases in their capital requirements. Overall, the aggregate amount of nonderivatives-based leverage in the financial system has remained stable and is below peak levels. Total outstanding repurchase agreements (repos) and the issuance of financial products with embedded leverage are below pre-crisis levels. However, we lack detailed information on derivatives-based leverage; it is an area that suffers from data opacity and warrants further analysis.

There are a few worrying exceptions to this low-leverage trend. While financial institutions have reduced the amount of debt on their balance sheets compared to their assets, debt accumulation has increased among nonfinancial companies and the government. Managers of structured investment products such as collateralized loan obligations are also increasing their use of leverage, and total margin debt (debt used to purchase securities) has risen. These trends require close monitoring.

Financial Stability Monitoring Activities

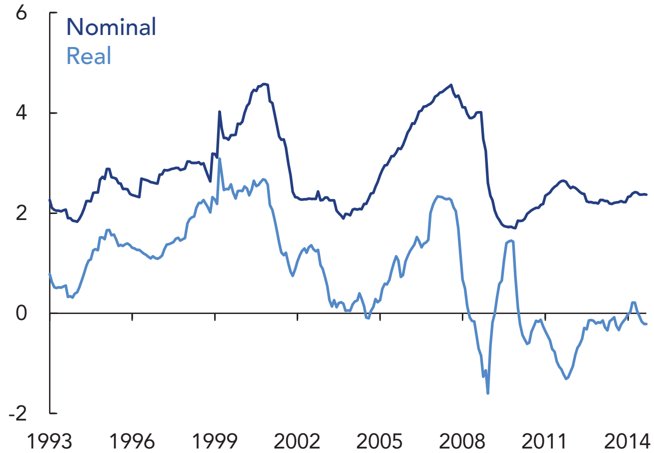
The OFR continues to build and refine our financial stability monitoring and analytical toolkit to include a spectrum of monitors, models, metrics, and visualization tools. We will continue to gather market intelligence and acquire data to quantify and analyze vulnerabilities and risks.

The OFR's Financial Stability Monitor provides a high-level summary of the buildup and overall level of vulnerabilities in the financial system as of September 30, 2014 compared to October 31, 2013 (see **Figure 2-5**). Several financial stability risks have risen since our last report, notably those that measure market and liquidity risks. While overall threats are not particularly elevated compared to the peak of the 2007-09 financial crisis, a number of risks are close to those prevailing in late 2005 or early 2006. Highlights include:

- **Macroeconomic risks remain little changed.** The U.S. macroeconomic outlook has improved amid stronger sentiment and stable quarterly growth. Market perceptions of tail risks have diminished, as reflected by a decline in global market-implied sovereign credit risk. Geopolitical tensions in emerging markets and uncertainty about growth in the eurozone have had limited spillover effects here (see **Emerging Markets** in **Section 2.3**). However, the risk of slow growth and low inflation — which some have called

Figure 2-3. Global Monetary Policy Rates (percent)

Amid a weak economic outlook, global monetary policy remains broadly accommodative

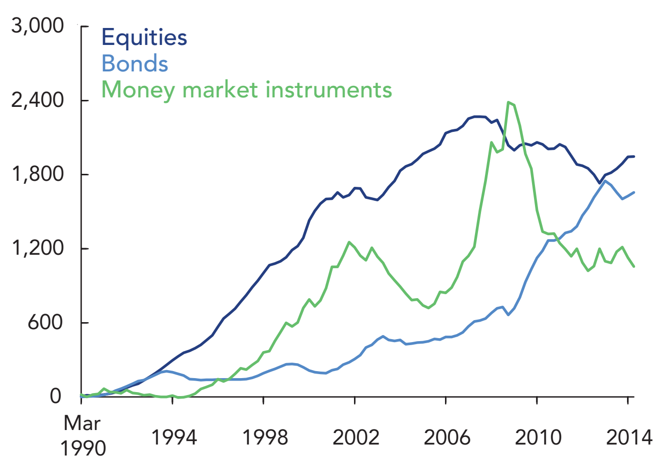


Note: Rates are weighted by gross domestic product and include Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Mexico, the Netherlands, Norway, Poland, Russia, South Korea, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Sources: Bloomberg L.P., OFR analysis

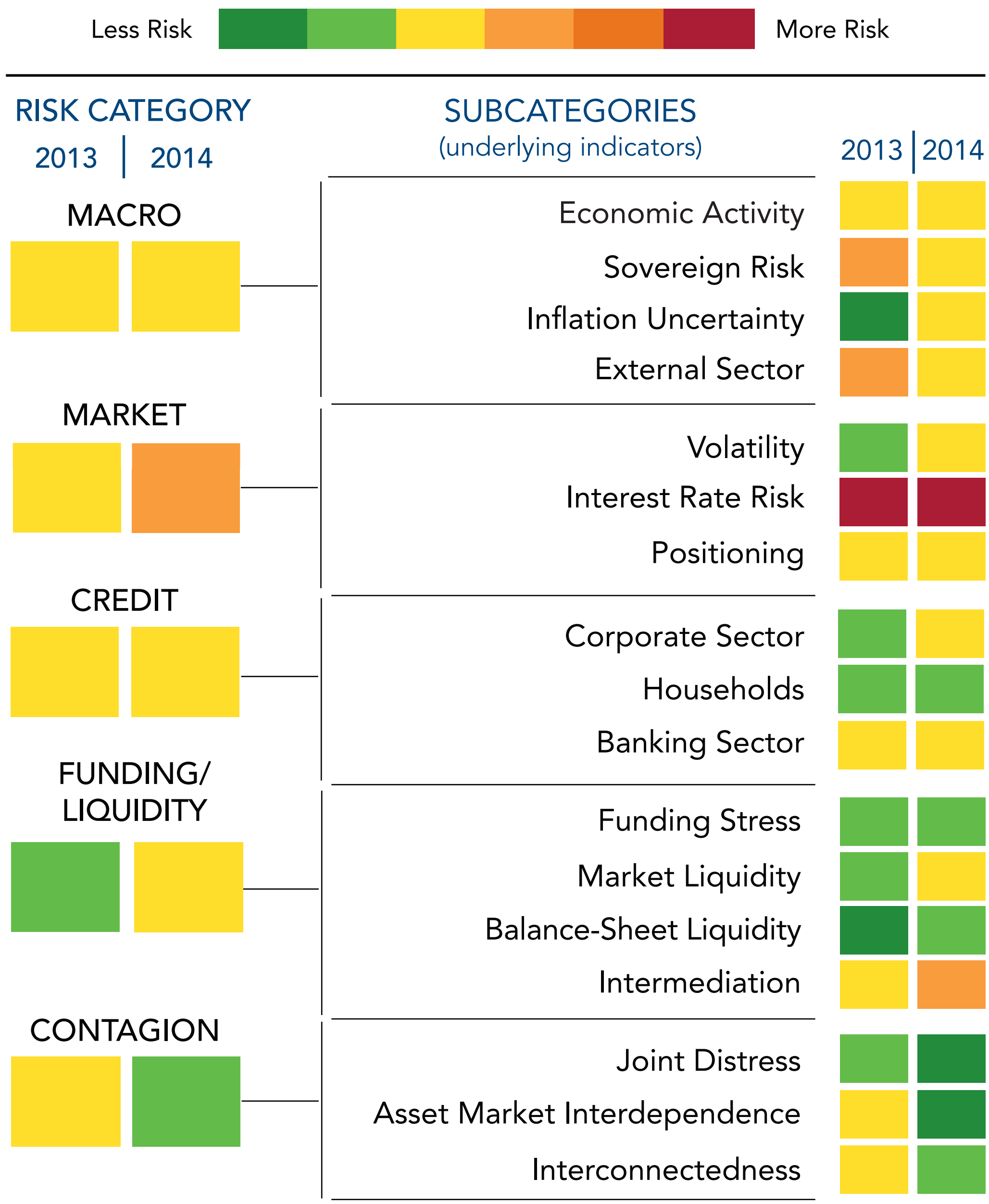
Figure 2-4. Cumulative Mutual Fund Flows to Bonds, Equities, and Money Market Instruments ($ billions)

Quantitative easing encouraged investors to shift out of cash into riskier assets



Sources: Haver Analytics, OFR analysis

Figure 2-5. OFR Financial Stability Monitor



Notes: Green signifies low financial stability risks, while red signifies elevated risks. The figure represents a series of underlying indicators based on maximum levels prevailing from January 1, 1990 (if available) to the present. Each risk category is constructed as a weighted average across the prevailing risk levels, with weights assigned based on the back-test performance of each of the indicators in the underlying categories. Positioning is determined by the weighted average z-scores of the underlying indicators since our last annual report. Data are as of September 30, 2014 and October 31, 2013. Some risk subcategories were revised to include indicators recently added to the Financial Stability Monitor. The OFR will issue a working paper in 2015 detailing the components that make up the monitor.

Sources: Bloomberg L.P., Haver Analytics, OFR analysis

Several financial stability risks have risen since our last report, notably those that measure market and liquidity risks.

Figure 2-6. Financial Stability Monitor Risk Classification and Examples of Indicators

Risk	Definition	Indicators
Macro-economic	Evaluates risks that have the potential to affect financial stability through various macro channels such as growth, external balances, fiscal vulnerabilities, and confidence channels.	Financial conditions, output gap, sovereign debt levels and financing costs, foreign exchange reserves, current account balances, consumer and business confidence, inflation volatility, and inflation expectations
Market	Assesses the risk of destabilizing losses across key asset classes and investment strategies as a result of adverse movements in asset prices.	Duration, positioning, risk premiums valuations, and volatility
Credit	Measures the propensity of a counterparty to meet its financial obligations, and includes market-implied and balance-sheet measures of risk.	Corporate credit spreads, balance-sheet leverage, lending conditions, delinquencies, asset quality of households, corporates, banks, and nonbank financial institutions
Funding/ liquidity	Captures market liquidity, balance-sheet liquidity ratios, stress in funding markets, and the potential for vulnerabilities that arise from excessive leverage.	Broker-dealer inventories, turnover, volume, cash balances, dependence on wholesale funding, changes in short-term investor assets under management and tenors, foreign exchange basis swaps, short-term funding rates/spreads
Contagion	Measures the vulnerability of the financial system to sudden shocks that may spread as a result of interconnectedness.	Contingent claims analysis, conditional value at risk, systemic expected shortfall, distressed insurance premium, network analysis, cross-border exposures, sovereign-bank exposures, correlation risk

Source: OFR analysis

"secular stagnation" — leaves some economies and financial systems vulnerable to shocks.

- **Market risk has increased across a number of measures.** Duration risk (the sensitivity of bond investments to a change in interest rates) remains elevated, and could potentially expose investment portfolios to sizeable losses in the event of an unanticipated rise in interest rates (see **Credit Risks** and **Interest Rate Risks** in **Section 2.3**). There is evidence of valuation misalignments and crowded positioning in some market segments, posing the risk of a disorderly withdrawal if market participants exit similar positions simultaneously. These buildups have occurred amid historically low volatility, which increases the potential for excessive risk-taking and high leverage and could worsen the consequences if volatility suddenly spikes (see **Volatility Risks** in **Section 2.3**).
- **Credit risk measures are mixed — improving in the household and banking sectors, but continuing to deteriorate at the margin in the corporate sector.** Overall bank fundamentals in the United States are strong, with much of the improvement attributed to enhanced capital and liquidity buffers to comply with new regulations. Delinquencies, default rates, and debt overhangs have continued to abate since the financial crisis; indeed, delinquencies and charge-offs at commercial banks for nonmortgage consumer and commercial loans are near record lows. However, overseas banks, particularly in the eurozone, show unresolved structural weaknesses and balance-sheet repair is incomplete (see IMF, 2014c). Our concerns focus on the buildup of risks in U.S. nonfinancial corporates. Although delinquencies in this sector remain low, we expect that the credit cycle, when it turns, will be exacerbated by the combination of increased balance-sheet leverage, reduced compensation for risk, lower credit quality, weaker covenants, and easing lending standards (see **Credit Risks** in **Section 2.3**).
- **Measures of funding appear stable, but market liquidity is a concern.** Monetary policy is still accommodative and wholesale funding markets show reduced concentration risk, maturity risk, and intraday credit risk, while collateral quality has improved. However, these are precisely the circumstances that have in the past fostered excessive leverage, maturity transformation, and liquidity transformation. And funding markets can shift rapidly in the event of an

unanticipated market disturbance, especially when it is accompanied by leverage or a liquidity mismatch (see **Run Risks and Asset Fire Sale Risks** in **Section 2.3**). Corporate balance-sheet liquidity remains strong, measured by cash balances, although somewhat diminished since our last annual report. We remain concerned that traditional liquidity providers are less able than they were before the crisis to intermediate and provide liquidity in the event of a market disruption (see **Market Liquidity Risks** in **Section 2.3**). Furthermore, six years of abundant funding liquidity may have masked the depth of the deterioration in trading liquidity.

- **Measures of contagion risk have moderated.** Market-based measures of joint distress of major U.S. financial institutions are at post-crisis lows. (However, it is worth noting that market-implied contagion measures tend to show weak forward-looking properties. Such measures are more effective at identifying peaks in the midst of a crisis.) Direct measures of interconnectedness, such as financial institutions' holdings of sovereign debt and foreign claims of U.S. banks, have also declined over the past year. Conservative balance sheets have made banks more resilient to financial shocks. Measures of cross-asset correlation are at modest levels.

CONSTRUCTION OF THE MONITOR

The OFR's Financial Stability Monitor does not predict when or how future systemic shocks could materialize. It would be difficult, if not impossible, to pinpoint the probability, magnitude, or timing of shocks that might trigger a systemic financial event. The monitor instead attempts to isolate and analyze vulnerabilities in the financial system that could be exposed by shocks, such as incentives to take excessive risks.

The Financial Stability Monitor considers five categories of risk: macroeconomic, market, credit, funding and liquidity, and contagion. These categories closely align with the tasks of a well-functioning financial system — credit allocation, maturity transformation, risk transfer, liquidity intermediation, and a smoothly operating system for payments (see **Figure 2-6**).

In selecting the monitor's underlying indicators, we focused on ones with high frequency and history over multiple business cycles and periods of financial distress. Most start in 1990 and have a daily or monthly frequency.

The Financial Stability Monitor cuts across different geographies, sectors, and measurement methods (see **Figure 2-7A**). We concentrate primarily on risks directly related to U.S. financial stability, but we also take into account spillovers or shocks to and from other major economies and large, complex financial institutions. The monitor includes indicators for sectors such as government, households, corporations, banks, and nonbank financial services firms. The monitor uses model-based indicators, as well as measures based on balance sheets, surveys, and markets.

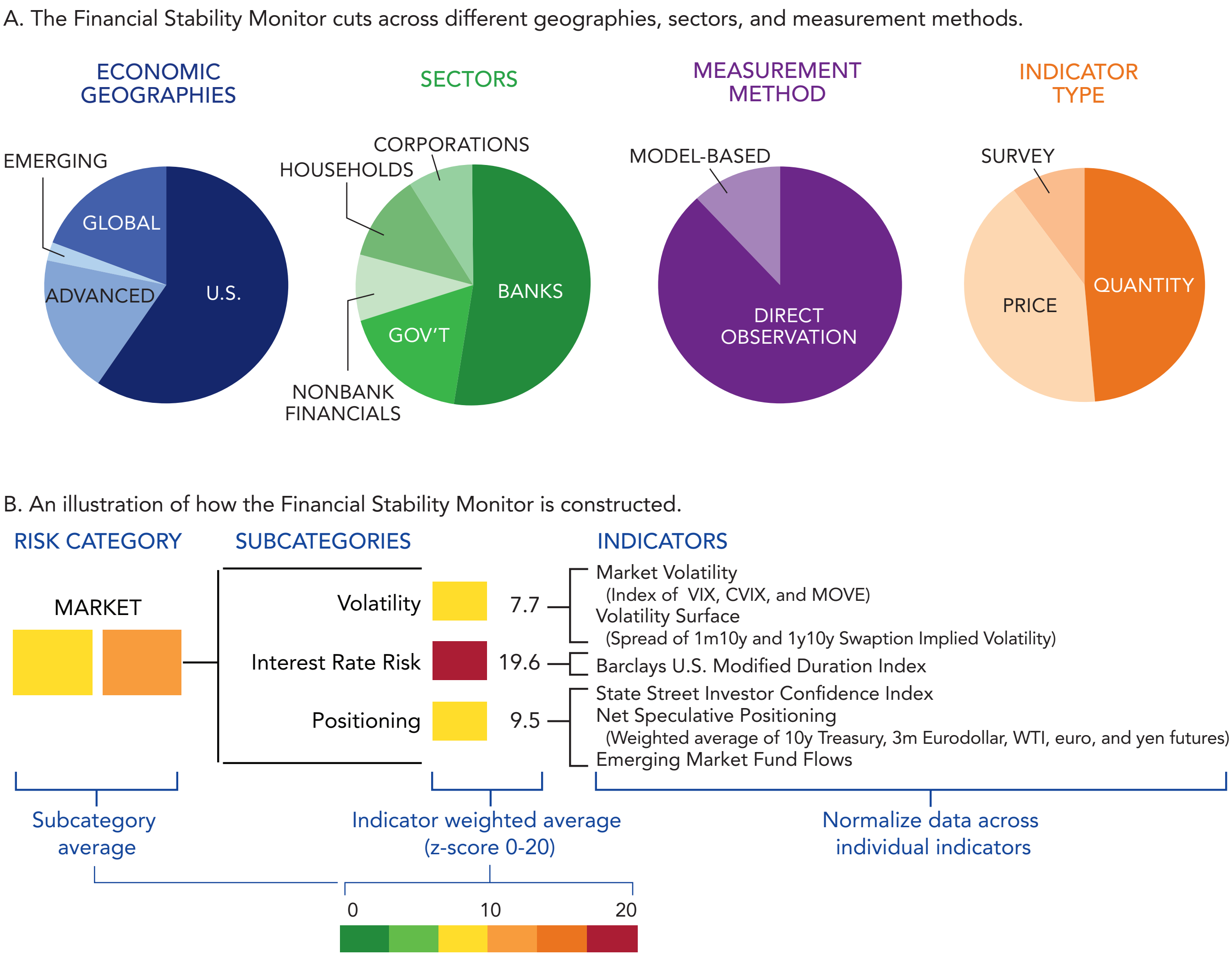
The Financial Stability Monitor is constructed with five risk categories (see **Figure 2-7B**). Each category is evaluated using a series of underlying indicators based on maximum and minimum daily levels prevailing from January 1, 1990 (if available) to the present. Each indicator is weighted according to its performance in a series of tests. Indicators are then combined into subcategories, such as interconnectedness or joint distress. Several subcategories make up each risk category, which is constructed as a weighted average of the prevailing risk levels for each indicator. Results are summarized on a heat map, in which green indicates that risks to stability are low and red indicates they are elevated.

The Financial Stability Monitor aims to identify underlying vulnerabilities that may predispose a system to a crisis. We have a good sense of preconditions that lead to crises: for example, excessive leverage, excessive risk-taking, a rapid rise in capital flows, and reduced policy buffers. Indicators were partly selected based on the experience with historical episodes of stress. However, every crisis has been unique, both in terms of the triggers and the propagation. Had we designed the monitor prior to the 2007-09 global financial crisis, we would likely have underestimated the role of funding markets in transmitting stress or underestimated the importance of macrofinancial linkages. (Given the benefit of hindsight, the monitor shows a pronounced buildup of risk during the runup to the crisis.) The lesson is that we will need to adjust our framework as new, more forward-looking metrics are developed, as our understanding about the transmission of risk evolves, and as the system is tested during future periods of stress. The Financial Stability Monitor is a dynamic framework that we will adjust as conditions evolve.

The monitor's main limitations include:

- It may miss some vulnerabilities, especially those that are hard to quantify. For instance, containing operational risk, and cyberattacks in particular, is important to assure infrastructure resilience. But it would be a

Figure 2-7. Composition (A) and Construction (B) of the Financial Stability Monitor



Source: OFR analysis

challenge to develop metrics to monitor cyber-related vulnerabilities, assess their systemic impacts, and identify gaps in oversight.

- A number of the indicators in the monitor are near-coincidental. More work is needed to make it more forward-looking. The difficulty in providing early warnings or reliable turning points may not allow policymakers time to take action to avoid a crisis or substantially dampen its effects.
- The Financial Stability Monitor does not take into account systemwide feedback effects, changes in historical relationships, or different phases in the business, credit, and monetary policy cycles.
- Because the Financial Stability Monitor is calculated relative to historical norms, it does not account for unprecedented events, although post-crisis forensic analysis may still be informative.

We are seeking ways to make the monitor more forward-looking — not to try to predict shocks with precision, but to signal that trouble might be on the horizon. We are also working to increasingly take into account the complexity and interconnectedness of institutions and markets, as well as the channels that can transmit or amplify shocks.

Since the OFR introduced the Financial Stability Monitor one year ago, we have substantially refined our framework. First, we expanded the monitor's breadth and depth, and acquired data to populate the underlying metrics. Second, we conducted performance tests on the underlying indicators to gauge each one's reliability. We identified indicators that can provide early warnings, identify critical thresholds, and

Back-testing the Financial Stability Monitor

The Financial Stability Monitor was designed based on historical experiences that inform our understanding of the preconditions that lead to crises. To assess the quality of the underlying indicators in the monitor, we tested each indicator for its ability to capture extreme events such as market peaks and troughs, identify turning points, and give early warning signals of stress at a reasonable horizon during prior crises (see Arsov and others, 2013; Dattels and others, 2010).

We looked at selected historical crisis episodes to assess how the range of indicators performed. If a particular indicator performed poorly on all three tests, we removed it from the monitor. Indicators that performed well on the tests were weighted more heavily.

The tests are summarized as follows:

EARLY WARNING SIGNAL

The early warning signal tested an indicator's ability to signal stress far enough in advance to give policymakers time to implement contingency measures. We tested each underlying indicator against a proxy for systemic risk, the Financial Stress Index published by the Federal Reserve Bank of Cleveland (FRB Cleveland).

We applied a Granger causality test, a statistical technique that tests if one time series precedes (or "Granger-causes") another. We used F-tests to test whether lagged information on a variable in the monitor provided statistically significant information about the FRB Cleveland stress index. If it did not, we gave it a low score on its early warning characteristics. A final early warning score was computed by taking a simple average of the measure's performance on the Granger causality and lag-length regression tests.

EXTREME EVENT SIGNAL

The extreme event tested an indicator's ability to forecast extreme stress events such as market peaks and troughs with reasonable accuracy. We used a statistical technique known as logistic regression to test lags of each indicator against periods of high financial stress. We defined a period of high stress occurring when the FRB Cleveland stress index exceeded its 75th percentile on a historical basis. The extreme event score was computed by taking a simple average of the measure's performance based on statistical significance and model fit.

TURNING POINT SIGNAL

The turning point tested an indicator's ability to capture the timing of critical turning points during a stress event. We examined how each indicator performed ahead of sharp and sustained equity market selloffs during recent crises, such as the January 1991 savings and loan crisis, the July 1997 Asian financial crisis, the August 2000 bursting of the U.S. Internet bubble, and the July 2007 global credit crisis. To reach our turning point conclusions, we asked four questions:

1. Did the indicator fall outside the threshold (defined as plus or minus one standard deviation from the mean) six months ahead of the stress event, providing an early warning signal?
2. Did the indicator fall outside the threshold during or within six months after the stress event, capturing its severity?
3. Did the indicator signal a stress event that never materialized over the next 12 months? If so, we classified it as a false positive error.
4. Did the indicator fail to signal a stress event before or during a stress event that actually materialized? If so, we classified it as a false negative error.

Identifying measures that provide consistent early warning signals is a challenge for policymakers. Our initial findings showed few indicators performed well in identifying early warning signals. However, a large number performed better in the extreme event study. A mix of market- and institution-based indicators across all five risk categories included in the Financial Stability Monitor showed some ability to identify and capture stress events. Measurements that estimate the impact of broader financial distress on a specific bank's market value or insurance premium performed well in all the tests, and so did measures of volatility, corporate credit pricing, and asset return correlation.

The turning point exercise produced mixed results in testing for errors. While more than 90 percent of the measures were able to capture the stress events, many signaled false positives. A policymaker might worry less about false positives and prefer to err on the side of caution rather than overlooking a stress event entirely. In any case, follow-up analysis and judgment will be needed prior to taking any action.

The indicators we selected seem to successfully capture mounting risks ahead of selected crisis events and to help us evaluate their depth. But it is only one tool in our toolkit. We continue to identify and develop forward-looking indicators that may help improve our ability to monitor vulnerabilities.

accurately mark the severity of a crisis (see **Back-testing the Financial Stability Monitor**). Third, we shifted from an equal-weighting scheme to one that gives more weight to indicators that generate a higher-quality signal.

OTHER MONITORING ACTIVITIES

The Financial Stability Monitor is just one tool policymakers can use to monitor the health of the financial system. It is a starting point to highlight potential weak links that require further investigation. It should be accompanied by rigorous and robust quantitative assessments, such as stress tests and macroprudential surveillance.

The OFR is building a suite of monitoring tools to assess risks to the financial system (see **Building Tools for Financial Stability Monitoring**). Some will appear as analytical tools or as working papers, including one that describes our Financial Stability Monitor in greater detail. We will also publish research briefs about some of the current threats in this chapter.

Macroprudential surveillance, a complement to this toolkit, contains five critical elements:

1. Robust technology and granular data to monitor price fluctuations, transactions, and investor positioning across assets.
2. Real-time market intelligence-gathering from a broad range of sources.
3. Flexibility to update surveillance techniques as financial instruments and markets evolve.
4. Collaboration and routine information-sharing with regulators in the United States and internationally.
5. Ability to communicate concerns promptly to authorities when action may be needed.

Central banks, regulators, and supervisors collect large amounts of data and intelligence about financial institutions and markets (see Watkins, 2008). Authorities have made significant progress since the financial crisis, with greater access to detailed financial data, enhanced monitoring efforts, and expanded sources of information through interagency briefings, surveys, and interactions with industry and market participants.

But more is needed. There is no integrated platform to analyze large amounts of data across asset classes, nor are there sufficiently detailed data to detect real-time vulnerabilities in major asset markets or key participants. Surveillance efforts

Building Tools for Financial Stability Monitoring

The tools we are developing to assess risks to the financial system include:

MONITORING PRODUCTS

Financial Markets Monitor for the public that summarizes major developments and emerging trends in global capital markets. A version is currently distributed or presented roughly twice a month to the Council and its Systemic Risk Committee.

Interactive money market fund monitor that examines holdings of individual funds and the industry as a whole on the basis of credit, interest rate, and liquidity risk.

Credit default swap monitor that provides analytics on various financial stability metrics in the credit default swap (CDS) market, such as market concentration and interconnectivity.

Liquidity library to monitor market liquidity conditions on a broad, high-frequency basis.

Hedge fund monitor based on regulatory and commercial data to provide insights into this traditionally opaque alternative asset class.

MONITORING-RELATED PAPERS

Methodology paper on the Financial Stability Monitor.

Reference guide on U.S. repurchase agreement (repo) and securities lending markets. The guide will examine how dealers and their clients use these markets, building on the Office's ongoing research on the sources and uses of short-term funding, and will identify potential vulnerabilities and data gaps.

Short, nontechnical papers analyzing potential emerging threats to financial stability in our new OFR Briefs series (see **Section 4.5**).

are overly dependent on potentially unobjective market participants to provide intelligence and data.

The Securities and Exchange Commission's (SEC's) Market Information Data Analytics System and the Financial Industry Regulatory Authority's Order Audit Trail System and planned Consolidated Audit Trail are steps in the right direction (see **Section 6.3**). But they were not designed to support the analysis of financial stability and they cover only public markets. Large gaps in coverage remain and the process for collecting critical data and developing sophisticated technology can be slow.

Monitoring tools need to be improved. For instance, natural language processing tools could be more widely used to identify and monitor emerging trends and themes (see Leskovec and others, 2009), to develop more timely and accurate metrics for monitoring and forecasting macroeconomic variables (see Choi and Varian, 2009; Antenucci and others, 2014), and to understand the impact of disparate information sources on markets such as how markets interpret negative and positive economic news (see Sinha, 2010).

While monitoring tools provide insight into the buildup of vulnerabilities, they reveal little about the amplification and propagation of shocks. For those insights, we need other forensic analytical tools. For example, we can apply agent-based models to financial markets to run dynamic simulations and observe how an individual agent's behavior can transform a crisis by withdrawing funding or selling assets (see **Section 4.2**). Unlike existing monitoring tools, dynamic agent-based simulations can help explain complex situations in which the relationships among variables do not necessarily follow historical patterns.

Although accommodative policy supports a robust economic recovery, there are increasing signs that the Federal Reserve's low interest rate policy may be encouraging excessive risk-taking in some asset classes, increasing the potential for adverse market outcomes.

2.3 Potential Threats to Financial Stability

Although overall financial stability risks are not particularly elevated, some vulnerabilities have intensified. In this section, we take a closer look at the risks that either signal further deterioration or suggest caution is warranted. We highlight cyclical vulnerabilities, many of which are interrelated. For example, low interest rates combined with low market volatility may have reinforced excessive risk-taking related to credit and liquidity. A reversal in these conditions could interact with underlying vulnerabilities to pose a threat to financial stability. We also highlight structural vulnerabilities in market liquidity, run risk in short-term wholesale funding markets, market infrastructure, and risk migration.

Cyclical Risks

INTEREST RATE RISKS

The risk associated with keeping long-term rates low for a protracted period and the challenge of managing a smooth exit from extraordinary monetary policy remains a recurring theme. Although accommodative policy supports a robust economic recovery, there are increasing signs that the Federal Reserve's low interest rate policy may be encouraging excessive risk-taking in some asset classes, increasing the potential for adverse market outcomes. These signs include an increase in corporate credit risk (for example, low long-term borrowing costs have encouraged nonfinancial corporates to increase leverage to peak levels prevailing in 2005-07); carry trades and other trading strategies that are contingent on volatility remaining low; and a shift into higher-yielding but less liquid assets.

There is a tradeoff between mitigating excessive risk-taking and promoting the mandated macroeconomic objectives of the Federal Reserve. While the purpose of quantitative easing is to encourage risk-taking in an effort to spur economic growth, there may be a point at which it could also increase the vulnerability of the financial system to a future shock. This illustrates the often-necessary complementarity between monetary policy, which addresses risks in the real economy, and macroprudential policy, which addresses potential financial stability concerns using a separate set of tools. In recent years, while monetary policy deliberately sought to stimulate economic risk-taking by boosting risky asset values, macroprudential policy narrowly targeted financial risk-taking in order to mitigate potential vulnerabilities (see **Chapter 3**).

Despite the recent market dislocation, market pricing and investment positions continue to suggest market participants expect interest rates to remain low, followed by a gradual rise when the Federal Reserve begins to tighten monetary policy. This expectation is reflected, for instance, in: (1) low near-term market-implied interest rates and low nominal growth expectations relative to the forecasts of the Federal Open Market Committee (FOMC); (2) depressed medium-term interest rate and inflation expectations relative to prior monetary policy cycles, as implied by yields on five-year U.S. Treasury notes five years ahead (see **Figure 2-8**); and (3) elevated duration in bond portfolios.

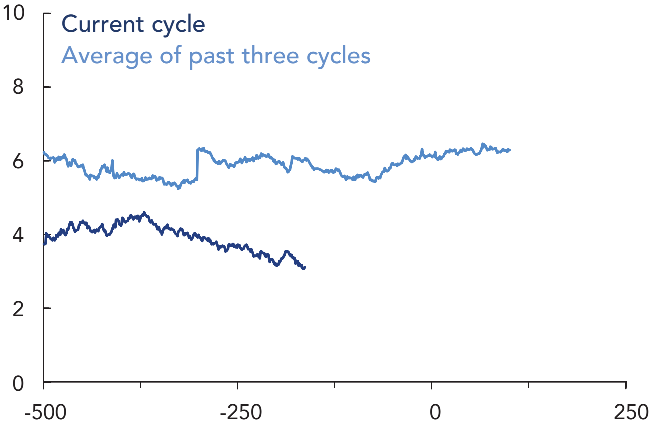
There are a few important potential risks associated with the policy normalization process. First, there is the risk that the adjustment occurs more quickly than some market participants expect — this could have adverse results, for example, investors could experience large portfolio losses on longer-dated assets, and bank depositors could shift large amounts from banks to alternative, higher-yielding investments. Second, there is the risk that financial markets may overreact to a change in policy, causing destabilizing volatility and conditions to tighten more quickly than policymakers would otherwise like, both domestically and abroad.

When we published our 2013 annual report, the duration of a typical U.S. fixed-income portfolio was high, suggesting that investors were not particularly concerned about an imminent rise in long-term interest rates. (Duration measures the vulnerability of a portfolio of assets to a rise in interest rates.) Portfolio duration is even higher today. An immediate 100 basis point shock to interest rates would result in an estimated $212 billion (unhedged) loss to U.S. bond mutual funds, or 5.6 percent on average across funds — well above estimated losses at this point in previous monetary policy cycles (see **Figure 2-9**). Losses from a given change in interest rates would be larger than in the past.

Outsized losses may be difficult for some market participants to absorb in the event of an unanticipated increase in long-term rates. Of course, the impact of such losses depends on the distribution, time frame, hedging activity, and other conditions. For instance, losses that are concentrated in entities with large unhedged positions or with mismatches between assets and liabilities would likely be more difficult to absorb.

Figure 2-8. Five-Year/Five-Year Forward Rates During Federal Reserve Tightening Cycles (percent)

Long-term interest rate and inflation expectations are low compared to historical tightening episodes

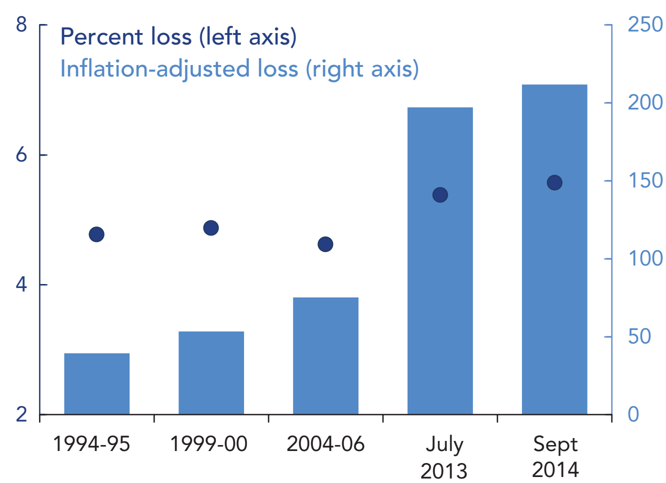


Note: Data are based on prior periods U.S. monetary policy tightening starting in February 1994, July 1999, and July 2004. Hypothetical interest rate tightening in the current cycle is assumed to begin in June 2015, as implied by interest rate futures markets. The horizontal axis represents the number of trading days before and after the first interest rate hike (which occurs at time t=0).

Sources: Bloomberg L.P., OFR analysis

Figure 2-9. Estimated Loss to U.S. Bond Funds Following a 100 Basis Point Shock to Interest Rates ($ billions and percent)

Extended duration increases vulnerability to interest rate shocks

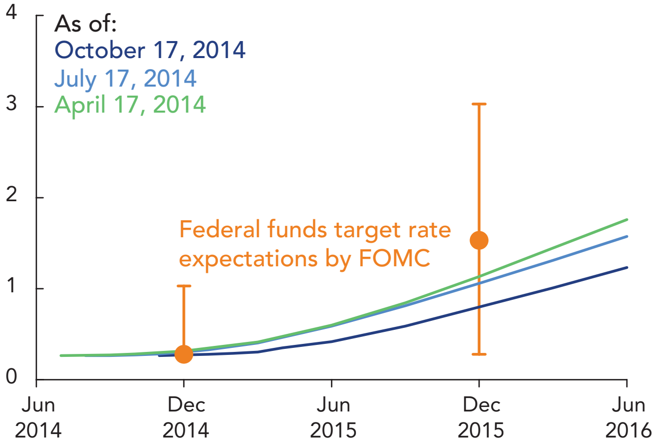


Note: Data are based on prior periods of U.S. monetary policy tightening starting in February 1994, July 1999, and July 2004. For the 1994-95 cycle, bond convexity is set to zero, because convexity data for that period are unavailable. The Barclays Capital U.S. Aggregate Float Adjusted Index which excludes the Federal Reserve's holdings of MBS and Treasuries, was used as a proxy for duration of an average fixed-income portfolio. Modified duration stood at 5.6 years during the month of September 2014, a long-term peak.

Sources: Bloomberg L.P., Haver Analytics, OFR analysis

Figure 2-10. Three-Month Eurodollar Futures (percent)

Market-implied interest rate expectations are more dovish than Federal Open Market Committee (FOMC) projections



Note: Expectations are based on the Federal Reserve's September 17, 2014 FOMC meeting. The federal funds target rate is the policy rate determined by the FOMC. Whiskers represent the range of FOMC projections and dots represent median FOMC projections.

Sources: Bloomberg L.P., Board of Governors, OFR analysis

Interest rate risk extends beyond nonfinancial bond portfolios. On the liability side, a reversal of banking system deposits is a potential risk once interest rates rise. U.S. banks have seen dramatic growth in their non-interest-bearing deposits relative to total banking system liabilities. There is a non-negligible risk that these deposits could shift to alternative, higher-yielding investments as rates rise. The lack of historical data on deposit behavior at near-zero rates, coupled with structural changes post-crisis, make it difficult to quantify potential deposit outflows if rates were to normalize. Additional institutional deposit outflows may also occur as a result of a reallocation by eligible participants to the Federal Reserve's Overnight Fixed-Rate Reverse Repurchase Agreement Operational Exercise.

More broadly, the Federal Reserve's monetary policy trajectory could have spillover effects on global interest rates, currencies, and capital flows, tightening domestic or global financial conditions more quickly than expected. Historically, tightening in U.S. monetary policy has been accompanied by a rise in interest rate volatility, as markets adjust to the shift in stance. (There are, of course, exceptions: in 2004, for instance, long-term rates and volatility rose only marginally in reaction to monetary policy tightening.)

During the past year, global monetary policies became less synchronized. Central banks in the United States and the United Kingdom took the first steps toward slowing the pace of policy accommodation, while central banks in Japan and the eurozone have further eased policy. Even if central banks can control short-term rates through forward guidance, there is a risk that normalization of the U.S. term premium could exert upward pressure on long-term rates in other countries. The sharp but short-lived selloff in emerging markets during the so-called Taper Tantrum in mid-2013 illustrates this risk.

The process of departing from a policy of low interest rates may also pose operational and market challenges. The FOMC's current strategy for normalizing monetary policy, when economic conditions permit, contains the following elements: (1) raise the target range for the federal funds rate and (2) reduce the Federal Reserve's securities holdings, primarily by ceasing to reinvest repayments of principal on securities held in its long-term securities portfolio.

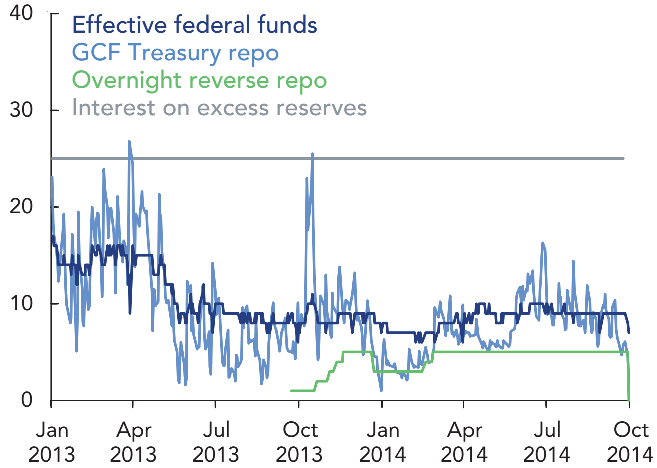
To implement this strategy, the Federal Reserve has said it will use the interest rate it pays on excess reserve balances as the primary tool to guide the federal funds rate into the target range, while relying on other tools, like the reverse repo and the term deposit facilities, to augment the process, if needed. This strategy is contingent on the evolution of economic and financial developments.

The more immediate challenges associated with the mechanics of the exit strategy include the lack of experience with new monetary policy tools, the difficulty of managing short-term interest rates in the normalization process, and reliance on a larger set of counterparties, all against the backdrop of ongoing regulatory reforms. Specifically, those challenges include:

- **Communication challenges.** Enhancing its communications strategy has been a long-term priority for the Federal Reserve. There has been considerable improvement in transparency (see Yellen, 2012; Jeremy Stein, 2014). However, the Federal Reserve has never implemented such a complex exit strategy. There is noticeable skepticism among investors, as indicated by a gap between market-implied expectations of the future path of interest rates and the FOMC's projections (see **Figure 2-10**). Uncertainty could result if market participants misinterpret the plans or if the Federal Reserve's actions are perceived as incomplete or still evolving in response to changes in financial or economic conditions.
- **Inability to guide short-term rates.** In September 2013, the Federal Reserve authorized overnight reverse repo auctions to help control the federal funds rate. The reverse repo facility appears able to support the floor for overnight interest rates at the level paid by the facility. However, demand for the facility increases at the end of each quarter, at which time short-term market interest rates decline below the facility rate (see **Figure 2-11**). This dynamic suggests a potential challenge for the Federal Reserve to maintain the target for the effective fed funds rate. To mitigate the risk of significant shifts in short-term rates, the Federal Reserve plans to vary the rate offered on its overnight facility, adjust the facility cap, and provide term reverse repo operations.
- **Disintermediation and run risk.** Because the Federal Reserve may need to drain a large amount of its reserves to control the federal funds rate, the central bank expanded its list of authorized counterparties for the reverse repo facility beyond primary dealers. The Federal Reserve is now the largest counterparty in the triparty repo market,

Figure 2-11. Federal Reserve Policy Rates and Short-term Market Interest Rates (basis points)

The exit strategy may pose challenges guiding short-term market rates

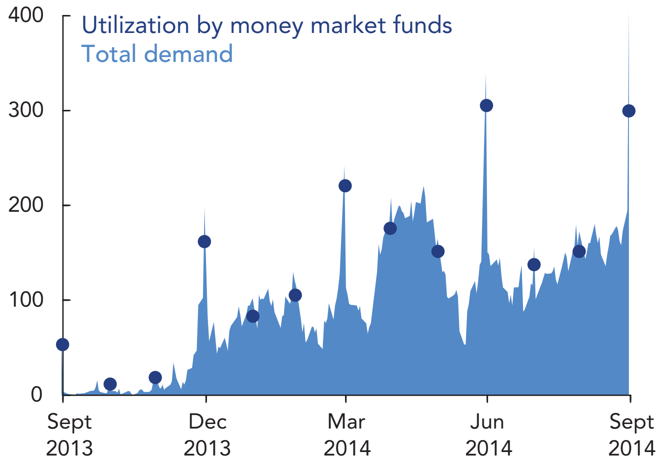


Notes: The overnight reverse repo facility began on September 23, 2013.

Sources: Bloomberg L.P., Board of Governors, Depository Trust & Clearing Corp., Federal Reserve Bank of New York

Figure 2-12. Federal Reserve Reverse Repo Facility Demand and Utilization ($ billions)

Utilization spikes at the end of each quarter reflect increased demand from money market funds



Note: Money market fund utilization data are available on a monthly basis.

Sources: Federal Reserve Bank of New York, SEC Form N-MFP, OFR analysis and its role is likely to remain substantial, subject to a cap. As new nonbank counterparties rely on the reverse repo facility as an overnight cash investment, the Federal Reserve may potentially supplant other funding intermediaries, the consequences of which are difficult to fully project (see **Figure 2-12**). This risk of disintermediation should be mostly contained by limiting the size of the facility and by phasing it out when it is no longer required for monetary policy normalization purposes.

CREDIT RISKS

Vulnerabilities to credit-related risks highlighted in our annual report last year persist; if anything, they have increased.

The traditional credit cycle goes through four phases:

- **Repair** (balance-sheet cleansing),
- **Recovery** (restructuring),
- **Expansion** (increasing leverage, weakening lending conditions, diminishing cash buffers), followed by
- **Downturn** (rising defaults, falling asset prices, increasing funding pressure).

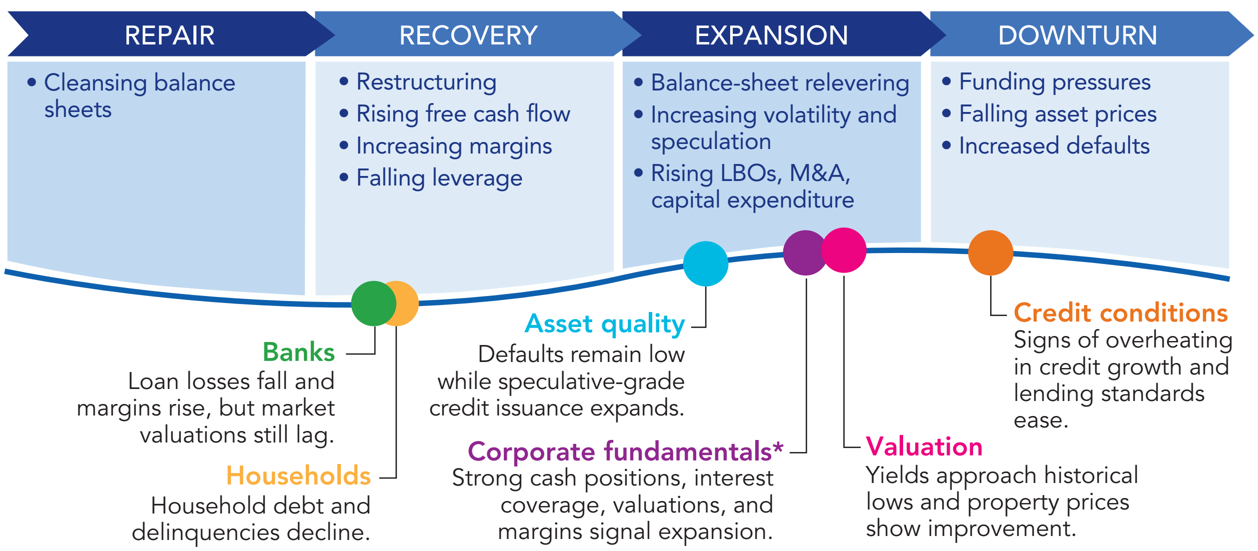
Figure 2-13 illustrates where we are in the credit cycle. Most nonfinancial corporate credit market indicators show the United States is currently somewhere between the expansion and downturn phases, while the household and banking sectors are still recovering from the financial crisis. Nonfinancial corporate balance-sheet leverage is still rising, underwriting standards continue to weaken, and an increasing share of corporate credit risk is being distributed through market-based financing vehicles that are exposed to redemption and refinancing risk. Credit spreads remain tight and risk premiums low, even after the repricing that occurred in September and October 2014.

Earlier in the cycle, corporations issued long-term debt to replace short-term debt and to finance capital expenditures, but the share of proceeds allocated to these activities has diminished. Proceeds are instead being used in ways that increase leverage such as through stock buybacks, dividend increases, mergers and acquisitions, and leveraged buyouts, rather than to support business growth.

Low interest rates and looser bank lending standards have encouraged a rapid expansion in corporate credit. These conditions have enabled corporations to reduce debt servicing costs and lock in a low cost of funding. But easy

Figure 2-13. Where Are We in the Credit Cycle?

Late-cycle behavior is becoming increasingly pronounced



Note: Metric includes credit growth, lending conditions, leverage, interest coverage, capital expenditures, EBITDA margins, bond yields, housing prices, default rates, non-performing loans, price-to-book ratio, gross debt, foreclosures, and delinquencies. The current value of each credit metric was compared to the range of values in each phase for the last credit cycle ending around 2007-08 and placed accordingly. EBITDA is an indicator of a company's operating performance and refers to earnings before interest, tax, depreciation, and amortization.
* Corporate fundamentals data are through Q1 2014.

Sources: Bloomberg L.P., Haver Analytics, Morgan Stanley, OFR analysis credit conditions have also allowed companies to lever up, perhaps taking on more debt than they can service. The ratio of debt to earnings before interest, taxes, depreciation, and amortization for the most highly leveraged loans rose to 7.7 in October 2014, up from a low of 5.5 in 2009, and is approaching the peak registered in 2007. Even an average rate of default could lead to outsized losses once interest rates normalize, given the expansion in corporate debt.

The quality of new debt issued by companies has also been weaker than in previous cycles. High-yield debt accounts for 24 percent of total corporate debt issued since 2008, compared with 14 percent during past cycles, and low-rated credits dominated new issuance volumes over the past year. Companies have also taken advantage of looser bank lending standards. Two-thirds of loans to companies during this cycle have been covenant-lite (lacking strict legal covenants), compared with 33 percent during previous cycles (see **Figure 2-14**). In addition, there has been a trend of eroding debt cushions for covenant-lite loans and a significant increase in bank debt-only structures. These attributes are likely to lead to lower recovery rates on defaulted credit instruments once the credit cycle turns.

The combined issuance of collateralized loan obligations — securities backed by pools of corporate loans — and leveraged loans, which are higher-risk bank loans often sold to institutional investors, has exceeded the peak levels of the last credit cycle. Bank regulators are clearly aware of the buildup in credit risk and have responded with guidance and exhortations to banks (see **Section 3.5**).

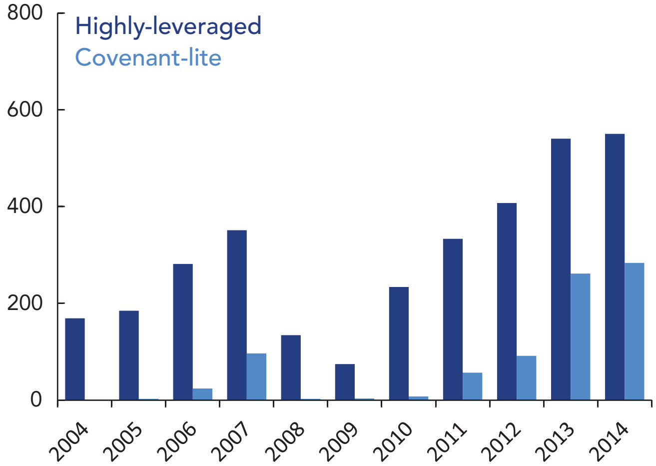
Leveraged loans are often viewed as a hedge for investors against a rise in interest rates because they tend to carry floating rates. However, interest rate risk may be higher than perceived, because recent deals have been sold with high interest rate floors. Were the Federal Reserve to tighten monetary policy, causing market rates to rise, the value of those floors would decline initially and prices on leveraged loans would fall.

For now, still-strong retained earnings and better liability management help companies mitigate potential refinancing risk. But as the cycle turns from expansion to downturn, the buildup of past excesses will eventually lead to future defaults and losses.

Some investors remain undeterred by the deterioration in corporate credit fundamentals and rising debt levels. Although corporate credit spreads are not excessively tight

Figure 2-14. New Issue Covenant-Lite and Highly-Leveraged Loan Volumes ($ billions)

New issuance reflects weak covenant structures and higher deal leverage

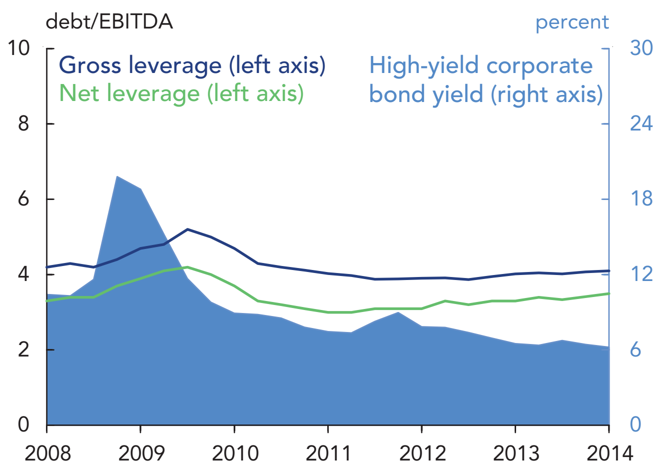


Note: 2014 data are based on annualized data through September 30, 2014. Highly-leveraged loans are defined as loans with a spread of London Interbank Offered Rate (LIBOR) + 225 basis points or more.

Sources: Standard & Poor's, OFR analysis

Figure 2-15. High-Yield Corporate Leverage and Bond Yield

Rise in leverage has not translated into a higher cost of credit

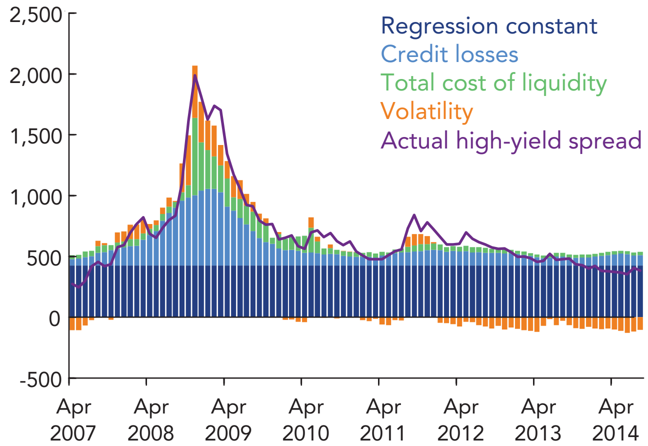


Note: EBITDA is an indicator of a company's operating performance and refers to earnings before interest, tax, depreciation, and amortization. Gross leverage is the ratio of total debt to EBITDA. Net leverage is the ratio of net debt to EBITDA, where net debt is total debt less cash and short-term investments.

Sources: Haver Analytics, JPMorgan Chase & Co., OFR analysis

Figure 2-16. Fair Value of U.S. High-Yield Bond Spread (basis points)

Depressed volatility and liquidity risk premia contribute to underpricing in high-yield bonds

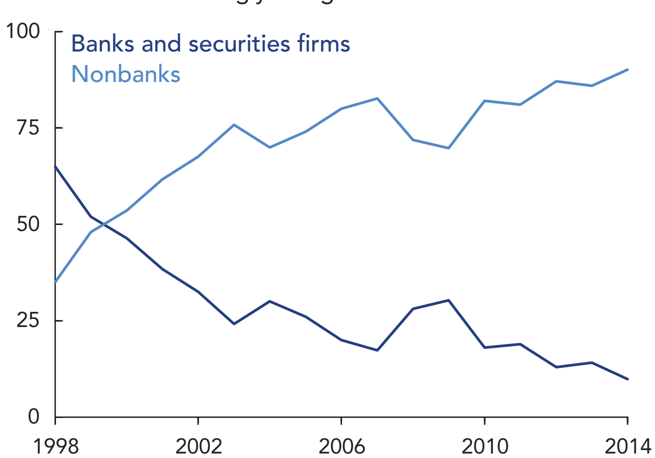


Note: Credit losses are defined as the expected loss from default (using Moody's actual and forecast high-yield default rates and assuming a constant 30 percent recovery rate). Volatility is based on an average of the normalized VIX and MOVE indices. The cost of liquidity incorporates two components: cost of trading (defined as high-yield bond turnover multiplied by bid-ask spreads), and the opportunity cost of cash (defined as mutual fund liquidity).

Sources: Bloomberg L.P., Haver Analytics, Moody's Analytics, OFR analysis

Figure 2-17. Primary Market for Highly Leveraged Loans: Banks versus Nonbanks (percent)

Credit risk is increasingly being distributed via nonbanks



Note: Nonbanks include institutional investors, insurance companies, and finance companies. Data for 2014 are through June 30, 2014. Highly-leveraged loans are defined as loans with a spread of LIBOR + 225 basis points or more.

Source: Standard & Poor's

relative to the historical trend, yields on leveraged loans and high-yield bonds, and spreads per unit of leverage, are at historic lows. Current low rates indicate investors are not being compensated for the incremental increase in corporate leverage (see **Figure 2-15**). Mispricing is also evident from the fair value estimates we calculated based on a set of fundamental determinants of high-yield bonds. High-yield bond spreads are roughly 50 basis points rich based on our estimates (see **Figure 2-16**). Credit, liquidity, and volatility risk have contributed to the mispricing, and all three risks tend to rise simultaneously during periods of stress.

Product innovation has also increased in corporate credit markets, a hallmark of late-stage credit cycles. Recent issues have provided broader, cheaper access to credit such as exchange-traded, high-yield, and leveraged loan funds; total return swaps on leveraged loans; and synthetic collateralized debt obligations. This development contrasts with limited innovation elsewhere in the financial system.

Nonbank lenders have increased their credit exposure significantly since the financial crisis (see **Figure 2-17**) and engage in riskier deals than banks because of low interest rates (see Aramonte, Jung, and Stebunovs, 2014). The composition of investors in the corporate bond market has also changed since 2007. Insurance companies and pension funds collectively own about one quarter of outstanding corporate bonds, but mutual funds and exchange-traded funds (ETFs) are rapidly catching up. Investments in corporate bonds by mutual funds and ETFs have increased by 500 percent to $622 billion since the end of 2008, with almost half allocated to high-yield bonds. Short-duration funds, which invest in leveraged loans, have shown the most significant growth. Assets under management have increased ten-fold over the last five years, driven by a search for yield and a hedge against an eventual rise in interest rates. In sum, much of the recent growth in credit risk-taking is concentrated in nonbank entities that are not directly regulated by banking supervisors.

VOLATILITY RISKS

In our last annual report, we discussed the volatility paradox — the increased potential for excessive leverage or risk-taking during periods of low volatility. Expectations of low volatility and continued benign conditions paradoxically incentivize market participants to extend risk positions, sowing the seeds of financial stress and high volatility when excesses unwind. This section analyzes broad developments in volatility markets, documenting where volatility has

Carry Trades Rise When Volatility Is Low

Investors' expectations of low volatility have increased the popularity of carry trades.

In its broadest sense, a carry trade is a trade that takes advantage of the difference between the income stream earned on a financial contract or asset and the cost of funding to hold the asset. Carry trades are most predominant in currency, fixed-income, volatility, and derivatives markets.

In a simple currency carry trade, an investor borrows a currency with low interest rates to finance the purchase of a higher-yielding currency. The trade generates an income stream, or carry, while the investor holds the asset. The final returns on the investment depend on the difference in interest rates and the movements of the exchange rate between the two currencies. A depreciation of the higher-yielding currency can offset the returns from the interest rate differentials.

Carry trades have implications for financial stability (see FSOC, 2014). A crowded carry trade position — when many investors use similar trading strategies — may contribute to excessive volatility during a market selloff as investors liquidate positions at the same time. The inherent leverage can amplify losses that stem from higher funding costs and reduced returns on long positions.

Market conditions that support the activity and performance of carry trades are relatively easy to track. Carry trade performance is gauged by the returns on portfolios with long positions in high-yielding assets and short positions in low-yielding assets. This measure shows that while returns were positive for the first eight months of 2014, they have declined from those registered between 2004 and 2007 (see **Figure 2-18**). The rally in the U.S. dollar has wiped out most of the year-to-date returns for dollar-funded carry trades, and there is some evidence that fewer leveraged investors have been involved in currency carry trades.

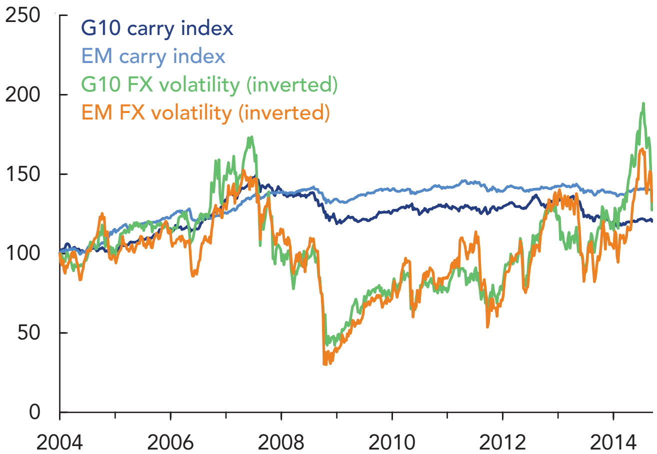
The CFTC reports the positioning of speculative traders in foreign exchange futures contracts on the Chicago Mercantile Exchange. While a useful guide the data do not differentiate carry trades from other trades, and forward markets are not captured. The flow of funds across borders is another potential proxy for activity. However, gross portfolio debt inflows do not show a particularly strong link with the carry-to-risk ratio over a long period.

Another important metric is the likelihood of carry trades to unwind. For instance, the Barclays Capital Carry Unwind Risk Index measures the probability of a decline in carry trades based on volatility, swap spreads, speculative positioning, and an estimated price of risk (see **Figure 2-19**). That index showed an increase in the probability of a broad selloff as volatility temporarily rose in October.

To monitor carry trade activity, we need better data. The Depository Trust & Clearing Corporation (DTCC) has been collecting data on derivatives positions and could expand the granularity of such data to identify investors who simultaneously hold short positions in low-yielding currencies and long positions in high-yielding currencies. Similarly, the CFTC could provide more disaggregated classification data to include a similar identifier.

Figure 2-18. Foreign Exchange Carry Returns and Implied Volatility (Index January 2, 2004 = 100)

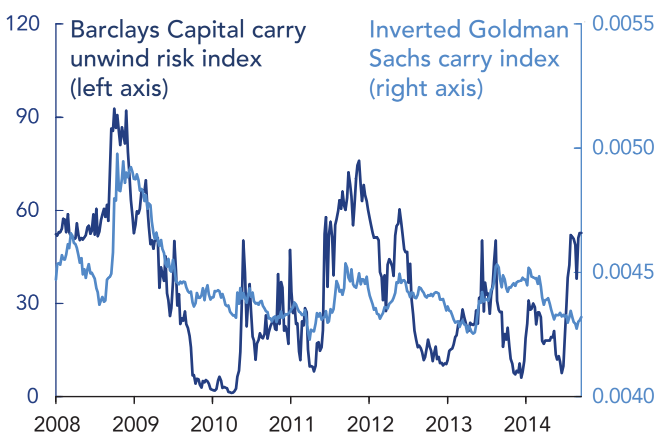
Low volatility has supported carry trade returns



Note: The G10 carry index is the Barclays Intelligent Carry Index. The EM carry index is the Citi Foreign Exchange Emerging Markets Carry Beta Index. G10 FX volatility (inverted) is the Deutsche Bank Currency Volatility Index. EM FX volatility (inverted) is the J.P. Morgan Emerging Market Volatility Index.

Figure 2-19. Risk of Carry Unwind Leads Carry Index

The risk of a reversal in carry trades increase with a rise in volatility

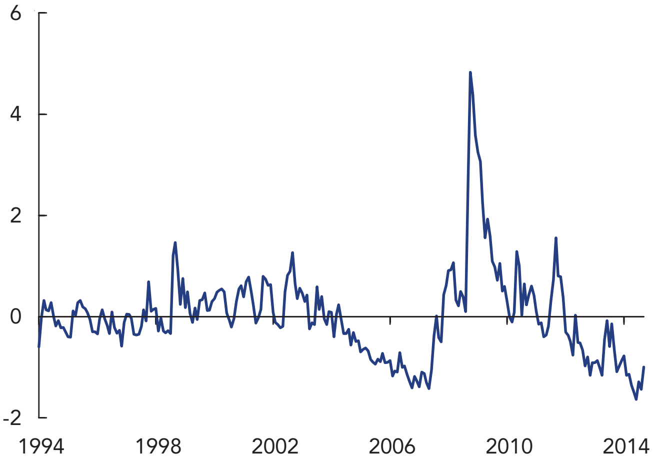


Note: A decrease in the Barclays Carry Unwind Risk Index represents a decrease in the risk of carry unwinds. A decrease in the inverted Goldman Sachs Carry Index indicates the index is increasing in value.

Sources (both charts): Bloomberg L.P., OFR analysis

Figure 2-20. Implied Volatility Indexes (normalized to Z-scores)

Implied volatility is unusually low across all major assets…

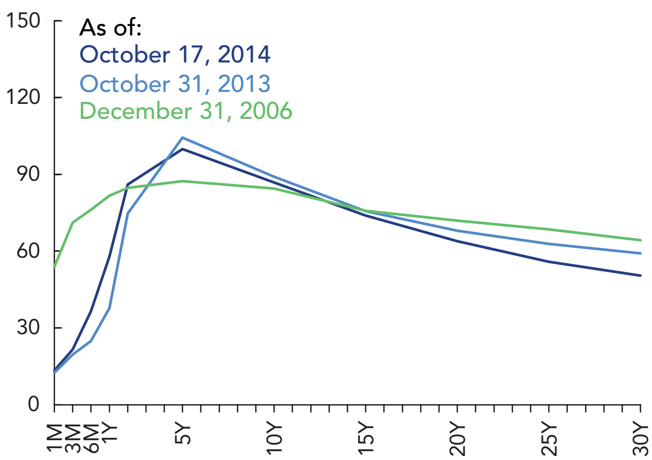


Note: Simple average of the standardized Chicago Board Options Exchange Equity Market Volatility Index (VIX)®, the three-month Deutsche Bank Currency Volatility Index (CVIX), and the Merrill Option Volatility Estimate Index (MOVE) based on data since January 1991.

Sources: Bloomberg L.P., OFR analysis

Figure 2-21. One-Year Swap Rate Volatility Term Structure (basis points)

…although steeper curves reflect uncertainty in the longer run



Note: The x-axis indicates option expiry dates.

Source: Bloomberg L.P.

Option-implied volatility has rarely been so low over this length of time across such a wide range of assets.

declined and the factors keeping it low. This type of analysis is essential to complement market-based measures that tend to reflect low risk when volatility is low.

Option-implied volatility has been unusually low across most major asset markets during the post-financial crisis period, with brief interruptions in mid-2013 when the Federal Reserve indicated it might reduce asset purchases sooner than investors expected and in October 2014 as investors reassessed their expectations for global growth (see **Figure 2-20**). Similarly, a measure of the attractiveness of selling volatility — the difference between implied and trailing one-month realized volatility — is also at low levels. Since September 2014, there has been some evidence that risk sentiment is beginning to shift. The slope of the volatility curve has steepened somewhat, reflecting increased concern about a rise in volatility in the intermediate term (see **Figure 2-21**), and demand for downside protection has increased in some markets, notably foreign exchange and equities.

Option-implied volatility has rarely been so low over this length of time across such a wide range of assets. Low volatility creates moral hazard by reducing investors' perception of risk. A sustained period of low volatility can lead investors to an increased use of carry trades and willingness to use leverage inexpensively through options to amplify returns (see **Carry Trades Rise When Volatility is Low**). This in turn sows the seeds for a market reversal, as market participants become too levered and reduce their buffers against adverse shocks.

Several factors have contributed to the decline in volatility:

- **Less uncertainty about future monetary policy.** The dispersion of risk-neutral option-implied expectations has narrowed for the federal funds rate, the interest rate set by the Federal Reserve for a bank to lend overnight funds to another bank. That suggests convergence across investors on the central bank's monetary policy plans. To be clear: there is reduced uncertainty amongst market participants on the timing and pace of interest rate hikes, but still high uncertainty on the mechanism of exiting from unconventional policies.
- **Less uncertainty about the economic outlook.** Lower volatility in asset prices is linked to lower volatility in forecasts about inflation and economic growth.
- **Reduced signs of financial stress.** Periods of significant financial stress can generate market volatility.

The OFR Financial Stress Index

Our Financial Stress Index (FSI) is a real-time snapshot of global risk appetite. When it is low or declining, it signals risk appetite is high or increasing. Its purpose is to distill information embedded in daily market pricing into a measurement of global financial stress, which can be further decomposed into various dimensions of stress.

While the Financial Stability Monitor signals the buildup of vulnerabilities across different dimensions of risk, the OFR's FSI shows the overall risk appetite of market participants. The markets included in the FSI are based on their responsiveness to factors associated with financial stress. They include equities, high-yield debt, emerging market assets, volatility, and other traditional risk assets (see **Figure 2-1** in **Section 2.2**).

The index uses a statistical technique called principal component analysis, which identifies the unique factors or components that influence the total variation across the sample. The FSI uses a rolling window on the set of inputs in order to take into account changes in market conditions.

To construct the index on a given date, we first use a subset of the data from the previous 500 trading days. Each of the series in this subset is standardized to have zero mean and variance equal to one. A principal components analysis is run on these standardized series and the first principal component is extracted. This first principal component, which by construction reflects the extent that the variables move together, is interpreted to reflect the degree of financial stress. The value of the FSI on the given date is then the projection of the actual data on the date along the first principal component.

A higher value of the index reflects greater financial stress and lower risk tolerance among investors. In contrast to financial stress indexes published by the Federal Reserve banks of Cleveland, Kansas City, and St. Louis, our FSI uses a statistical technique that allows the relationships among its risk factors to change over time. (We use a rolling principal component window rather than a static window, which allows us to capture relationships dynamically.) In addition, while other financial stress indexes focus on signals derived from U.S. capital markets, our FSI has a more global scope. This is intended to reflect the potential for contagion to transmit risk across national borders.

Figure 2-22 shows our FSI's performance over the past decade, including the contributions of five key risk factors.

Figure 2-22. OFR Financial Stress Index

The recent rise in stress reflects broad sources of instability

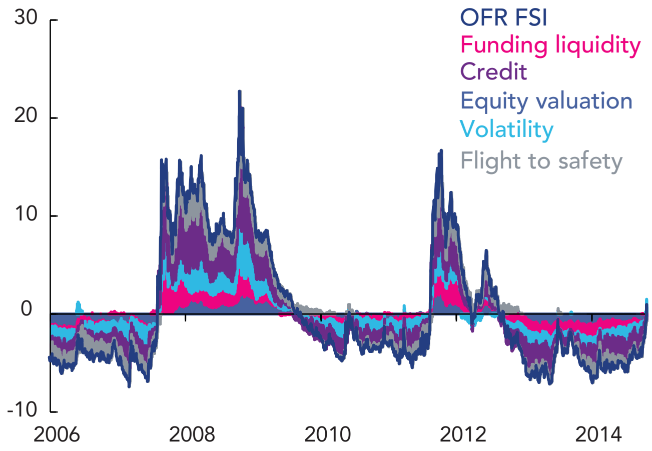
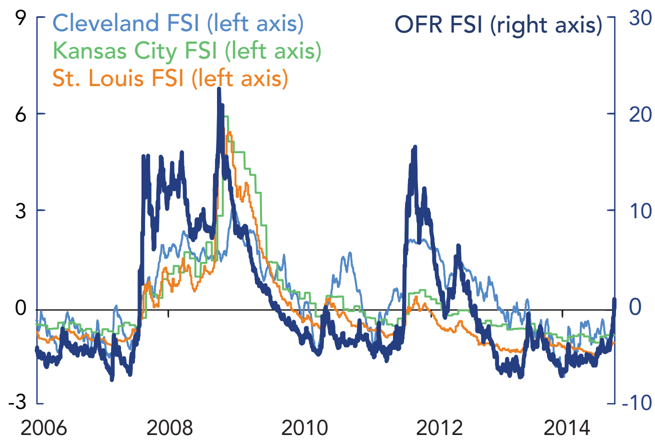


Figure 2-23. Comparison of the OFR and Federal Reserve Banks' Financial Stress Indexes



Sources (both): Bloomberg L.P., Federal Reserve banks of Cleveland, Kansas City, and St. Louis, Haver Analytics, JPMorgan Chase & Co., OFR analysis

Since January 2013, the index suggests that until recently, financial stress remained subdued, due primarily to low stress in short-term funding markets, credit markets, and volatility. While further investigation is needed, our initial findings suggest that the innovative construction and the broader reach appear to improve the responsiveness of the FSI relative to other indices. Note, for instance, that the index signaled increased stress — rising more steeply and sooner than other FSIs — prior to the beginning of the financial crisis in 2007, and again, during the more recent dislocation in September and October 2014 (see **Figure 2-23**).

Figure 2-24. Explanatory Variables

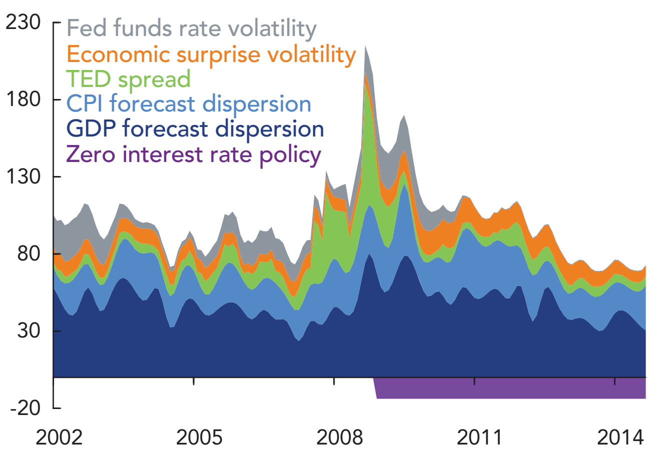
Area of Focus	Variables
Unconventional Monetary Policy	Zero-lower bound dummy
Dispersion of Market Expectations	CPI forecasts GDP forecasts Volatility of federal funds rate Volatility of U.S. Economic Surprise Index
Lack of Financial Stress	TED Spread
Reduced Mortgage-Related Hedging Activity	Size of Federal Reserve balance sheet Size of Fannie Mae and Freddie Mac retained portfolios

Note: The TED spread is the difference between the three-month U.S. Treasury bill interest rate and the London Interbank Offered Rate.

Sources: Bloomberg L.P., Federal Reserve Bank of Philadelphia, Haver Analytics, OFR analysis

Figure 2-25. Contributors to Interest Rate Volatility (basis points)

Macroeconomic and monetary policy clarity have lowered interest rate volatility



Sources: Bloomberg L.P., Federal Reserve Bank of Philadelphia, OFR analysis

Such stress occurred during the global financial crisis in 2007-09 and during the eurozone crisis in 2010-12. Since then, financial stress has receded (see **The OFR Financial Stress Index**).

- **Supply and demand in volatility markets have changed.** Greater willingness to sell volatility has also suppressed its price, driven by two developments. First, asset managers, high-yield funds, and leveraged loan funds have increased their short volatility positions, indicating they expect volatility to remain at a low level, at least in the near term. Second, a contraction in the balance sheets of the government-sponsored enterprises, Fannie Mae and Freddie Mac, led to reduced demand to hedge negative convexity risk and reduced demand for interest rate volatility protection.

We assessed the relative weight of these factors in explaining the current low levels of implied interest rate volatility (see **Figure 2-24**).

We found both structural and cyclical factors help to explain a reasonable amount of the overall level of implied volatility in interest rates. Contrary to expectations, there was no evidence that reduced demand to hedge mortgage-related securities has contributed to changes in volatility. The results confirm that greater clarity about the macroeconomic and monetary policy outlooks, in particular, was an important driver of implied volatility (see **Figure 2-25**). Any significant change in these factors (assuming coefficients remain stable) could lead to a reversal in the current low volatility environment.

EMERGING MARKETS

Low interest rates, stronger growth prospects, and greater risk appetite have attracted large capital flows into emerging market assets and enabled borrowers in emerging market economies to increase leverage. This section examines the growing investment in emerging markets and attempts to assess the importance of domestic and external factors as drivers of local currency emerging market bonds.

The same vulnerabilities highlighted in last year's annual report remain, including the risk of a reversal in capital inflows, the buildup of corporate debt, and the potential for a policy misstep as a result of diminished policy buffers. Despite the rise in idiosyncratic risks over the last year — such as Argentina's currency devaluation and default, the crisis in Ukraine (see **Russian and Eastern European Developments**), tensions in the Middle East, and concerns about an economic slowdown in China — spillovers to

Since the OFR's last annual report, tensions in Ukraine and Russia have increased, exposing regional financial markets to potential risks.

In late 2013, the Ukrainian government came under pressure from Russia not to sign a historic European Union (EU) deal. Russian militants began to take control of the Crimean peninsula and in mid-March 2014, Crimean voters passed a referendum to join Russia. After the referendum, the United States and the EU imposed sanctions against Russian individuals and companies, including travel bans, asset freezes, and restricted access to capital markets. Russia responded with retaliatory travel and trade sanctions. Violence continues in parts of eastern Ukraine.

Price declines have been limited to assets with significant exposure to Russia and Ukraine. Russian equities, bonds, and currencies sold off significantly after the United States and EU imposed several rounds of sanctions. The ruble is 20 percent weaker against the U.S. dollar, and external sovereign bond spreads are 135 basis points wider (see **Figures 2-26** and **2-27**). Spillovers have been limited in other regional asset classes.

TRANSMISSION CHANNELS

Escalation of the crisis could spread to financial markets in the United States and Europe through several channels. The first is through total foreign claims on Russia: external debt totals roughly $700 billion, of which foreign bank claims represented roughly $209 billion as of the first quarter of 2014. Some European banks are heavily exposed. The direct exposure of U.S. banks is a manageable $27 billion (or 0.8 percent of bank claims), but if other claims such as derivatives, guarantees, and trade credit are included, the combined exposure amounts to 3.4 percent. U.S. banks have tried to mitigate these risks by reducing their exposure to Russia.

Another direct linkage comes from financial investments. Roughly half of Russia's foreign portfolio assets are held by offshore centers, including holdings by investment funds. The dominance of these funds increases the vulnerability to outflows. Russia registered $85 billion of private capital outflows by nonresidents during the first nine months of 2014, an increase in the pace of outflows.

Stress could also be transmitted through energy trade and other macroeconomic channels. Russia accounts for 8 percent of global crude oil imports and the EU imports 25 to 30 percent of its crude oil and gas from Russia. A decline in overall domestic demand in Russia and Ukraine could also affect trade among major exporters, especially for nations in central Europe and the former Soviet Union.

An escalation in political tensions could lead to more aggressive sanctions and potentially more counter actions by Russia. Foreign financial institutions could be affected if Russia seized foreign assets or if the creditworthiness of Russian assets declined.

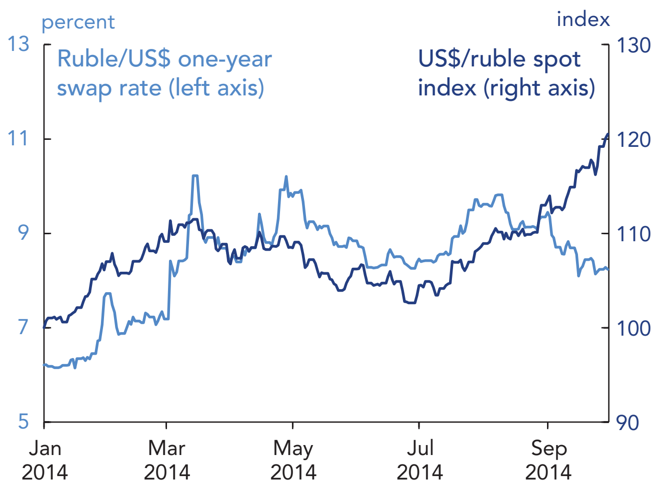
Figure 2-26. Performance of Russian Sovereign and Corporate Bonds

Russian assets under significant pressure as geopolitical risks rise

Note: CEMBI is the Corporate Emerging Market Bond Index denominated in U.S. dollars. EMBIG is the Emerging Market Bond Index Global denominated in hard currency. GBI-EM is Government Bond Index-Emerging Markets denominated in local currencies. All three are JPMorgan Chase & Co. indexes.

Sources: Bloomberg L.P., JPMorgan Chase & Co., OFR analysis

Figure 2-27. Performance of Russian Ruble and Cross-Currency Basis Swap

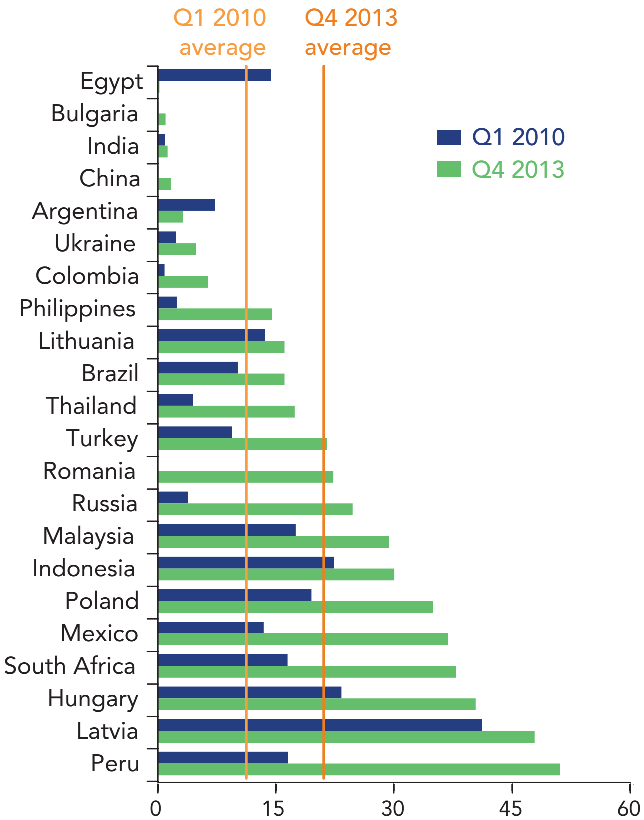


Note: An increase in the spot rate is associated with a depreciation of the ruble. Index: January 2, 2014 = 100.

Sources: Bloomberg L.P., OFR analysis

Figure 2-28. Foreign Ownership of Emerging Market Local Currency Government Bonds (percent of outstanding)

Foreign participation in emerging markets has increased as capital markets have deepened



Sources: International Monetary Fund, OFR analysis

broader emerging market assets have been limited. Even the risk-reduction that occurred in September and October 2014 in response to global growth concerns had limited sustained impact on emerging market assets. Emerging market bonds are still one of the best performing assets this year.

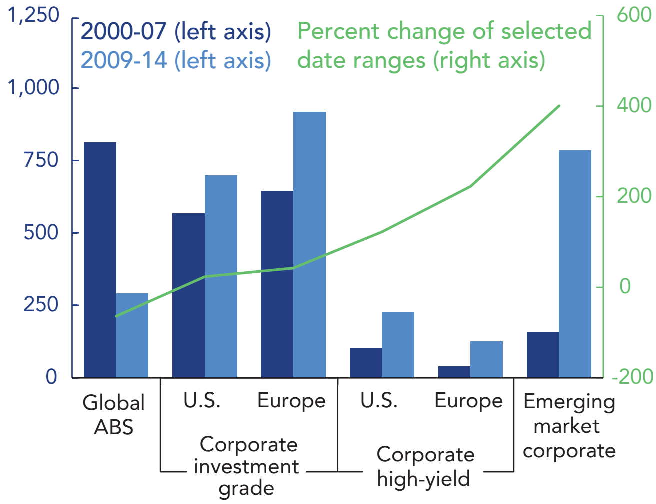
Cross-border investment flows into emerging market assets have been above their long-term trend in recent years. Emerging markets have registered $177 billion in short-term equity and debt capital inflows this year, bringing their influx since 2010 to $1.3 trillion. Yield-sensitive debt flows account for most of the increase. Foreign holdings as a share of total outstanding debt are also substantially higher relative to the immediate post-crisis period across most emerging markets, driven both by a deepening in local capital markets as well as by a search for higher-yielding assets (see **Figure 2-28**). While foreign participation lowers borrowing costs and provides access to a larger, more diverse investor base, research shows that cross-border capital flows are more volatile, particularly when they include retail investors. The continued development of a local investor base could mitigate the effects of foreign capital outflows in future crises.

Nonfinancial corporations, which took advantage of low interest rates and strong demand to increase leverage, are especially vulnerable to the curtailing of foreign investment (see **Figure 2-30**). Corporate debt in emerging markets has expanded more rapidly than nearly all other credit asset classes since the crisis (see **Figure 2-29**). There are a number of countries and sectors with high and rising debt levels, which may complicate the adjustment when financial conditions eventually tighten. A sharper-than-expected slowdown could lead to increased default rates as revenues slow relative to debt service requirements. Indeed, profitability has already decreased in a number of countries where leverage is elevated amid slower growth, in turn eroding debt servicing capacity (see IMF, 2014b). An increasing amount of debt of nonfinancial corporations is also denominated in foreign currency. This may increase sensitivity to debt servicing risks and rising losses in the event of depreciation in local currencies if corporations do not have natural or financial hedges.

Given the sensitivity of emerging market assets to U.S. interest rates during the selloff that occurred in mid-2013, we assessed the relative importance of domestic fundamentals and global factors in driving the yields of emerging market local currency bonds (see Ebeke and Lu, 2014; Miyajima, Mohanty, and Chan, 2012). We regressed nine

Figure 2-29. Average Annual Gross Debt Issuance ($ billions, percent)

Emerging market corporate debt has expanded at a fast pace

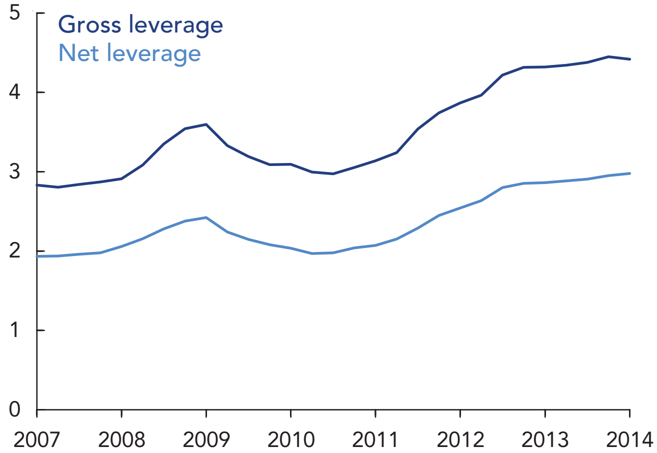


Note: Data include private placements and publicly-issued bonds. 2014 data are through August 2014 and annualized.

Sources: Dealogic, OFR analysis

Figure 2-30. Median Corporate Leverage in Emerging Markets (GDP-weighted, ratio)

Emerging market corporate leverage is at elevated levels

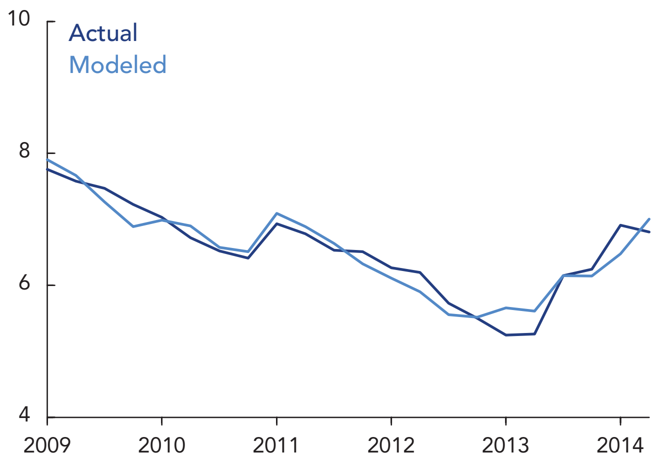


Note: Gross leverage is the ratio of total debt to EBITDA and net leverage is the ratio of net debt to EBITDA, where net debt is equal to total debt less cash and short-term investments. Corporate leverage is averaged from the trailing four quarters and is based on firms in countries including: Brazil, China, India, Indonesia, Poland, Russia, South Africa, South Korea, and Turkey. EBITDA is an indicator of a company's operating performance and refers to earnings before interest, tax, depreciation, and amortization.

Sources: Bloomberg L.P., Morgan Stanley, OFR analysis

Figure 2-31. Fair Value for Emerging Market Local Currency Government Bonds (percent)

Bond yields are no longer depressed relative to fundamentals, but are sensitive to changes in external factors

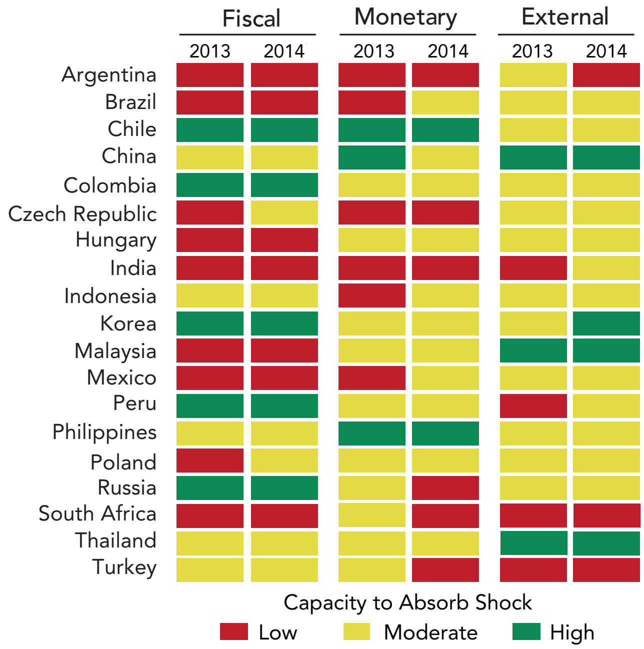


Note: Domestic factors are proxied by the headline inflation rate, domestic policy rate, GDP growth rate, ratio of current account balance to GDP, ratio of fiscal balance to GDP, and ratio of external debt to GDP. External factors are proxied by the U.S. 10-year Treasury yield, foreign ownership of domestic bonds, and the Chicago Board Options Exchange Market Volatility Index, or VIX®.

Sources: Bank of Mexico, Bloomberg L.P., Central Bank of the Republic of Turkey, Central Reserve Bank of Peru, Haver Analytics, Hungarian National Bank, International Monetary Fund, OFR analysis

Figure 2-32. Policy Buffers in Emerging Markets

Diminished policy buffers reduce the ability to cushion an external shock



Note: Color-coding is determined as follows:
Fiscal Buffer: Green if gross financing needs are less than 5% of gross domestic product (GDP) and overall balance is less negative than -2% of GDP. Red if gross financing needs are greater than 10% of GDP or overall balance is more negative than -3% of GDP. Yellow otherwise.
Monetary Buffer: For inflation targeters, green if the policy rate is at least 4% and projected CPI inflation is at least 1 percentage point lower than the (upper bound of the) inflation target (range); red if the policy rate is lower than 2% or projected inflation is above the (upper end of the) inflation target (range); and yellow otherwise. For noninflation targeters, green if the policy rate is at least 4% and projected inflation is 3% or lower. Red if the policy rate is lower than 2% or projected inflation is above 6%. Yellow otherwise. Countries operating under currency board regimes are coded as red.
External Buffer: Green if current account balance is greater than 6% of GDP and foreign exchange reserves are greater than 6% of GDP; or if current account balance is less negative than -5% of GDP and foreign exchange reserves are greater than 40% of GDP. Red if current account balance is more negative than -5% of GDP or foreign exchange reserves are smaller than 6% of GDP. Yellow otherwise.

Sources: Bloomberg L.P., Haver Analytics, International Monetary Fund, OFR analysis

domestic and global factors against the level of yields on 16 emerging market bonds, using quarterly data from the first quarter of 2009 through the second quarter of 2014. The analysis leads to the following conclusions:

- **Local currency valuations in emerging markets appear appropriately priced**. Despite earlier outsized inflows and demand for higher yielding assets, the selloffs in mid-2013 and again in 2014 appears to have curtailed some of the excesses in emerging market debt pricing (see **Figure 2-31**).
- **However, yields appear vulnerable to future changes in global factors.** A one standard deviation increase in U.S. long-term yields is associated with an increase of roughly 60 basis points in emerging market local yields, while a one standard deviation increase in the VIX® is associated with a 25 basis point increase in yields. Meanwhile, domestic fundamentals, such as local policy rates and external debt, have been weaker drivers of emerging market bond yields over the past few years.

Although valuations of bonds in emerging markets do not currently appear high, greater sensitivity to global forces, the rapid growth in short-term capital flows across borders, and a weakening in corporate balance sheets increase vulnerability to external shocks. An abrupt flight of investment would be especially challenging for countries where policy buffers — or the capability to cushion a shock — are weak or have diminished such as in Argentina, Russia, South Africa, and Turkey (see **Figure 2-32**).

Structural Vulnerabilities

MARKET LIQUIDITY RISKS

Various developments since the crisis have led to changes in market liquidity, such as changes in broker-dealer risk preferences, changes in the investor base, financial product innovation, and regulatory changes. This section discusses how changes in the provision of liquidity could disrupt market conditions and impair financial stability. We also discuss potential liquidity-related risks with mutual funds and exchange-traded funds (ETFs) that invest in illiquid assets (see **Bank Loan Funds and Liquidity Mismatches**).

Market liquidity is essential for markets to operate efficiently. Whereas funding liquidity relates to conditions that affect the liabilities of institutions (that is, the availability of wholesale funding), market liquidity applies to the trading activity that takes place in capital markets. The two are

Bank Loan Funds and Liquidity Mismatches

Bank loans, which are mostly floating-rate products, have attracted investor interest as a hedge for rising interest rates and for yield enhancement. However, investments in mutual funds and ETFs that invest in bank loans carry risks from a mismatch of liquidity as a result of different settlement practices and liquidity between fund shares and the underlying bank loan assets.

ETF shares are traded on an exchange throughout the day at market-determined prices, unlike mutual funds, whose shares can only be traded at the fund's net asset value that is calculated at the end of each business day. ETFs were initially created to provide retail investors with intraday liquidity in actively-traded asset classes. Market-makers facilitate trading and profit from a small margin they earn between the purchase and sale price of ETF shares.

ETFs have been marketed to a broad range of investors as a way to diversify exposure into less liquid asset classes, including high-yield corporate bonds and emerging market assets. In October 2014, assets under management of U.S. ETFs and exchange-traded products stood at a record high of nearly $1.9 trillion.

Demand for instruments to hedge interest rate risk has led to growth in floating-rate bank loan ETFs. At present, the outstanding size of bank loan ETFs is relatively small at around $8 billion, while bank loan mutual funds are larger with more than $70 billion in assets.

The following scenario illustrates underappreciated liquidity risks in bank loan ETFs. It shows how a mismatch in liquidity may fuel a self-reinforcing cycle of price declines in ETF shares and underlying assets. While the same liquidity mismatch is also present in mutual funds investing in bank loans, ETFs could be more vulnerable because of investors' expectations of intraday liquidity.

- Bank loan prices drop modestly due to an isolated credit event, change in market expectations, or other development. The decline leads some investors to exit the market by selling their ETF shares in the secondary market.

- Investors in bank loan ETFs attempt to limit losses by selling shares. Because an ETF is explicitly marketed as a product with better liquidity than the underlying assets or a similar mutual fund portfolio, ETFs attract investors who are more likely to trade in response to a large intraday price movement.

- ETF market-makers now hold substantial inventories of ETF shares. To limit the selling pressure, market-makers cut the price at which they are willing to buy ETF shares in the secondary market. This accelerates the price decline for ETF investors.

- ETF market-makers (through authorized participants) turn to ETF portfolios to redeem shares purchased in the secondary market, although the majority of ETF share trading occurs in the secondary market and does not affect ETF portfolio liquidity (see ICI, 2014).

- However, liquidity risk management practices may vary. If the ETF portfolio does not have sufficient liquid assets to meet redemptions, its manager may attempt to raise cash by selling portfolio assets — bank loans — in the secondary market. Because the settlement period for bank loans is longer than for ETF shares, the ETF portfolio is unable to meet requests for cash redemptions. ETF shares are normally settled within three to seven days, while the settlement time of bank loans is generally longer than seven days (see Moody's, 2014). Mutual funds investing in bank loans are also susceptible to the settlement mismatch.

- As available liquidity in bank loan funds evaporates and selling pressure from investors builds, ETF market-makers may refrain from buying additional ETF shares altogether if they reach their balance-sheet capacity.

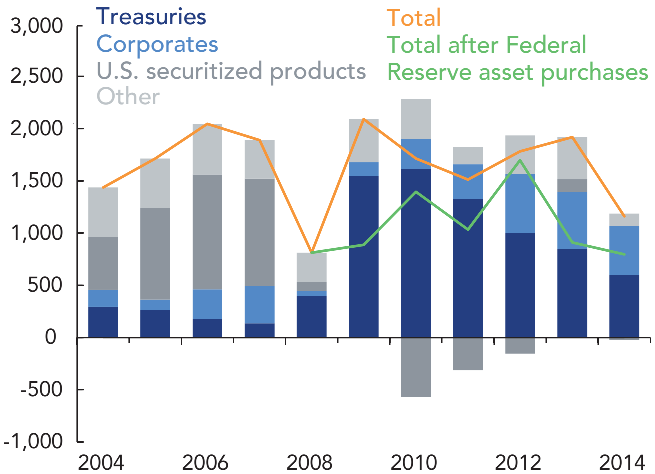
This illustrative scenario shows how demand for liquidity from ETF investors ultimately translates into demand for liquidity in the ETF's underlying assets, affecting other types of funds with similar investments.

Not all ETFs are vulnerable to a self-reinforcing cycle of liquidity-induced price declines. For example, ETFs tracking equities — which represent the bulk of the ETF universe — do not exhibit the same price opacity and potential settlement delays as bank loan ETFs. But investors may not appreciate the liquidity differences of the underlying markets for bank loan ETFs and equity ETFs.

At present, mutual funds and ETFs that invest in illiquid assets such as bank loans represent a small part of total mutual fund and ETF assets. However, the continued search for yield and demand for secondary market liquidity could spur growth. Under normal market conditions, these investment alternatives work as intended. But funds that reference assets with weak market liquidity may give investors a false sense of security about liquidity during stressful episodes.

Figure 2-33. Net Issuance of Fixed-Income Securities ($ billions)

Lack of available collateral may have contributed to changes in trading liquidity

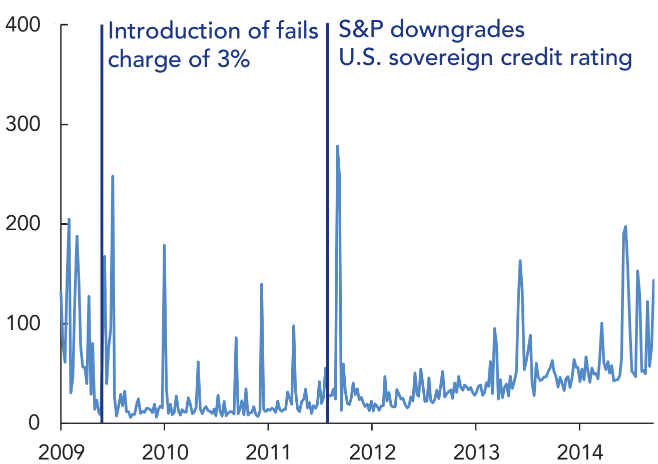


Note: Other includes agency debt, municipal bonds, emerging market sovereign bonds, and corporates. 2014 data are estimated annual figures.

Sources: Haver Analytics, JPMorgan Chase & Co., OFR analysis

Figure 2-34. Primary Dealer Settlement Fails to Deliver U.S. Treasury Securities ($ billions)

U.S. Treasury securities show a structural increase in trades that failed to settle as scheduled



Sources: Bloomberg L.P., Federal Reserve Bank of New York, OFR analysis

related because the ease with which an asset is traded is contingent on the ease with which funding can be obtained. Financial crises often include sharp reductions in liquidity and downward cascades in prices, as large losses force asset sales and risk aversion increases the hoarding of cash.

Several developments since the financial crisis have altered the amount of liquidity available in the financial system and the ways investors redeem holdings to get cash. Regulations requiring banks to hold more capital and more restrictive constraints on leverage have increased the cost of securities financing activities and reduced incentives to maintain them. Changes in the investor base, securities markets, financial products, and risk appetite have also contributed importantly to the decline in liquidity. Some changes are cyclical, such as a decline in available collateral (see **Figure 2-33**) from slow-to-recover securitization markets and the removal of a sizable portion of Treasury securities, agency mortgage-backed securities (MBS), and agency debt from the market as a result of the Federal Reserve's asset purchase program. Other changes are structural, such as regulatory changes that introduce longer-term balance-sheet constraints and an evident reduction in broker-dealer willingness to put capital at risk (see Adrian and others, 2013).

Traditional indicators do not show excessive concern about market liquidity. But signs are emerging that market liquidity has become more fragmented in a few markets since the crisis. These signs include the following, to varying degrees:

- Large broker-dealer inventories have shrunk, inventories have grown more concentrated in high-quality liquid assets, and dealer willingness to buffer periods of intense selling pressure has been more limited;
- Trading volumes have declined despite increased inflows (for instance, in emerging market sovereign bonds and U.S. corporate bonds), leading to depressed turnover in secondary markets;
- Trading activity is concentrated in the primary new issue market or in a small number of credits in U.S. and emerging market corporate bonds, suggesting reduced market depth;
- The size of an average trade has declined in both high-yield and investment grade corporate bond markets;
- Spreads for newly issued bonds have widened relative to older benchmark bonds for the same maturity in some asset classes; and

- Even traditionally liquid assets are failing to settle as scheduled as broker-dealer inventories and securities lending portfolios have diminished (see **Figure 2-34**).

The fragile nature of liquidity was especially evident during the selloff in fixed-income markets in mid-2013 and during the market dislocations in September and October of 2014. Neither development was widespread or severe enough to lead to outsized price declines and forced deleveraging.

To some extent, factors such as changes in the investor base and low volatility have helped prevent mild liquidity shortages from becoming more severe and sparking selloffs. The cycle is self-reinforcing. An increase in traditional buy-and-hold investors results in less turnover, which suppresses volatility. Low volatility enhances returns and reinforces trading strategies such as carry trades that assume volatility will remain low. Positive returns attract more investment to higher risk assets that are less liquid, which perpetuates the cycle.

Many market participants acknowledge the risk that market liquidity may decline once interest rates begin to rise. However, investors have no obvious hedge to manage liquidity shocks, aside from holding more cash or cash equivalents or securing committed liquidity facilities. Since the crisis, investors have not been subject to a true test of the market's resilience to provide liquidity, particularly in newer niche markets.

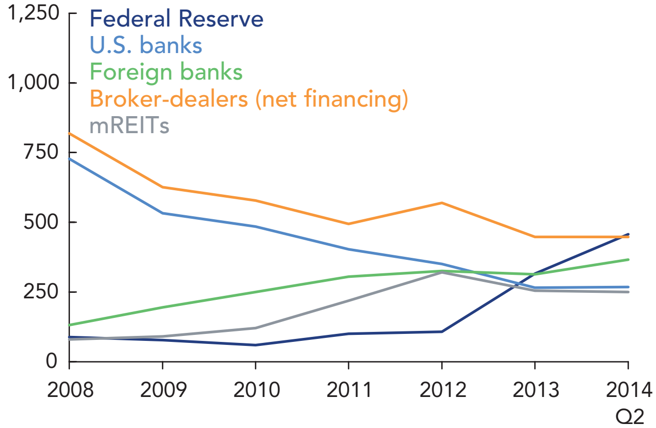
Tracking market liquidity is a further challenge because asset markets are numerous and diverse. The OFR is developing a set of measures to monitor liquidity across core markets. Our measures are organized into broad categories based on the aspect of liquidity they address: depth, breadth, resilience, quality, and immediacy (see **Figure 2-36**). This exercise will help develop a knowledge base on the use of the various measurement methodologies. Monitoring liquidity on an asset basis and across different dimensions may also provide insights into how liquidity shocks are transmitted across markets.

RUN RISKS AND ASSET FIRE SALE RISKS

Short-term funding markets are critical to market functioning as an efficient source of financing, but may create systemic vulnerabilities. We remain concerned about risks related to short-term wholesale funding markets, given that incentives still exist for runs and asset fire sales during periods of stress.

Figure 2-35. Funding in the Fed Funds and Repo Markets ($ billions)

The largest borrowers in short-term wholesale funding markets



Sources: Board of Governors, OFR analysis

The repo market, the largest short-term funding market, has undergone substantial change in recent years. However, it still remains susceptible to asset fire sales and runs when a borrower cannot roll over or renew short-term funding backed by collateral.

The repo market, the largest short-term funding market, has undergone substantial change in recent years. However, it still remains susceptible to asset fire sales and runs when a borrower cannot roll over or renew short-term funding backed by collateral.

Borrowers in the repo market obtain funding from repo dealers by posting collateral; repo dealers, in turn, often borrow cash from cash-rich lenders. The Federal Reserve, U.S.-based foreign banks, U.S. banks and broker-dealers, and mortgage real estate investment trusts (mREITs) are significant participants in repo markets (see **Figure 2-35**). Repo markets are vulnerable to runs for several reasons. Repo contracts tend to be short-term. In a market disruption, firms relying on short-term repos could quickly lose access to their funding sources when existing contracts expire and new ones become hard to obtain.

Figure 2-36. Market Liquidity Indicators

	Indicator	Data Requirements	Aspect of Liquidity Measured	Strengths and Weaknesses	Reference
Breadth	Trading volume	Volume	Higher volume implies more trading, suggesting more opportunities to buy or sell at a given price level.	Strengths: Readily available across multiple asset classes. Simple to update and understand. Weaknesses: Higher volumes may not imply higher liquidity, due to concomitant increased volatility. Double-counting of trades is frequently a problem in practice.	Blume, Easley and O'Hara (1994)
Breadth	Turnover	Volume, shares outstanding	Measures the pace of trading relative to the total amount of a security outstanding. Higher turnover suggests greater availability of possible buyers.	Strengths: Data are readily available across multiple asset classes. Simple to calculate and understand. Weaknesses: Frequently underestimates market depth, because some willing buyers and sellers do not participate in actual trades. Structural changes in markets can lead to false signals.	Amihud and Mendelson (1986); Datar, Naik, and Radcliffe (1998)
Breadth	Conventional liquidity ratio	Price, volume	Price change (impact) per dollar volume traded.	Strengths: Simple to calculate; data typically readily available. Weaknesses: Does not adjust for firm size and ignore daily lows and daily highs.	Gabrielsen, Marzo, and Zagaglia (2011)
Breadth	Martin's liquidity index	Price, volume	Price change per unit of volume traded. The higher the index, the higher the price dispersion relative to volume, and the lower the liquidity.	Strengths: Simple to calculate; data typically readily available. Flexibility to run across various asset classes and time horizons.	Martin (1975)
Depth	Average rolling differential	Volume, daily high/low prices, shares outstanding	Average of rolling 5-day windows of absolute percentage price change (from lowest daily low to highest daily high of 5 days) per unit volume, adjusted for market capitalization.	Strengths: Captures the full extent of price fluctuations by incorporating daily low and daily highs. Adjusts for market capitalization. Uses responsive five-day estimation periods. Weaknesses: Five days may still be too long for the index to detect certain market anomalies, because asset prices can adjust quickly to liquidity problems. Daily low/high prices are often unavailable.	Hui and Heubel (1984)
Depth	Average daily share price impact	Return, volume	Captures the average of the daily price impacts over a given sample period.	Strengths: Applicable in markets where the bid-ask spread is not available. Weaknesses: Ignoring the bid-ask spread introduces minor imprecision. Volumes are not price-weighted.	Amihud (2002)
Depth	Average trade price impact	Price, number of trades	Captures average absolute percentage of price change across all trades.	Strengths: Simple intuition – many small transactions imply more liquidity than one large transaction. Not affected by firm size. Suitable for both dealer and auction markets. Weaknesses: Ignores volume.	Marsh and Rock (1986)
Depth	Micro-structure invariants	Price, volume, volatility	Measures the impact of a standardized quantity of order flow in a consistent way across markets.	Strengths: Price impact is normalized in a way that makes it directly comparable across markets and over time. Rationale for stable percentage price impact has a theoretical foundation. Weaknesses: Relatively new measure; needs broader testing.	Kyle and Obizhaeva (2014)

Sources: Gabrielsen, Marzo, and Zagaglia (2011), OFR analysis

continued on next page

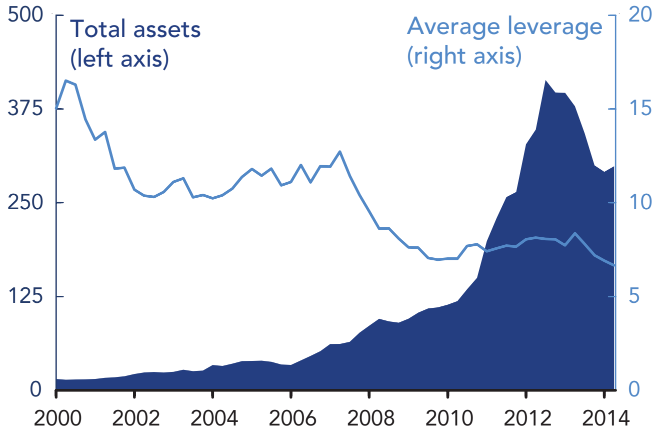
Figure 2-36. Market Liquidity Indicators (continued)

	Indicator	Data Requirements	Aspect of Liquidity Measured	Strengths and Weaknesses	Reference
Resiliency	Variance ratio	Price	Measures the impact of execution costs on price volatility over short horizons. Higher liquidity reduces variance of transaction prices around the equilibrium price.	Strengths: Applicable to contexts indirectly connected with market liquidity, such as volatility and intraday effects. Weaknesses: Can be sensitive to the time interval chosen for calculating the returns variance. Assumes unobservable equilibrium prices, but is measured from observed transaction prices.	Hasbrouck and Schwartz (1988)
	High frequency time series econometrics	Model dependent	Often using VAR and cointegration techniques, these methods provide insight to price discovery mechanisms and other microstructure aspects of liquidity.	Strengths: These methods allow for highly sophisticated analysis of market microstructure aspects of liquidity. Weaknesses: Complicated to conduct and require rigorous analysis to ensure appropriate interpretation.	Hasbrouck (1993); Chung, Han, and Tse (1996); Hasbrouck (2002); Harris, McInish, and Wood (2000)
Quality	Published bid-ask spread	Bid and ask quotes	Measures costs that market participants pay for "immediacy."	Strengths: Simple to calculate and interpret. Data are available for most exchange-traded instruments. Weaknesses: Innovations in electronic trading have reduced the spread in many cases to the minimal tick size, removing much of the information value.	Huang and Stoll (1996); Amihud and Mendelson (1991)
	Implied bid-ask spread	Price and/or return	Infers the effective spread from the autocorrelation that arises as an artifact of prices “bouncing” randomly between bids and asks.	Strengths: Simple, reduced-form equation; data are readily available; flexibility to run across various asset classes. Weaknesses: No insights on factors affecting the estimated spread. Fails to capture asymmetric information effects. Assumes no informed traders and homogeneous information across traders.	Roll (1984)
	Bid-ask spread decomposition	Bid/ask quotes, prices, source of order flow (buy vs. sell side)	Decomposes the bid-ask spread into order processing, inventory, and adverse information costs.	Strengths: Data requirements are modest (source of order flow can be imputed from bid/ask quotes and transacted prices). Provides attribution for source of transaction costs. Weaknesses: Bid-ask spreads are often tick constrained. Detailed transaction information is often unavailable. Appears to reveal little about overall market liquidity.	Stoll (1989); Huang and Stoll (1997)
Immediacy	Short-term reversals	Daily returns	Uses returns on a contrarian long-short strategy to estimate the cumulative impact of short-term price reversals due to noise traders’ transitory effect on dealer inventories.	Strengths: Data requirements are very modest and model implementation is straightforward. Weaknesses: Initial implementation limited to equities.	Rinne and Suominen (2010)
	Quantity structure of immediacy	Daily risk-free interest rates, volatility of daily returns, trades and bid-ask quotations	Estimates immediacy costs separately for purchase and sale orders as the price deviation needed to induce a dealer to transact immediately for the full amount of an order.	Strengths: Data requirements are modest (source of order flow can be imputed from bid/ask quotes and transacted prices). Weaknesses: Model assumption of a monopolistic dealer may be inappropriate for some markets.	Chacko, Jurek, and Stafford (2008)

Sources: Gabrielsen, Marzo, and Zagaglia (2011), OFR analysis

Figure 2-37. Total mREIT Assets and Average Leverage ($ billions and percent)

Agency mREITs have delevered but still are susceptible to shocks



Note: Leverage is total assets divided by total equity of 14 mREITs. Not all mREITs existed in all time periods in the figure.

Sources: SNL Financial LC, OFR analysis

> Embedded within the U.S. market structure are numerous economic incentives that influence where and how brokers route client orders. These incentives have implications for liquidity provisioning.

Repo contracts allow borrowers to boost returns by combining leverage with maturity mismatches, which contributes to contagion and fire sale risk. If a market shock leads to concerns about risky counterparties, a repo lender may demand higher margins or terminate the counterparty exposure altogether (see Copeland, Martin, and Walker, forthcoming). The demand for higher margins could force a highly leveraged counterparty to sell some of its assets to meet the new requirements, leading to fire sales. The downward spiral could accelerate if many firms sell assets simultaneously. The resulting drop in prices would lower the value of the collateral, causing counterparties to demand more collateral or raise haircuts. A haircut is an additional buffer of collateral that is held to protect against declines in the assets' market value over the life of the transaction. Chapter 3 describes policy changes to address vulnerabilities in wholesale funding markets.

Agency mREITs are one, but not the only, example of a leveraged financing vehicle that is vulnerable to run risk and asset fire sales. Agency mREITs borrow in short-term repo markets to purchase longer-dated real estate assets, typically MBS issued by Fannie Mae or Freddie Mac. Repo funding represents about 90 percent of their liabilities and the weighted average maturity of repo funding is relatively short compared to the duration of their assets, because repo borrowing is a cost effective way to obtain leverage. This makes agency mREITs vulnerable to runs by repo investors. Given the agency mREITs' relative importance in the repo market, any instability among large agency mREITs could aggravate broader short-term funding markets.

Their large MBS holdings also expose agency mREITs to risk from interest rate fluctuations, which they hedge using U.S. Treasury bonds, interest rate swaps, or similar instruments. However, mortgage bonds are negatively convex — as interest rates rise, their projected lives also extend, because fewer homeowners are likely to refinance — and agency mREITs must adjust their hedges as interest rates change. This hedging strategy exposes agency mREITs to the risk of fire sales (see FSOC, 2013). These exposures increased concern among investors and regulators following the rise in interest rates and volatility in mid-2013, leading agency mREITs' share prices and equity book values to decline. Some agency mREITs sold a portion of their MBS holdings, which exacerbated the widening in agency MBS spreads, or shifted into short-duration assets (see OFR, 2013a).

Assessing the Vulnerability of Agency mREITs

We used an agent-based model to assess how vulnerable agency mREITs are to a withdrawal of funding or an asset price shock. (See **Section 4.2** for the mechanics of the model.) The goal of this exercise was to incorporate both funding and interest rate risks to see how interest rate shocks reverberate through the system and to determine how capital levels react.

In our model, we used two groups of agency mREITs — one with high leverage and another with low leverage. Both had the same business objectives: to achieve a target amount of leverage and maintain a stable interest rate exposure. Both also hedged the interest rate risk of their MBS portfolios by shorting U.S. Treasury bonds, that is, by selling borrowed bonds with the expectation they can buy them back when prices have fallen. Adjusting the size of their MBS and U.S. Treasury bond positions allowed the mREITs to maintain a constant interest rate exposure. They met leverage targets by borrowing funds to purchase assets.

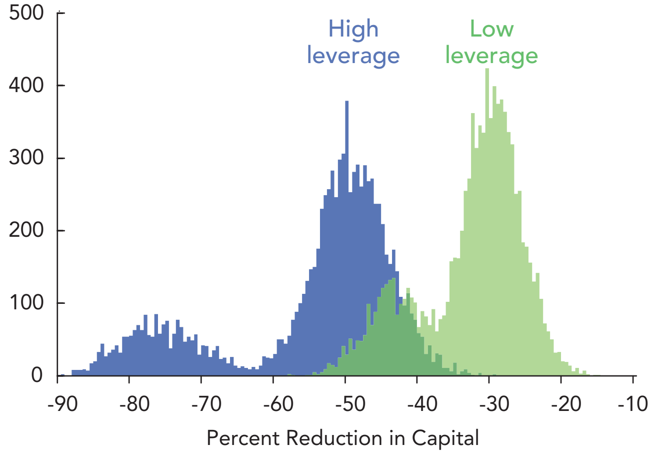
The scenario that we modeled began with a price shock that cut the value of MBS by 7 percent (a similar magnitude to the price decline that occurred in mid-2013), which reduced the agency mREITs' equity value and increased their leverage. As leverage rose above the target, both low-leverage and high-leverage agency mREITs were forced to delever and sell assets at a time when prices were already declining. The forced sales reduced MBS prices further, creating an adverse feedback loop.

Next, our model assumed that sharp movements in the MBS market would create uncertainty and increase risk aversion, raising concerns about counterparty and collateral risks that also affect the agency mREITs' funding. We introduced a funding shock by increasing the haircut substantially (by 7 percentage points to a cumulative 14 percent) on MBS assets pledged as collateral to obtain repo funding (see **Figure 2-38**). We ran the simulation 10,000 times to allow for some random variation in prices and capital stocks held prior to the shock.

On average, the simulations showed the capital of the agency mREITs with low leverage fell by 35 percent, followed by an additional reduction of up to 10 percent over the next two quarters. In the third quarter, the funding shock occurred and reduced capital again by up to 6 percent. The impact on the highly leveraged group was more extreme. Capital fell by a total of 52 percent and did not stabilize for eight quarters.

Figure 2-38. Illustrative Stress Test of Agency mREITs (number of simulations and percent)

Highly leveraged agency mREITs are more negatively affected by asset price and funding shocks



Note: The bimodal distribution represents the fact that if a fire sale occurs in the first period, a larger number of fire sales is likely to occur over the subsequent periods.

Sources: Bloomberg L.P., SNL Financial LC, OFR analysis

However, it is important to emphasize that these results are not forecasts. The strength of agent-based modeling lies not in the magnitude of the results but in its ability to compare scenarios — in this case, the loss was nearly twice as much for the more leveraged mREIT compared to the less leveraged mREIT.

The model also showed how the actions of one firm affect another. Our simulations showed a strong correlation and dependence between the two groups of agency mREITs. If one group was forced to sell assets, the resulting price drop forced the other group to sell during the following quarter. In most of our simulated scenarios, all the mREIT firms experienced significant losses but survived. In other instances, capital fell significantly — to a point where solvency was at risk. This divergence reflects the fact that in the majority of simulations, the imposed shock did not trigger any fire sales. But when the model produced fire sales, they lasted for a prolonged period and resulted in a dramatic reduction in capital.

Since then, agency mREITs have reduced their total assets, obtained longer-term funding, cut dividend payouts, and reduced their leverage (see **Figure 2-37**). However, the duration of their assets has extended by more than their liabilities, resulting in larger duration gaps compared to a year ago. Agency mREITS are still sensitive to a rise in interest rates or liquidity risks because of their reliance on repo funding and a sizeable duration gap. Their portfolios are also highly concentrated, increasing their vulnerability to an outsized price shock in the agency MBS or real estate market. Raising new equity has been difficult for agency mREITs because of depressed book values. To boost returns, agency mREITs may seek to increase leverage or increase the riskiness of assets they are accumulating (see **Assessing the Vulnerability of Agency mREITs**). Currently, agency mREITs are not as tightly supervised as other financial entities that are thought to pose systemic risks (see Pellerin, Sabol, and Walter, 2013).

MARKET INFRASTRUCTURE RISK

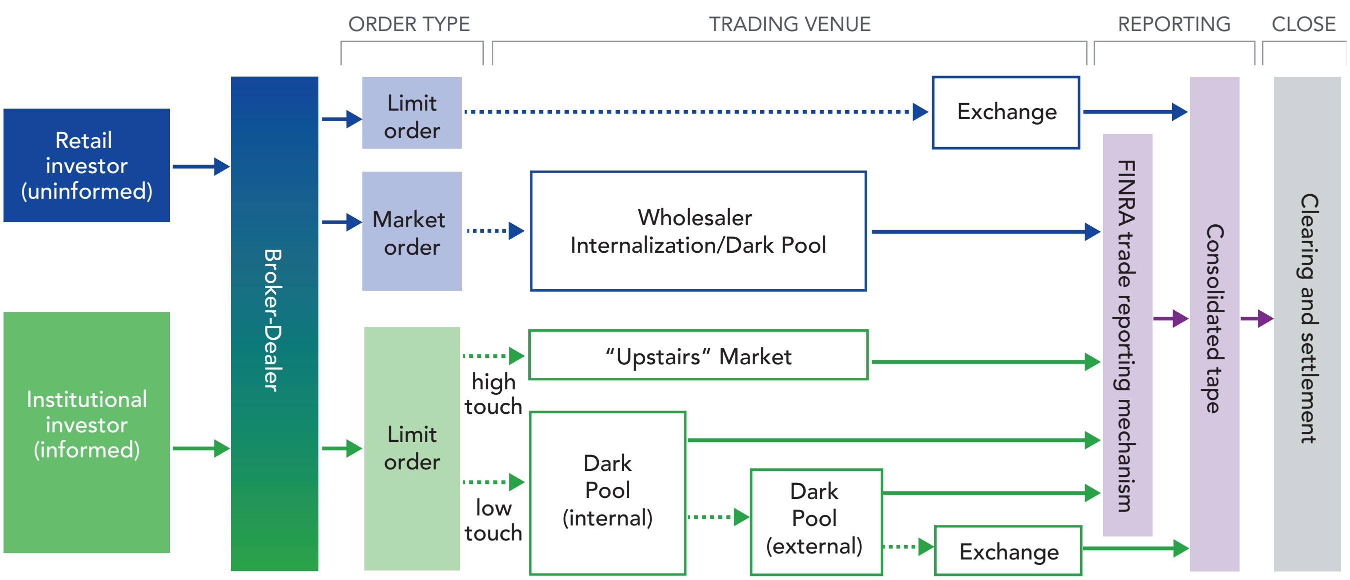
This section focuses on two characteristics of U.S. equity markets — complexity and fragmentation — that could contribute to systemic risk. Future efforts will extend this analysis to other markets, with an emphasis on the transmission of risks across market structures.

Policymakers are well aware of the adverse effects of market structure vulnerabilities in U.S. equity markets. The Financial Stability Oversight Council (Council), in its 2014 annual report, cited weakness in the financial infrastructure as a potential risk to financial stability. The SEC outlined several key initiatives the agency is taking to enhance market structure. Further, the Financial Industry Regulatory Authority (FINRA) implemented a new rule to improve transparency of off-exchange trading volumes. Congress has also conducted hearings on structural vulnerabilities in equity markets.

Financial markets are complex systems. Complex market systems are assembled from several subsystems that are independently controlled and managed without an overarching authority. Trading systems for many asset classes fit this description. Automated algorithm-based trading strategies and technologies for routing orders are layered on top of these trading systems and add to the complexity. Given the rapid speed at which trades are executed, mitigating errors when automated controls fail is a challenge.

These vulnerabilities are not unique to equity markets. Similar fragilities are also evident in other types of markets. For instance, high-frequency trading and algorithm trading are widely used in futures, options, foreign exchange, and

Figure 2-39. Routing Practices Differ Based on Investor Type and Order Type



Note: A limit order is an order to execute a securities trade only at a specified price (the limit) or better. A market order is an order to execute at the best available price. Wholesalers are dealers who execute trades on behalf of clients introduced by retail brokers. Internalization refers to trades in which dealers fill orders from their existing inventories. An upstairs market is an off-exchange market for large securities transactions. Dark pools are private electronic trading venues where traders anonymously buy and sell securities.

Source: OFR analysis

some fixed-income markets. Regulators need to cooperate to monitor and understand interconnections across markets (see Kara Stein, 2014).

Complexity and fragmentation are two key attributes of equity markets. Complexity arises from several factors, including the diverse needs of market participants, technological advancements that enable more complex trading strategies and faster speeds, and regulatory rules that may stem from good intentions but occasionally may bring unintended consequences. For instance, the proliferation of trading venues is largely attributed to the SEC's Regulation National Market System (Reg NMS) and Regulation Alternative Trading Systems (Reg ATS), implemented in 2007 and 1999, respectively. Both regulations fostered significant competition among trading centers and benefited investors through lower trading costs. However, they also increased complexity and market fragmentation.

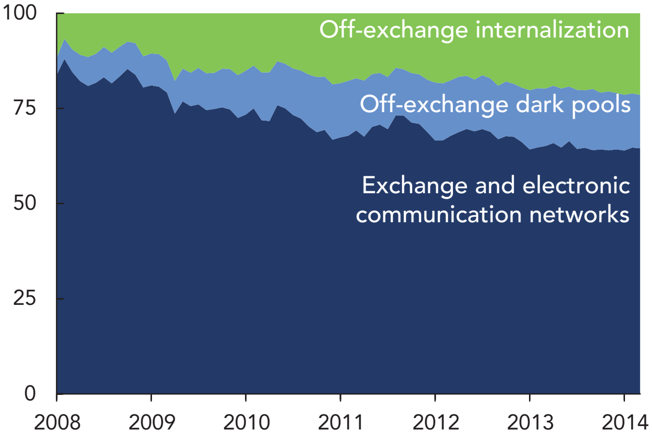
Complexity is underscored by the highly segmented process by which an equity order is routed through the system (see **Figure 2-39**). Reg NMS requires brokers to seek the best price (the national best bid offer) for each client trade. Brokers must connect and route orders to a number of trading venues to ensure best execution for client orders and connecting and accessing multiple venues adds significant complexity to order routing practices. Economic incentives embedded in order-routing practices have important implications for liquidity provisioning.

Another important element of complexity is the large number of order types. Each exchange and off-exchange trading venue offers numerous specialized order types, many of which are very complex. Order complexity feeds into a number of problems, including broker conflicts of interest, slower trade execution during times of stress, and an uneven playing field. The large number of venues where trading may occur on exchanges and off exchanges via dark pools, broker-dealer internal inventories (internalization), and electronic communication networks, further adds to the complexity (see **Figure 2-40**).

Complexity and fragmentation may constrain the normal functioning of markets by limiting the financial system's ability to provide basic services. Price discovery and providing liquidity are key services of effective markets. More often than not, equity markets function in a highly efficient and effective manner, with price discovery and liquidity provision effectively serving the interests of all investors.

Figure 2-40. Share of Trading Volume by Venue (percent of shares)

Off-exchange trading has increased for market orders and limit orders



Source: Rosenblatt Securities Inc.

However, complexity and fragmentation can impair these key services.

Price discovery. Unlike "lit markets," such as exchanges, where publicly displayed quotes determine the national best bid and offer, trades conducted in dark pools or through internalization are transacted at prices that are a derivative of those determined in lit markets. These off-exchange dark trades offer important benefits to investors (such as a reduction in information leakage, ability to conduct trades anonymously, and minimization of market price impact costs). But they also raise important questions regarding price discovery. In June 2014, SEC Chair Mary Jo White publicly expressed concerns about dark pools, noting that "dark trading can sometimes detract from market quality, including the information efficiency of prices" (see White, 2014). Other factors that may impede price discovery include "single points of failure," which bring trading to a halt when critical infrastructure components malfunction.

Liquidity provisioning. Market liquidity refers to the ability to trade a substantial amount of stock at close to the current market price. This liquidity is supplied by market intermediaries. During normal market environments, liquidity provisioning enables buyers and sellers to interact with one another efficiently. However, this mechanism can break down during times of market stress.

Market prices may be more sensitive to liquidity shocks in fragmented markets, resulting in more extreme price changes during periods of stress (Madhavan, 2011).

Historically, stock markets relied on intermediaries known as market-makers and specialists who are expected to buy and sell a particular stock at a publicly quoted price to maintain fair and orderly markets. Today, their role has significantly diminished as newer market participants, using high-frequency trading strategies, have emerged. Firms using high-frequency trading strategies are an important liquidity source under normal conditions, but do not have an explicit obligation to provide liquidity during times of stress.

The so-called flash crash in equity securities on May 6, 2010 is one such example. As prices of many U.S.-based equity products fell sharply and suddenly that day, market-makers acted in their own best interests and withdrew from the market, leading to a brief liquidity shock. By the end of the day, stocks had recovered most or all of their losses. A joint SEC and Commodity Futures Trading Commission (CFTC) investigation later concluded the crash was triggered when a fund sold a large number of stock index futures that exhausted available buyers, and then was exacerbated by aggressive selling by other computer-driven traders. That example shows how a future flash crash occurring at the end of a trading session could severely disrupt the close and the pricing of index derivative products, with effects spilling into overseas markets and subsequent trading sessions.

Embedded within the U.S. market structure are numerous economic incentives that influence where and how brokers route client orders. These incentives have implications for liquidity provisioning. Retail market orders are almost entirely routed to wholesalers. Meanwhile institutional orders may route through any number of dark and lit venues prior to execution, potentially exposing these orders to other traders which results in information leakage and adversely impacts the institutional investor. Complex order routing decisions have implications for all market participants, including those that supply liquidity on exchanges. Specifically, brokers may be disincentivized to post orders on a particular exchange because it offers lower liquidity rebates than other exchanges, even though that exchange offers the best possibility of order execution (see Battalio, Corwin, and Jennings, 2014).

Investor confidence deteriorates when price discovery and liquidity do not operate efficiently and effectively. To an extent, liquidity shocks are inherent in market structure as market intermediaries are not constant sources of liquidity. Liquidity and price discovery are ultimately determined by the combined interests of end investors who interact in the market via intermediaries.

MIGRATION OF ACTIVITIES AND FINANCIAL INNOVATION

Financial activities and risks are constantly evolving in response to market forces, regulatory developments, and technological innovation. Financial innovation can make the system more effective and efficient, provide value to customers, and promote economic growth. But it can also create, transfer, or amplify risks in ways that are not apparent. This section describes recent examples of activities shifting from banks to nonbank institutions, among subsidiaries of the same firm, and from firms to markets. This migration is sometimes driven by firms' desire to circumvent regulations, known as regulatory arbitrage.

Historically, improvements in technology, changes in competition, and new regulations have triggered financial innovations and other changes that lead to a migration in activity from one sector to another. Some of these changes are benign from a financial stability standpoint. For example, shifting a cash investment from an uninsured deposit to a money market fund may not increase the likelihood of a run on the investment.

But migration could increase risks to financial stability if the new activities are not subject to prudential regulation. If the regulatory playing field is not level across the financial system, the shift of certain activities to more lightly regulated sectors could increase risk-taking and reduce transparency in market practices. For example, financial institutions may try to reduce their regulatory capital requirements by shifting activities out of subsidiaries with relatively high capital requirements, such as banks and insurance companies, to subsidiaries, special purpose vehicles, or third parties that are subject to less stringent regulatory requirements. Financial innovation that creates new products without regulatory precedent also could introduce unforeseen risks that are poorly understood.

For these reasons, the migration of financial activities and financial innovation requires close monitoring. The remainder of this section discusses examples of migration and innovation that may require monitoring for their potential to pose financial stability risks including captive reinsurance, nonbank mortgage servicers, and single-family rental securitizations.

Captive Reinsurers

Captive reinsurance companies are affiliates of insurers not subject to the same prudential reserve and capital requirements as a primary insurer. Captive reinsurance companies are created for the purpose of assuming insurance risk transferred from a regulated insurance affiliate.

Life insurers' use of captive reinsurance has expanded dramatically in the past decade. By transferring ("ceding") life insurance and annuity risk to captive reinsurance companies, life insurers reduce their reserve and capital requirements.

Use of captives has grown rapidly since 2000, when the National Association of Insurance Commissioners (NAIC) passed its Valuation of Life Insurance Policies Regulation. The regulation, which most states have adopted, requires insurers to hold higher reserves on newly issued term and universal life insurance. Reserves ceded through captive reinsurance grew from $11 billion in 2002 to $364 billion in 2012 and now have expanded to include risk-sharing on products such as annuities that are not covered by the regulation.

The adoption of the regulation may have spurred the growth of captive reinsurance. As of 2012, the reported risk-based capital ratio for the average life insurer ceding risk to captives would have been 53 percentage points lower and the reported default probability more than three times higher without the use of reinsurance transactions, according to one study (see Koijen and Yogo, 2014; also see **Figure 2-41**).

U.S. life insurance companies now use captive affiliates more than they use nonaffiliated or third-party reinsurers (see Koijen and Yogo, 2014). NAIC, the Council, and the Federal Insurance Office have raised concerns about the solvency of captives and the potential that losses at captives could negatively affect their holding companies.

In 2013, the New York Department of Financial Services called attention to the use of risky assets to capitalize captive reinsurance companies (see **Figure 2-42**) and found that some insurers used the reserves freed via the use of captive reinsurance to boost risk-based capital (see NYSDFS, 2013). No other state regulators have publicly issued reviews of reinsurance practices. Although the NAIC has strengthened public disclosure around the quantity of

Figure 2-41. Captive Reinsurers Can Affect Capital and Default Risk

	Risk-Based Capital			10-Year Default Probability		
	Reported	Adjusted for captive reinsurance	Difference	Reported	Adjusted for captive reinsurance	Ratio
2002	160%	150%	-10%	0.8%	1.4%	1.8
2012	208%	155%	-53%	0.9%	3.3%	3.5

Source: Koijen and Yogo (2014)

Figure 2-42. Relatively Risky Assets Are Sometimes Used to Capitalize Captive Reinsurers

Type of Asset	Description of Asset
"Hollow assets"	A letter of credit from a bank is backed by a parental guarantee and recorded as an asset on the books of the captive reinsurance company. Unlike other assets such as cash or bonds, this does not provide for specific assets that can be used to support reinsurance recoverables.
Naked parental guarantee	The parent company promises to indemnify potential losses of the captive reinsurance company without setting aside dedicated resources. The asset is referred to as a "naked" parental guarantee because it does not involve the use of a letter of credit obtained from a bank.
Conditional letter of credit	The bank places a restriction on the letter of credit, such as making the letter of credit the last available fund before a drawdown can be initiated.

Sources: New York State Department of Financial Services, OFR analysis

Figure 2-43 Use of Captive Reinsurance Varies across U.S. Life Insurers ($ billions and percent)

Consolidated data for life insurers that wrote more than $2 billion of direct premiums in 2013

SNL Top-Tier Entity	Life Insurance in Force ($B)	Total Ceded to Captives ($B)	Ceded to U.S. Captives ($B)	Ceded to Non-U.S. Captives ($B)	As Percent of Total Life Insurance in Force		
					Total ceded to captives	Ceded to U.S. captives	Ceded to non-U.S. captives
MetLife Inc.	4,388.45	1,614.30	99.89	1,514.41	36.79	2.28	34.51
Prudential Financial Inc.	3,724.81	606.89	606.89	0.00	16.29	16.29	0.00
AEGON NV	1,506.49	447.26	241.72	205.54	29.69	16.04	13.64
Voya Financial Inc.	1,506.87	393.66	393.66	0.00	26.12	26.12	0.00
Protective Life Corp.	829.45	187.24	187.24	0.00	22.57	22.57	0.00
Lincoln National Corp.	1,277.66	126.04	126.04	0.00	9.87	9.87	0.00
Manulife Financial Corp.	642.76	94.53	0.00	94.53	14.71	0.00	14.71
AXA	541.20	71.64	71.64	0.00	13.24	13.24	0.00
Sammons Enterprises Inc.	236.81	52.21	52.21	0.00	22.05	22.05	0.00
Nationwide Mutual Group	243.24	35.64	35.64	0.00	14.65	14.65	0.00
Primerica Inc.	589.04	13.89	13.89	0.00	2.36	2.36	0.00
American International Group Inc.*	920.14	0.01	0.01	0.00	0.00	0.00	0.00
Northwestern Mutual Life Insurance Co.	1,462.93	0.00	0.00	0.00	0.00	0.00	0.00
New York Life Insurance Group	1,253.50	0.00	0.00	0.00	0.00	0.00	0.00
Massachusetts Mutual Life Insurance Co.	508.76	0.00	0.00	0.00	0.00	0.00	0.00
Aflac Inc.	157.02	0.00	0.00	0.00	0.00	0.00	0.00
State Farm Mutual Automobile Insurance Co.	798.97	0.00	0.00	0.00	0.00	0.00	0.00
Guardian Life Insurance Co. of America	494.19	0.00	0.00	0.00	0.00	0.00	0.00
Securian Financial Group	978.04	0.00	0.00	0.00	0.00	0.00	0.00
Hartford Financial Services Group Inc.	951.84	0.00	0.00	0.00	0.00	0.00	0.00
Pacific Mutual Holding Co.	299.26	0.00	0.00	0.00	0.00	0.00	0.00
TOTAL*	23,311.43	3,643.31	1,828.83	1,814.48	15.63	7.85	7.78
INDUSTRY*	43,627.36	6,390.10	4,426.26	1,963.84	14.65	10.15	4.50

Note: Data as of September 11, 2014, are from annual filings to the National Association of Insurance Commissioners (NAIC) and may include business directly written outside the United States if reported in NAIC statements. Direct premiums represent a consolidation of credit life insurance, group life insurance, ordinary life insurance, and industrial life insurance.

*Data for American International Group, Inc. include adjustments for intercompany reinsurance.

Source: SNL Financial LC

reinsurance that firms obtain from captives, more public data about the quality and quantity of captives' capital would be useful to evaluate risk migration.

The practice of using captive reinsurance is not uniform across the life insurance industry and some risk is being ceded to offshore captive reinsurance affiliates, which are not subject to U.S. regulatory oversight (see **Figure 2-43**). While the growing use of captive reinsurance could be driven by factors such as differences in tax and regulatory regimes, it remains difficult not only for policyholders and investors, but also in some cases for state regulators, to determine the capital adequacy and financial strength of captive reinsurers (see **Section 6.2**).

Mortgage Servicers

Mortgage servicers collect payments from borrowers; set aside escrows and insurance payments; forward principal and interest to the mortgage owners, including payments to investors in agency MBS; and handle tasks such as foreclosing. Rights to service mortgages for fees — mortgage servicing rights (MSRs) — are assets that can be bought and sold.

When federal bank regulators set standards for bank capital under the Basel III international accord, they limited how much MSR assets could count toward bank capital. MSRs now cannot count as more than 10 percent of a bank's Tier 1 common equity capital (or 15 percent when deferred tax assets are taken into account), reflecting the difficulty in valuing these assets. Beyond that level, excess holdings of MSRs must have dollar-for-dollar capital allocated to them. Additionally, regulators increased risk weights for the portion of MSRs included in capital from 100 to 250 percent.

These regulatory changes have created incentives for banks to sell MSRs to nonbanks. Over the past two years, the top five nonbank servicers alone have increased their share of servicing nationwide from 5 percent to 14 percent, and further growth is likely. Mortgage servicing activity and the accompanying risks appear to be migrating to sectors of the financial system that do not have comparable prudential supervision or capital standards and that rely on debt or securitization to finance servicing. Additionally, these firms have much less diversified revenue streams than banks and generally do not hold mortgages on their balance sheets, which can act to hedge MSR risk.

More so than most mortgage assets, MSRs are highly sensitive to interest rates and mortgage defaults. They drop in value when interest rates fall, because of the risk that borrowers will prepay and refinance their mortgages. Mortgage servicers face additional risks because they must continue to service loans and advance payments to investors after a borrower defaults, although they can recoup servicing fees and payments advanced only after foreclosure and sale of the home. As a result, servicers must finance activities that produce no revenue during tight funding environments that typically accompany periods of rising mortgage defaults. Mortgage servicing can also carry the risk of litigation arising from operational failures, another potential expense that nonbank servicers may not be prepared for. Issues with transferring mortgage servicing, even without a firm failure, are an ongoing problem in the industry (see CFPB, 2013). If a large servicer fails, shifting its activities to another servicer while ensuring the continued transfer of timely payments to investors could prove difficult, particularly given the risk that nonbank servicers would experience stress simultaneously.

One potential mitigant to these risks would be for state regulators to define prudential standards for nonbank servicers, including standards for capital, liquidity, and operating practices, a recommendation the Council made in its 2014 annual report. State regulators, through the Conference of State Bank Supervisors, have launched an initiative to evaluate potential prudential standards.

Two additional reforms would also be helpful. First, reforming the model for servicer compensation could align the interests of servicers more closely with those of investors and borrowers. Second, establishing industrywide standards for transferring servicing files would make it easier to transfer servicing rights if a servicer failed.

Single-Family Rental Securitizations

Since the crisis, investors have purchased large numbers of single-family homes with distressed mortgages and converted them into rental properties, betting on combined returns from rental income and home price appreciation. This practice was concentrated in a handful of metropolitan areas where home prices had declined sharply during the crisis. More recently, home prices in these areas have increased more than the national average.

Several investment firms have recently issued floating-rate securities backed by pools of single-family rental properties they purchased. As of September 2014, there have been nine of these deals, totaling close to $5 billion in par value outstanding. At this point, there is no evidence of an impact on financial stability from this practice, but the activity should be monitored.

The structures and risks of these rental securitization bonds are more similar to commercial mortgage-backed securities than residential MBS in two ways: (1) they rely on medium-term debt to fund long-term assets, and (2) there is little or no amortization of principal. These features create maturity mismatch, which means the securities must be refinanced at regular intervals, creating risk for investors and sponsors.

These bonds are structured through special purpose vehicles, which relieve deal sponsors of any legal obligation to bail out a failing entity. Although not required, a sponsor may bail out a failing vehicle to prevent damage to the sponsor's reputation, which happened with similar products many times during the recent crisis and in earlier episodes (see Gorton and Souleles, 2007).

However, in severe stress, concerns about possible failure could trump reputation risk. Sponsors retain equity stakes in these vehicles, but bankruptcy protections create an incentive for deal sponsors to let the vehicles default if home prices drop significantly. Such a price drop could spur large-scale sales of investment properties, losses for investors, and possible spillover to households. In addition, deal sponsors have some incentive to sell properties that increase in value, although this risk is mitigated by deal provisions.

Although financial stability risks from these deals are currently limited, how much of a threat they might pose in the future depends on how large the market becomes, whether standard practices develop, and how rental-backed securities are used as collateral elsewhere in the financial system. The market is expected to grow — perhaps rapidly. Analysts disagree on the potential size of the market, with estimates ranging from $20 billion or less (see Goodman, 2014) to as much as $900 billion (see Rahmani, George, and O'Steen, 2013). To grow beyond the $20 billion estimate, the market — which currently finances mainly rental properties held by large institutional investors — would need to expand to finance small investors who own only a few rental properties.

EVALUATING MACROPRUDENTIAL POLICY TOOLS

3

Macroprudential policies are essential to increase the resilience of the financial system and address emerging vulnerabilities. Since the crisis, bank regulators have taken important steps intended to shore up capital, liquidity, and risk management standards at large banking organizations. Routine stress testing and resolution planning have further changed the regulatory approach to these companies. Regulators have also developed some new tools to strengthen nonbank financial institutions and financial markets. However, implementation at this new frontier has so far been limited. Additional measures would help prevent a significant migration of financial activity to institutions and markets subject to less prudential regulation. Also, several countries are experimenting with policy tools to address cyclical excesses, such as housing booms; assessments of their effectiveness are preliminary.

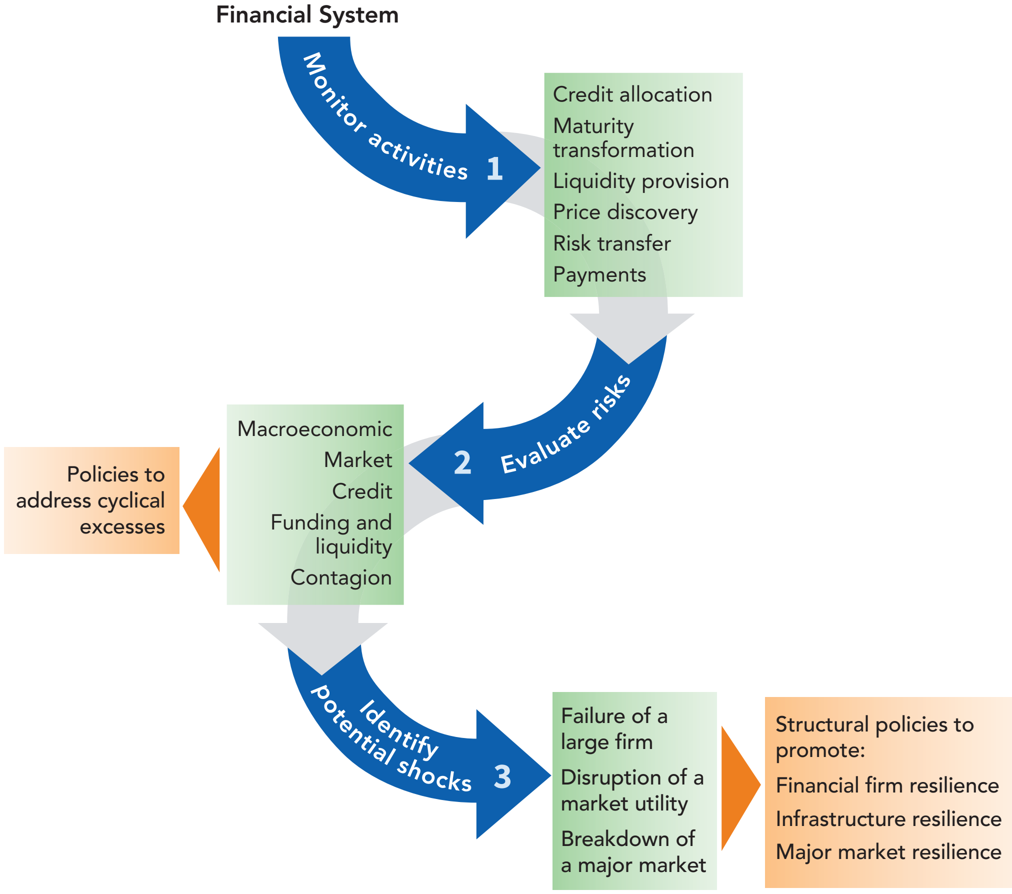
3.1 Framework for Policy Tool Evaluation

Macroprudential policy aims to make the financial system more resilient to shocks by addressing cyclical and structural vulnerabilities. To formulate macroprudential policy and to evaluate its effectiveness, we need to: (1) monitor financial developments for potential weaknesses, keeping an eye on innovation and the movement of financial activities to less regulated institutions, markets, and products; (2) identify the best tool for the job, through quantitative limits, buffers, or incentives that increase the price of risk-taking; (3) examine how tools may interact with each other and with microprudential oversight and monetary policy; and (4) understand how these tools may limit the transmission or amplification of shocks across national borders.

> Macroprudential policies are, by definition, intended to address vulnerabilities across the financial system. But financial regulation is traditionally implemented through oversight of financial institutions or particular markets.

Macroprudential policies that address the financial stability risks described in Chapter 2 can be cyclical or structural (see **Figure 3-1**). Most of the policies discussed in this chapter address structural vulnerabilities. There are also many potential tools to address the cyclical risks discussed in Chapter 2, such as rapid credit growth and deteriorating underwriting standards in leveraged lending; "time-varying" tools — which can be used to respond to a cyclical buildup of risks — are being developed and used outside the United States. How those tools are used should shed light on their effectiveness and utility.

Figure 3-1. Financial System Activities, Risks, Potential Shocks, and Policy Responses



Source: OFR analysis

Macroprudential policies are, by definition, intended to address vulnerabilities across the financial system. But financial regulation is traditionally implemented through oversight of financial institutions or particular markets. Consequently, a robust policy response to financial stability risks will likely need to include prudential and market oversight and to span more than one regulatory jurisdiction. Post-crisis regulations have begun to recognize that reality. For example, the Dodd-Frank Act widened the Federal Reserve's supervisory umbrella to include designated nonbank financial institutions. But much remains to be done.

Structural Policies to Promote Resilience in Financial Institutions. To address risks posed by the largest financial firms, regulators have tightened standards for bank capital, liquidity, and risk management (see **Section 3.2**). These regulations are intended to increase banks' buffers against shocks, which the financial crisis revealed to be insufficient. However, some of the specific provisions of these regulations may have unintended consequences, which could pose financial stability concerns.

The use of stress testing as a core supervisory tool for U.S. bank regulators is an important innovation; a number of agencies on the Council are also developing stress testing regimes for nonbank financial companies. Another innovation is the requirement that large, complex financial institutions file resolution plans, or "living wills," that describe how they could be resolved in a rapid and orderly manner under bankruptcy laws to limit possible spillovers from a failure. The creation of new legal authorities to wind down or resolve such firms in an orderly way is also new.

The Council has designated three large nonbank financial institutions and eight financial market utilities for heightened supervision, and regulators are working to develop supervisory and regulatory frameworks tailored to the businesses of those companies.

Structural Policies to Promote Market Resilience. Regulators have also taken or proposed measures intended to address potential risks posed by certain market activities (see **Section 3.3**). They have taken steps to address run risks in money market funds, suggested remedies to reduce the likelihood of fire sales in repo markets, and proposed new standards for mortgage markets. However, there remains more work to do to promote market resilience.

Structural Policies to Promote Resilience in Clearing Infrastructure. The Dodd-Frank Act directed all standardized swaps to be cleared through a central counterparty (see **Section 3.4**). To address risks posed by these central counterparties, the Act also gave regulators, through the Council, the power to designate them for heightened supervision. To date, the Council has designated eight financial market utilities, including two central counterparties that clear swaps.

Policies to Address Cyclical Financial Excesses. Both through-the-cycle and time-varying macroprudential policies can help mitigate cyclical excesses, such as credit, leverage, or liquidity transformation, that could lead to financial instability (see **Section 3.5**). Although supervisors have firm-specific tools, such as enforcement actions and supervisory rating downgrades, they have few systemwide tools to address market and credit excesses during the current extended period of low interest rates.

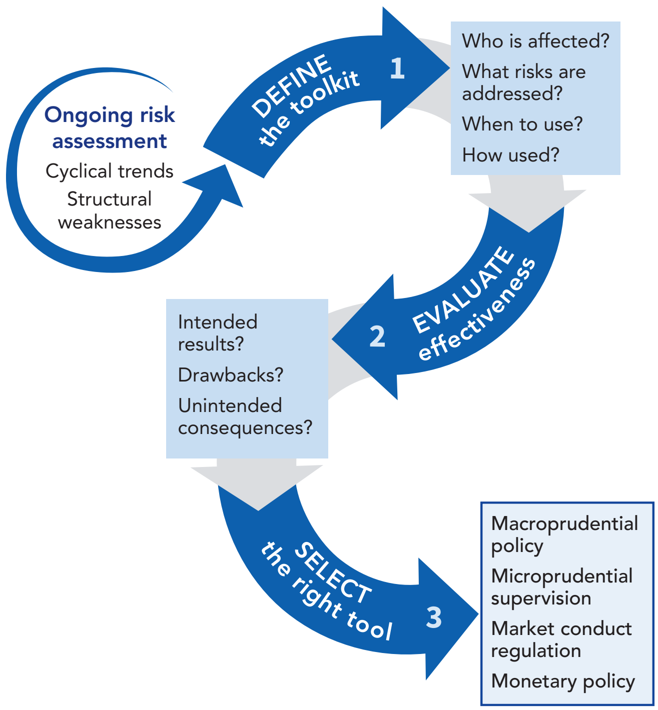
An important test case is the regulators' response to increased risk-taking in leveraged lending markets. Although bank regulators have issued updated guidance intended to strengthen banks' risk management in leveraged lending activities, it is not clear whether the guidance or other supervisory actions are curbing those activities or merely encouraging the activity to continue to move to products offered by asset managers, such as high-yield bond funds, exchange-traded funds (ETFs), hedge funds, and other private funds.

In the OFR's *2013 Annual Report*, we introduced an analytical framework for evaluating potential structural and cyclical macroprudential policy tools (see **Figure 3-2**).

Current vulnerabilities influence decisions about appropriate policy options. Policymakers need to define the toolkit in advance; prepare to evaluate the effectiveness of options, including potential drawbacks and unintended consequences; and then pick the right tool for the job. Policymakers must also be vigilant about whether macroprudential policy, traditional microprudential regulatory tools, and monetary policy complement or conflict with each other.

The macroprudential toolkit is far from complete and will be a moving target. Financial innovation and the migration

Figure 3-2. Macroprudential Policy Framework



Source: OFR analysis

Although supervisors have firm-specific tools…they have few systemwide tools to address market and credit excesses.

of activities will create new vulnerabilities, and new structural and cyclical challenges will continue to emerge as institutions, markets, and products evolve. By assessing vulnerabilities in the context of the basic functions of the financial system, as detailed in our first annual report in 2012, policymakers can make progress towards a better and more complete financial stability toolkit.

3.2 Structural Policies to Promote Resilience in Financial Institutions

This section discusses changes to the existing supervisory framework that address the risk of a large financial firm failing. These policies can play a crucial role in reducing risks to financial stability. However, these policies can also have unintended consequences that could conflict with financial stability.

The failure of a large, complex, and interconnected financial institution could have a negative impact on the real economy, shrinking credit to households, initiating a cascade of losses at other financial companies, or limiting access to payment and settlement services, if few substitutes are available.

This section describes key tools regulators have introduced or significantly changed since the crisis to promote the resilience of financial firms, such as stronger bank capital and liquidity standards, stress tests, resolution planning, and designation of nonbank financial companies. These tools are inherently microprudential — that is, they are used by regulators to ensure the safety and soundness of individual financial companies. But they also have implications for macroprudential policy because they affect large financial institutions' risk-taking.

Bank Capital and Liquidity Standards

Stronger regulatory capital rules and new liquidity standards for banks have been central to post-crisis regulatory reform. The financial crisis of 2007-09 revealed that a number of the largest U.S. banks lacked sufficient high-quality capital to weather a severe economic downturn without government financial assistance, such as the Troubled Asset Relief Program. The crisis also revealed material liquidity risk at U.S. banks and bank holding companies, as evidenced by large-scale Federal Reserve discount window lending and the introduction of special liquidity programs the Federal Reserve used to provide hundreds of billions of dollars in loans to banks and their broker-dealer affiliates.

The Basel Committee on Banking Supervision and U.S. bank supervisors introduced reforms to capital regulation and new quantitative liquidity metrics to force firms to rely less on public support and limit leverage and maturity transformation. Since early 2013, bank regulators have issued final rules implementing Basel III capital requirements, including the countercyclical capital buffer (see **Section 3.5**) and capital conservation buffer (July 2013), supplementary leverage ratio (October 2013), enhanced supplementary leverage ratio (May 2014), and liquidity coverage ratio (September 2014). A rule modifying the calculation of the supplementary and enhanced supplementary leverage ratios also was issued in September 2014. Regulators have also begun to discuss another proposal that would introduce a new type of loss-bearing liability instrument to support recapitalization during the resolution of a large bank; together with existing capital requirements, this has been called the Total Loss Absorbing Capacity.

With these new measures, regulators have sought to strengthen banks' ability to weather stress. However, analysis of the economic and financial stability impacts of the regulations is warranted. For example, it is possible the new capital and liquidity standards could reduce banks' ability to lend. Large banks' loan growth has been slow relative to the growth in gross domestic product in recent years (see **Figure 3-3**). That could (1) interfere with the credit channel and efforts by the central bank to stimulate economic activity, and (2) shift lending activity from banks to capital markets and other forms of nonbank financing that do not have a federal government backstop and generally are subject to less prudential oversight. While regulators have tried to lessen these effects through long phase-in periods for revised or new prudential regulations, large banks have worked towards early compliance.

RISK-BASED CAPITAL REQUIREMENTS

In Basel III, regulators here and abroad agreed on several new global risk-based capital requirements. First, regulators increased the quality and quantity of capital and introduced a common equity Tier 1 capital requirement for all banks and bank holding companies. Banks and bank holding companies will also phase in a capital conservation buffer that will limit dividends and discretionary bonuses paid when a bank's total capital ratio is less than 250 basis points above the regulatory minimum of 10.5 percent. For bank holding companies that regulators have identified as globally systemically important banks (G-SIBs), there will be an additional capital surcharge of 100 to 250 basis points of risk-weighted assets.

The forthcoming U.S. G-SIB proposal will use the G-SIB framework developed by the Basel Committee as a starting point. However, the Federal Reserve is considering implementing standards beyond the Basel framework in two areas: (1) the surcharge levels for U.S. G-SIBs would be higher than those finalized in the Basel framework, and (2) the surcharge formula would directly take into account each U.S. G-SIB's reliance on short-term wholesale funding.

Risk-based capital standards are based on the risk of each asset and exposure. Smaller, less complex banks may use a set of standard risk weights for assets defined by regulators, simplifying compliance. Larger banks may determine their own capital requirements based on internal risk-based models (reviewed by regulators) that can be complex and diverse across banks. The Basel Committee's fundamental review of the trading book shows that regulators are concerned about the accuracy and rigor of these models, because many parameters are needed to estimate a single firm's capital requirement. In the United States, a section of the Dodd-Frank Act requires that the standardized approach should serve as the minimum for all U.S. banks' risk-based capital requirements.

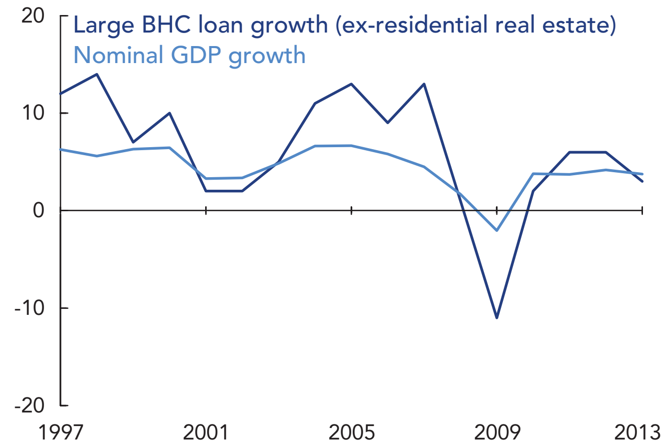
The advanced approach may also increase the procyclicality of bank lending, because internal risk-based models tend to base risk calculations on the recent historical performance of each asset class, resulting in higher capital requirements during a downturn and lower requirements during a boom (see Andersen, 2011). Some companies and regulators have tried to reduce this problem by developing models that use longer historical data series to estimate potential loss.

SUPPLEMENTARY AND ENHANCED SUPPLEMENTARY LEVERAGE RATIO STANDARDS

U.S. bank regulators have also strengthened the leverage ratio, a simpler capital standard based on total exposures, to include a broader definition of off-balance-sheet items. In the leverage ratio, the measure of total assets includes exposures with no risk weights, as well as off-balance-sheet exposures, such as derivatives and repos. Some regulators have even argued that advanced approaches to risk-based capital should be discarded in favor of greater reliance on

Figure 3-3. Large Bank Holding Company Loan Growth, Excluding Residential Real Estate Loans (percent change)

Annual loan growth at large banks remains weak relative to growth in GDP



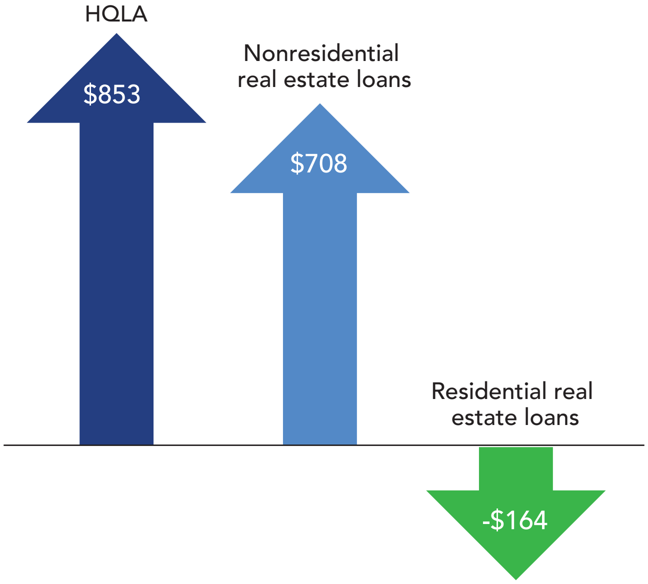
Note: Large bank holding company (BHC) loan growth is calculated using the median rate for bank holding companies with assets greater than $50 billion.

Source: Bureau of Economic Analysis, Federal Reserve Form Y-9C

The advanced approach may also increase the procyclicality of bank lending, because internal risk-based models tend to base risk calculations on the recent historical performance of each asset class, resulting in higher capital requirements during a downturn and lower requirements during a boom.

Figure 3-4. Large U.S. Bank Balance-Sheet Trends ($ billions)

The strongest area of bank balance-sheet growth since 2010 is high quality liquid assets (HQLA)

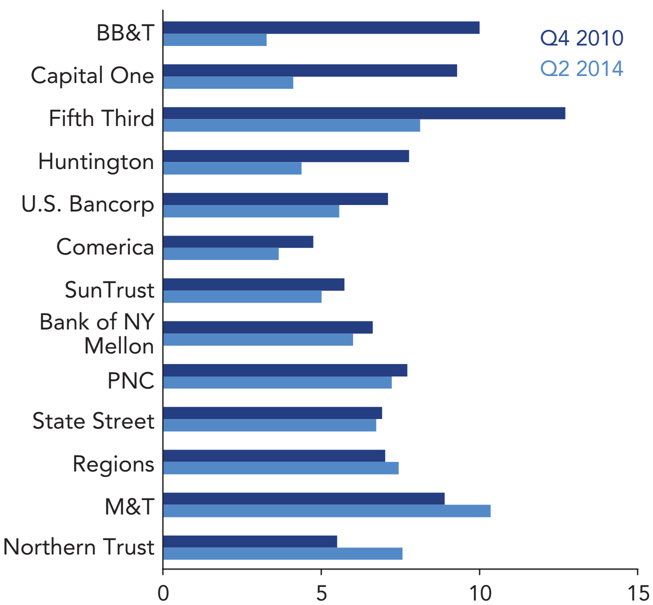


Note: Growth is measured from June 30, 2010, to June 30, 2014. High-quality liquid assets include cash, U.S. Treasuries, agency debt, and agency mortgage-backed securities.

Source: Federal Reserve Form Y-9C

Figure 3-5. Weighted Average Maturity of Banks' Bonds Outstanding (years)

Some large banks are reducing weighted average maturity



Sources: Bloomberg L.P., OFR analysis

supervisory stress tests, the leverage ratio, and the U.S. statutory floor (see Tarullo, 2014).

U.S. supervisors also adopted stronger requirements for U.S. bank holding companies with $700 billion or more in assets. These firms must begin to report an enhanced supplementary leverage ratio in January 2015 and must meet a minimum 5 percent enhanced supplemental leverage requirement beginning in January 2018. (Currently, eight bank holding companies would qualify.) Their affiliated banks must meet a minimum ratio of 6 percent. Both covered bank holding companies and banks must meet the required ratios to be free from restrictions on capital distributions and discretionary bonuses to executives.

Based on large banks' public reporting, it appears that the enhanced supplementary leverage ratio is likely to prove more of a constraint than risk-based standards for some large banks and may lead to unintended consequences. Leverage ratios tend to encourage banks to hold higher-yielding but riskier assets relative to low-risk assets, such as excess central bank reserves and repurchase agreement (repo) transactions backed by government securities. Also, in a stressed environment, the leverage ratio may create an incentive to sell securities rather than finance them in the repo market, potentially promoting asset fire sales. This type of risk is poorly understood but could be assessed in stress tests.

LIQUIDITY COVERAGE RATIO

The liquidity coverage ratio (LCR) requires certain companies to maintain sufficient high-quality liquid assets (HQLA) to cover potential net cash outflows over a 30-day stress period. The ratio applies to consolidated bank holding companies with assets greater than $250 billion or foreign exposures greater than $10 billion and affiliated banks with assets greater than $10 billion. The Federal Reserve also adopted a separate modified LCR rule for bank holding companies with assets greater than $50 billion, which in practice allows these firms to hold HQLA sufficient to meet 70 percent of anticipated net cash outflows.

The requirement is aimed at the perceived runoff risk of different types of liabilities, drawdown rates on commitments, and contractually scheduled cash flows over a 30-day period. Although capital and liquidity have long been given equal weight in assigning U.S. banks' supervisory ratings, supervisory assessments of liquidity have lacked a standardized quantitative metric. For this reason, the LCR metric is a useful common yardstick, but it also represents new territory for supervisors.

Banks can comply with the LCR by increasing holdings of liquid assets, changing the maturity or composition of their liabilities to reduce projected cash outflows, or shortening the maturity of assets to increase projected cash inflows. Banks have been getting ready for the LCR's 2015 phase-in mostly by acquiring liquid assets (see **Figure 3-4**).

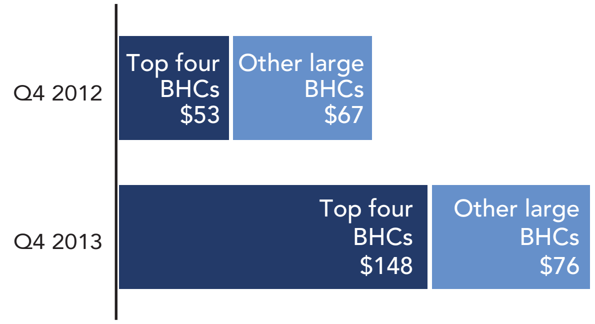
Just as capital standards promote some types of assets as less risky than others, the LCR promotes some types of liabilities over others. For example, the LCR requires banks to hold HQLA to cover the risk of heightened withdrawals by depositors, but only a fractional amount for bonds and other debt with a maturity of 30 days or more. Banks may be responding to the approach of the LCR by issuing more bonds and using the proceeds to acquire HQLA. In some cases, they also have shortened the weighted average maturity of their outstanding bonds to reduce their interest expense, offsetting the lower interest income on HQLA (see **Figure 3-5**).

In anticipation of the phase-in of the LCR, four of the largest banks increased their use of financing from the Federal Home Loan Banks (FHLBs) by 150 percent between March 2012 and December 2013 (see FHFA, 2014). Much of this funding was used to acquire high-quality liquid assets that can include the debt of the FHLBs and other government-sponsored enterprises (GSEs) under the rule. However, this development could heighten the risk of contagion through an increase in interconnectedness between banks and FHLBs (see **Figure 3-6**). The LCR also assumes that banks can roll over 75 percent of FHLB borrowing due within 30 days, which is more favorable than other forms of wholesale funding. If bond markets were to freeze up and FHLB issuance became difficult, it is not clear if the FHLBs hold sufficient liquidity to roll over maturing bank borrowings.

Does the LCR also increase the cost of bank lending? The answer depends. When banks make loans, deposits increase in the banking system, requiring banks to acquire liquid assets or otherwise build their LCRs. If deposits increase enough to make banks subject to the LCR noncompliant with the minimum requirement, the banks would have to acquire liquid assets or otherwise build LCR, which would increase net funding costs. Banks can absorb the cost and reduce profitability or take measures to offset the increased regulatory costs, such as raising interest rates or fees,

Figure 3-6. Large U.S. Banks' FHLB Borrowings ($ billions)

The largest banks are ramping up FHLB borrowing to acquire buffer assets to comply with LCR



Note: The four largest bank holding companies (BHCs) are Bank of America Corporation, Citigroup Inc., JPMorgan Chase & Co., and Wells Fargo & Company. Other BHCs include all other bank holding companies with total assets greater than $50 billion.

Source: Federal Reserve Form Y-9C

In anticipation of the phase-in of the LCR, four of the largest banks increased their use of financing from the Federal Home Loan Banks (FHLBs) by 150 percent between March 2012 and December 2013...the risk of contagion could be heightened through an increase in interconnectedness between banks and FHLBs.

Figure 3-7. Results of Selected Studies on Liquidity Coverage Ratio Economic Impacts

Study	LCR compliance gap size and closure method	Sample	Lending spread increase	Lending volume decline	Impact on GDP
BIS-MAG (2010)	25% increase in liquid assets/total assets	International	14.9 basis points (bps) (median country estimate in 18 quarters)	-3.2% (median country estimate)	-11 to 14 bps Standard macro and DSGE model (median country)
Interagency Study (2011)	$1.2 trillion bank by bank LCR gap closure for US. individual banks using estimate of "least cost" mechanism	U.S.	15 to 27 bps (median estimate for different loan sectors)	n/a	-2-33 bps decline in level of nominal GDP
EBA LCR impact study (2013)	EUR 264 billion compliance gap from supervisory data	E.U.	6.9 bps (short-term) 3.6 bps (steady state)	n/a	-3 to 7 bps impact on level of real GDP in transition
IIF (2011)	Banks issue term debt to buy buffer assets to close $1.8 trillion LCR gap (but also includes impact of higher capital standards and Dodd Frank)	U.S. (all countries)	468 bps (364 bps)	-4.6% (-3.2%)	300 bps decline in real GDP
Covas/Driscoll (2011)	Banks cut loans and increase liquid asset holdings by 20%	U.S.	20 bps (long-run estimate)	-5%	-70 bps change in level of output

BIS-MAG = Bank of International Settlements-Macroeconomic Assessment Group
EBA = European Banking Authority
IIF = Institute of International Finance

Source: Office of the Comptroller of the Currency (2014b)

investing in riskier assets with higher returns, or cutting expenses.

Studies estimate the effects of the LCR requirement could be significant, with lending declining 3 to 5 percent and interest rates rising 15 to 30 basis points (see **Figure 3-7**). However, those studies date from 2011 and consider an early version of the LCR, which the Basel Committee subsequently made less stringent. The final U.S. rule is a stronger requirement than the final Basel rule. Although it is early to analyze the economic impact of the LCR in practice, these studies provide some preliminary analysis of the question.

It remains unclear whether the LCR will work as a buffer that banks can draw down during times of financial stress (see BCBS, 2012), one of the key intended benefits of the regulation. In the final rule, regulators say they "should not discourage or deter a banking organization from using [high-quality liquid assets] when necessary to meet unforeseen liquidity needs arising from financial stress that exceeds normal business fluctuations" (see OCC, Board of Governors, and FDIC, 2014).

However, publicly listed banks might be hesitant to allow LCRs to fall below the regulatory minimum during a crisis if they were required to report breaches to comply with disclosure regulations, because that could signal weakness to their investors. The final rule does not provide a clear mechanism, such as a reduction or waiver of the LCR requirement by U.S. supervisors, to allow banks to use their liquidity buffers during a systemic stress without potentially triggering disclosure issues. Such a mechanism could allow supervisors to use the LCR as a countercyclical macroprudential tool to address liquidity shocks (see van den End and Kruidhof, 2013).

NET STABLE FUNDING RATIO

The net stable funding ratio (NSFR), which was finalized in October by the Basel Committee for implementation by January 2018, is a structural balance-sheet measure to address liquidity risk beyond the LCR's 30-day horizon. Unlike the LCR, which is a measure of a bank's short-term cash flow profile under stressed conditions, the NSFR is intended to address more normal market conditions. The

Basel framework for the NSFR states that available stable funding must equal or exceed required stable funding (see BCBS, 2014b).

The Basel framework's calculation of available stable funding is weighted by the perceived stability of each liability — higher for more stable funding, such as time deposits or equity, and lower for less stable funding, such as short-term loans from another bank. The calculation of required stable funding is weighted by the perceived liquidity of a bank's assets and off-balance-sheet exposures — lower for liquid assets (zero for cash and 5 percent for unencumbered U.S. Treasuries) and higher for loans and other long-term assets.

Stress Tests

The Dodd-Frank Act introduced significant new capital stress testing requirements for financial companies, including Federal Reserve-run supervisory stress tests and company-run stress tests with supervisor-prescribed scenarios to complement firms' internal stress test processes.

Supervisors give companies three economic scenarios to use for their stress tests: (1) a baseline scenario that reflects the consensus view of the U.S. economy, (2) an adverse scenario that reflects a decline in economic activity and other risks, and (3) a severely adverse scenario that reflects a significant decline in the U.S. economy.

Both the adverse and severely adverse scenarios include a trading shock. Stress testing is an important macroprudential tool because it allows supervisors to evaluate financial institutions' resilience under various stress scenarios, which supervisors can tailor to address perceived systemwide threats.

The three federal bank supervisors — the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) — collaborate on common scenarios and have examination teams review stress-testing model governance and capital planning, a critical but resource-intensive component of the process.

FEDERAL RESERVE STRESS TESTS

The Federal Reserve this year performed supervisory stress tests on the 30 largest bank holding companies. In the future the three nonbank financial companies the Council has designated for heightened prudential supervision will be included in this stress test, although not in 2015. The Federal Reserve specifies baseline, adverse, and severely adverse scenarios for the tests. The Federal Reserve uses the results from its own models and the company-run models in its comprehensive capital analysis and review process (CCAR), which assesses capital adequacy and the strength of each company's capital planning.

The Federal Reserve's 2014 test estimated total losses of $501 billion for the 30 companies under the severely adverse scenario, which included a deep recession in the United States, Europe, and Japan; sharp declines in asset prices; and an economic slowdown in developing Asia. Despite those steep losses, banks' capital ratios remained about the level experienced during the financial crisis. In its CCAR results, the Federal Reserve again noted qualitative issues with the capital planning processes at several banks.

COMPANY-RUN STRESS TESTS

The Dodd-Frank Act also mandated company-run stress testing be performed by certain financial companies. The law requires semiannual company-run stress tests for bank holding companies with assets greater than $50 billion, as well as Council-designated nonbank financial companies.

In one semiannual cycle, the firms use supervisor-prescribed scenarios and their results are compared to those of the Federal Reserve's CCAR model. In the other cycle, firms provide to supervisors stress test results based on their own internally generated scenarios.

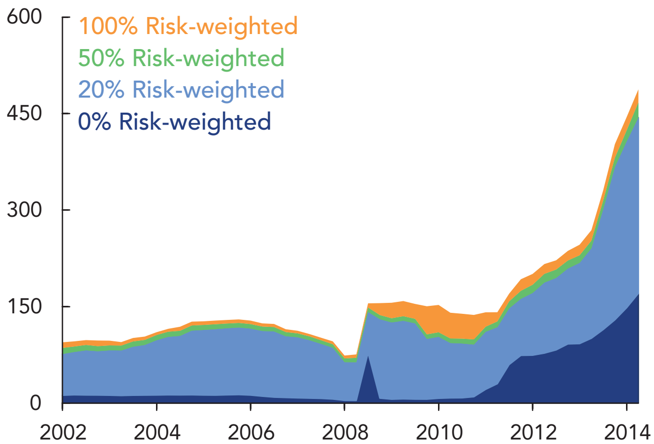
Dodd-Frank also required annual company-run stress tests for any financial company with assets greater than $10 billion and regulated by a primary federal financial regulatory agency. The Federal Reserve, OCC, FDIC, and Federal Housing Finance Agency (FHFA) have finalized rules implementing this requirement. The SEC and CFTC have not yet proposed rules. The National Credit Union Administration approved a proposed rule last year requiring annual stress tests at any credit union with more than $10 billion in assets, although it was not required to do so under the Dodd-Frank Act.

A number of companies recently held their first company-run stress test under the Dodd-Frank Act, including Fannie Mae, Freddie Mac, and banks and bank holding companies supervised by the Federal Reserve, OCC, and FDIC with assets in the $10 billion to $50 billion range.

Large insurance companies are not subject to the Dodd-Frank Act company-run stress testing, unless designated by the Council for heightened prudential supervision.

Figure 3-8. Held-to-Maturity Securities Portfolios at U.S. Banks ($ billions)

Revised capital standards are contributing to rapid growth



Source: Federal Financial Institutions Examination Council Call Reports for all FDIC-insured banks

Stress tests also could be more valuable if they were flexible enough to consider a broader range of possible supervisor-prescribed stress scenarios.

State insurance regulators traditionally have required stress testing only in certain industry sectors; for example, asset-liability testing by life insurers. State insurance regulators, acting through the National Association of Insurance Commissioners, recently adopted a model and supporting guidance that, if adopted by states, would require larger insurers and insurance groups to annually perform an "Own Risk and Solvency Assessment" including a prospective solvency assessment in both normal and stressed environments. The new model and guidance do not prescribe a specific degree of stress or a specific methodology of application.

STRESS TESTS AND FINANCIAL STABILITY

OFR staff's initial work in this area suggests that there remains room for further enhancements to the current stress test framework (see Bookstaber and others, 2014). For example, bank supervisors provide 28 high-level, national and international variables in the supervisor-prescribed stress scenarios. Although agencies also provide a description of the macrofinancial scenario, to estimate losses banks must extrapolate those variables into several hundred more variables. The results may be neither consistent with the scenario nor comparable across firms, which could affect company-run stress test results. Stress tests also could be more valuable if they were flexible enough to consider a broader range of possible supervisor-prescribed stress scenarios, although this could be difficult to implement in the current process. This is particularly important as the range of sizes and business models of banks subject to stress tests has grown and become more diverse.

Supervisory stress tests currently assume credit losses are the driver that will pressure capital. It is also possible that the driver of a bank's stress is not a macroeconomic shock, but a funding stress that arises inside the financial sector or a credit shock that could be magnified by funding stress. Potential liquidity and solvency interactions receive little consideration. For example, banks have increased securities holdings in held-to-maturity portfolios by nearly half a trillion dollars since the crisis — in part, this reflects new capital standards that require advanced approach banks to take a capital charge for unrealized losses on available-for-sale securities, but not held-to-maturity securities (see **Figure 3-8**). Under stress, banks may need to use these securities to generate liquidity, either by selling them (which could result in a capital loss) or by financing them through repos (which could reduce a bank's leverage ratio and LCR).

Resolution Plans and Orderly Liquidation Authority

Despite the recent enhancements in prudential standards for the largest banks and bank holding companies, the risk of a systemically important bank failure cannot be reduced to zero. The financial crisis illustrated that the U.S. Bankruptcy Code is not always able to handle a rapid and orderly resolution of a large, complex insolvent financial institution. However, the resolution of such a financial firm should occur efficiently and quickly to minimize market disruption and potential systemic consequences. Title I and Title II of the Dodd-Frank Act introduced a new regulatory approach to help expedite the orderly resolution of large firms.

Title I required certain companies to prepare resolution plans to demonstrate how they could be resolved in a rapid and orderly manner under the Bankruptcy Code, without extraordinary government assistance, in the event of their material financial distress or failure. The Federal Reserve Board and the FDIC have joint authority to review and set information requirements for the plans, in addition to the information requirements set out in the Dodd-Frank Act.

Title II gave the FDIC the back-up authority to resolve a financial company if it is determined that the firm cannot be resolved through bankruptcy without serious, adverse effects on financial stability. After the Federal Reserve and either the FDIC, SEC, or Federal Insurance Office make a recommendation, the Treasury Secretary, in consultation with the President, must make a determination to begin a Title II proceeding. Under Title II, the FDIC would be appointed as receiver, succeeding to all rights and title to the company's assets, and would manage the insolvency process. The Dodd-Frank Act provided for an Orderly Liquidation Fund, subject to certain parameters, as a backup source of liquidity support.

Title I required periodic submission of resolution plans by the largest bank holding companies and designated nonbank financial companies to the FDIC and the Federal Reserve (see Board of Governors and FDIC, 2013). Eleven companies submitted plans in 2012 and revised them in 2013 and 2014. About 120 institutions submitted their first plans in 2013 and have submitted revised plans in 2014. The three nonbank financial companies designated by the Council (American International Group, Inc., General Electric Capital Corporation and Prudential Financial, Inc.) submitted initial resolution plans in 2014.

After reviewing the revised 2013 plans of the 11 largest, most complex banking organizations, the Federal Reserve and FDIC jointly directed the companies to address shortcomings and demonstrate they are taking actions to be able to be resolved under the Bankruptcy Code (see Board of Governors and FDIC, 2014). Directed actions included rationalizing corporate structures, amending financial contracts to stay, or suspend, certain early termination rights of external counterparties, and taking action to ensure continuation of critical services. Firms are expected to respond to regulatory feedback in their 2015 resolution plans.

Resolving a large, complex insolvent financial firm raises many challenges under the Bankruptcy Code. These include the risk of multiple, competing insolvency proceedings in different jurisdictions, domestic and international; the threatened discontinuity of critical operations; and potential systemic consequences of counterparty actions.

In addition, in some cases, a diversified, global company may be resolved under the strategy called "multiple-point-of-entry," which means its subsidiaries would enter resolution under different bankruptcy regimes. Lack of convergence in insolvency law makes this exercise complicated.

An alternative is the single-point-of-entry strategy, which may provide for a more rapid and orderly resolution under the bankruptcy code. The FDIC has proposed this approach as one of several possible strategies available for implementing its Title II back-up authority (see FDIC, 2013).

Under the single-point-of-entry proposal, the FDIC would be appointed receiver only of the top-tier U.S. holding company, while subsidiaries would remain open and continue operating. The FDIC would organize a bridge financial company that would receive the failed parent company's assets, primarily investments in and loans to its subsidiaries. Losses would be apportioned first to the equity holders and then to other claimants of the failed company according to the order of statutory priority. In theory, the bridge financial company could be created quickly, possibly over a weekend, potentially allowing for continuation of subsidiaries' critical operations with minimal disruption.

However, the single-point-of-entry strategy does not solve all concerns with a Title II resolution. A key requirement of the single-point-of-entry strategy is that bank holding companies must have sufficient long-term, unsecured debt ("bail-in debt"), so losses could be covered by the claimants of the parent company and a new company or companies could be capitalized when they break away from the bridge company. The reaction of foreign regulators is also uncertain. For example, the single-point-of-entry strategy may not work if foreign regulators ring-fence assets, that is, prevent the assets of a failing firm from leaving their jurisdiction.

Another concern is that a one-business-day stay on a counterparty's rights to terminate qualified financial contracts such as derivatives will not bind counterparties overseas or those with contracts governed by foreign law. This concern, however, is reduced by a new protocol developed by the International Swaps and Derivatives Association (ISDA), providing for temporary stays on certain default and early termination rights within standard ISDA derivatives contracts. So far, 18 large banking organizations have agreed to sign on to the protocol.

Firms have also been considering the possibility of using the single-point-of-entry approach under the Bankruptcy Code as a potential resolution strategy under Title I. Under a Title I resolution using the single-point-of-entry approach, the creation of a bridge company could be initiated by the firm itself or by the firm's primary regulator. Regulators have discussed possible changes to the Bankruptcy Code to allow the single-point-of-entry approach.

Designation of Nonbank Firms for Heightened Oversight

The financial crisis illustrated that the potential impact of the failure of a financial firm is related not only to the size of the institution but also to its business mix and the nature and extent of its connections to other market participants. The Dodd-Frank Act gave the Council the authority to designate nonbank financial companies that could pose a threat to financial stability for enhanced prudential standards and supervision by the Federal Reserve. The Council designated three companies in 2013 — AIG, General Electric Capital Corporation, and Prudential. Under a separate Dodd-Frank Act authority, the Council in 2012 designated eight financial market utilities, which are companies that manage or operate systems for transferring, clearing, or settling financial transactions.

The designation of nonbank financial companies has potential benefits for financial stability. The most important potential benefit is that it provides for consolidated supervision of the largest, most complex firms. Evaluating risks across a firm's businesses by a single supervisor reduces the likelihood that risky activities in one business line could be transmitted to other business lines in the same company but outside of regulators' authority. And it is intended to address "too-big to-fail" risk — that large, complex institutions might benefit from an implicit government backstop — by requiring that the risks posed by the largest, most complex financial institutions are prudently managed and subject to adequate oversight. The Federal Reserve is working to develop ways to supervise and regulate designated nonbank financial companies to ensure that standards and oversight are appropriate given the companies' business mixes, models, and practices.

There are also potential challenges associated with designation. The most important of these is the difficulty of developing and implementing appropriate prudential oversight for financial companies with diverse business models and mixes, because what is appropriate for some businesses may not work for others. In addition, regulatory costs for designated firms will rise on designation, and that could promote a migration of businesses or activities to other parts of the financial system.

Given those potential benefits and challenges, it is premature to assess the net effects of designation at this early stage. Some academic researchers have analyzed market pricing to evaluate whether market participants adjust their views of insurance companies identified under a separate international process by the Financial Stability Board. This research argues that there may be some erosion in market discipline (see Dewenter and Riddick, 2014).

Recognizing that tools other than firm-specific designation may be appropriate remedies for risks in some types of nonbank financial companies, the Council directed member agency staff to undertake a more focused analysis of industry-wide products and activities to assess risks associated with the asset management industry. For example, some industrywide activities that could introduce risk, such as investment in certain types of derivatives, may be more appropriately addressed through market-based or industrywide regulation.

3.3 Structural Policies to Promote Market Resilience

This section discusses policies that address the risk of a breakdown of a major market, which could include asset fire sales, runs on short-term liabilities, and a sudden loss of market liquidity.

Even as new measures strengthen regulatory requirements on banks and expand the universe of institutions subject to consolidated supervision, the credit intermediation of other types of financial institutions is growing. For example, the asset holdings of registered funds are now greater than bank assets (see **Figure 3-9**). As the OFR concluded in its 2013 study on the asset management industry, regulators need to consider potential financial stability risks associated with asset management activities, in addition to individual companies (see OFR, 2013b).

This section describes three types of microprudential tools that focus on activities and can promote market resilience: redemption policies and regulation, limits on haircuts and collateral, and risk retention rules. Registered investment funds have some built-in safeguards to protect investors, such as restrictions on exposure, leverage, and illiquidity, and requirements related to reporting and governance. Unregistered funds and other types of nonbank market participants have fewer built-in safeguards.

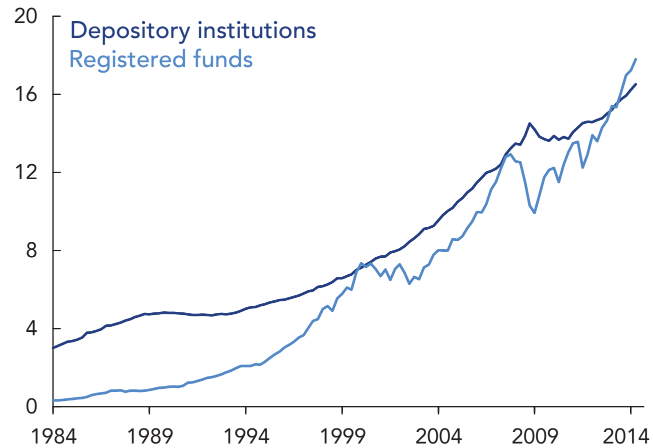
Redemption Policies and Regulation

Investors in collective investment vehicles are exposed to market risk and may have an incentive to redeem ahead of other investors in market downturns to reduce their losses. Individual fund managers can impose redemption policies to mitigate the impact of redemption risk on the fund and to improve its resilience in the event of widespread redemptions. Managed funds' redemption policies collectively can affect the spread of contagion during a systemic event based on how many assets funds are forced to sell to meet redemption obligations.

Each fund's redemption policy exerts an effect on its peers. If fund managers are allowed to compete for investors through their redemption policies, they may individually construct policies that in aggregate make the industry undesirably fragile. Funds with liquidity mismatches compared to the stated redemption policies can create market fragility. Although this is not a concern for funds invested in

Figure 3-9. Financial Assets in Registered Funds and Depository Institutions ($ trillions)

Asset holdings of registered funds are now greater than bank assets



Source: Haver Analytics

If fund managers are allowed to compete for investors through their redemption policy, they may individually construct policies that in aggregate make the industry undesirably fragile.

Figure 3-10. Redemption Policies

Fund Types	Earliest Redemption		Cost (ex-distribution fees and broker commissions)	
	Current Practice	Regulation	Current Practice	Regulation
Money Market Funds	Pricing: End of day Settlement: End of day	7 days or fewer depending on the prospectus If money market fund share is about to fall below its par value, board can suspend all redemptions and liquidate the fund. In 2016, discretionary redemption gates if weekly liquid assets fall below 30%.	None	In 2016, default liquidity fee; 1% liquidity fee when the fund's weekly liquid assets are less than 10% unless the board decides a fee is not in the best interest of the fund Discretionary liquidity fee; not exceeding 2% when the fund's weekly liquid assets are less than 30%, unless the board decides a fee is not in the best interest of the fund
Mutual Funds	Pricing: End of day Settlement: Transaction plus 1 day	7 days or fewer depending on the prospectus	Some charge 0.5% to 2% redemption fees against fund withdrawals too soon after fund purchase to discourage opportunistic trading	None
Exchange-Traded Funds	Pricing: End of day Settlement: Transaction plus 3 days	3 days for retail investors	None	None
Hedge Funds	Pricing and settlement determined by offering; that is one-to-two year "lock-up;" infrequent redemption once per month or once per quarter.	None	Some funds allow "soft lock;" early withdrawal with 2% to 10% penalty fee	None

Source: OFR analysis

highly liquid assets, such as large-cap equities or Treasuries, some funds offer exposure to less liquid assets, such as emerging markets, high-yield bonds, or syndicated bank loans. Prudential regulation could overcome this coordination problem for less liquid funds. For this reason, recent reforms to the valuation and redemption of money market fund shares are an area of interest and ongoing analysis for the OFR.

Redemption policies vary primarily in terms of speed (how quickly investors can liquidate) and cost (whether fees are associated with investor withdrawals) (see **Figure 3-10**).

SPEED LIMITS

Managers of private funds can suspend redemptions for a certain period of time using redemption restrictions, or "gates." Practices vary in the hedge fund industry. Hedge funds can limit redemption requests to only once per month or once per quarter and may require as much as six months advance notice. Hedge funds, which may invest in illiquid assets, might also impose a "lock-up period," often one or two years from the initial investment, during which an investor cannot withdraw funds without penalty.

Mutual funds are generally able to meet redemption requests within seven days, as required by current regulation. However, some mutual funds and exchange-traded funds (ETFs) offer exposures to less liquid asset classes, such as emerging markets, high-yield bonds, or syndicated bank loans (see **Exchange-Traded Funds and Liquidity Mismatches** in **Section 2.3**). Managing liquidity for mutual fund or ETF portfolios invested in less liquid asset classes may require additional risk management and regulatory tools.

Redemption restrictions should take into account the likelihood that market liquidity will become impaired during market stress and serve as a mechanism to limit systemic spillovers at those times. Under normal circumstances, money market funds offer same-day redemption because they invest in highly liquid assets. However, recent money

Money Market Fund Reform

The financial crisis illustrated the vulnerability of money market funds to mass redemptions and prompted regulators to implement a series of reforms in this market.

Under reforms implemented in 2010, the SEC requires at least 10 percent of money market fund assets to be cash, U.S. Treasuries, or other securities that can be converted into cash within a day; 30 percent must be able to be converted into cash within a week. The SEC's reforms also limited the maturity and credit risk in fund portfolios and introduced Form N-MFP, which requires detailed monthly disclosures (see SEC, 2010).

In November 2012, the Council issued for public comment a proposed recommendation that the SEC require either a floating or a fixed net asset value with significant new safeguards. This represents the first time the Council used its authority under Section 120 of the Dodd-Frank Act, which authorized the Council to recommend that a primary federal regulator apply new or heightened standards to address a risk to financial stability (see FSOC, 2012).

The SEC announced reforms in July 2014 addressing those concerns (see SEC, 2014b). Its rule requires institutional prime money market funds to implement a combination of floating net asset value, redemption restrictions, and liquidity fees by October 2016. The rule also made enhancements to the SEC's existing stress testing regime by requiring a fund to test its ability to maintain weekly liquid assets of at least 10 percent and to minimize principal volatility in response to certain specified hypothetical stress scenarios.

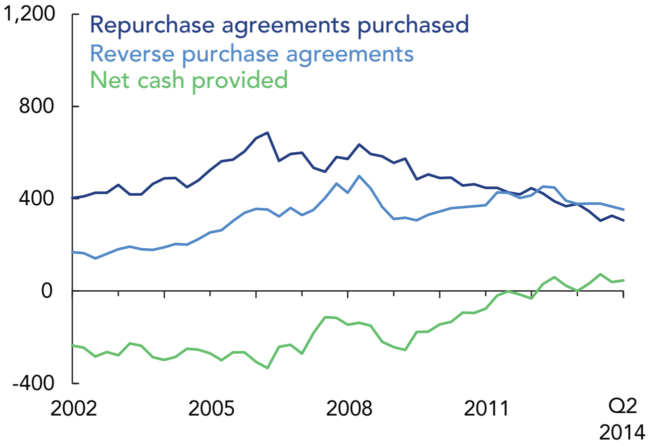
With the implementation of floating net asset values, institutional investors may leave prime money market funds for government money market funds, which invest mostly in government securities, cash, or repurchase agreements backed by government securities. Under the SEC rule, these funds retain their ability to transact at a stable net asset value. Investors may also increase their bank deposits and holdings of other cash products offered by banks. Some large institutional investors might also switch to separately managed cash accounts, which could be harder for supervisors to monitor (see **Chapter 6**).

The rule also sought to address potential preemptive runs by allowing boards of directors of funds the discretion to apply redemption restrictions. Redemption restrictions, often referred to as "gates," have been adopted in many overseas markets to limit fund outflows during financial crises (see Axenov, 2014). However, in Europe these gates are always in place as described in fund offering documents, but only rarely used. Some research has suggested shareholders might run preemptively if they feared redemption restrictions would be imposed (see Cipriani and others, 2014), meaning discretionary gates could worsen a run. Others have argued that liquidity fees may exacerbate institutional investor runs during a crisis (see Fecht and Wedow, 2014).

The benefit of the new rule cannot be evaluated until the money market industry again faces strain and run risks. The ongoing concentrations of money market fund assets within a few large asset managers may raise more systemic stability concerns and require enhanced monitoring of potential cash reallocation.

Figure 3-11. Use of U.S. Banks' Repo and Reverse Repos ($ billions)

Insured banks have become net cash providers in the repo market for the first time



Sources: Federal Financial Institutions Examination Council Call Reports for all FDIC-insured banks, OFR analysis

In October 2014, the Financial Stability Board (FSB) published a regulatory framework on minimum haircuts on securities-financing transactions that are not centrally cleared.

market fund reforms introduced discretionary redemption restrictions to better manage heavy redemptions if market liquidity is impaired. These reforms provide for discretionary gates by allowing the fund's board of directors to suspend redemptions under certain circumstances for up to 10 days (see **Money Market Fund Reform**). However, other mutual funds are not permitted to impose redemption gates under SEC rules.

COST

Funds can impose redemption fees on the dollar amount of shares an investor requests to sell. Some mutual funds impose fees only on redemptions by investors who move frequently into and out of the same fund to discourage opportunistic trading. Redemption fees can help force redeeming shareholders to bear the cost of liquidation. Research shows that liquidity fees can reduce the volatility of fund flows during periods of market illiquidity, when increasing redemptions might otherwise hurt shareholders who do not redeem shares (see Greene, Hodges, and Rakowski, 2007). However, it is a challenge to calibrate fees so that they reduce volatility, while still providing for a viable investment vehicle.

Haircuts and Collateral Requirements

Regulators have several options to address the risk of asset fire sales and other forms of contagion in the event of a market shock. First, firm-focused policies aim to reduce the reliance of individual banks and dealers on short-term funding to make it less likely they will sell assets preemptively to raise liquidity in a crisis. Banks' use of short-term secured funding now carries a higher FDIC deposit insurance assessment and higher capital and liquidity requirements under Basel III. Partly due to these reforms, repo liabilities for U.S. banks have declined sharply. Banks' repo assets have also contracted, but they have not fallen as sharply. As a result, U.S. banks now are net providers of repo funding to nonbanks (see **Figure 3-11**).

Market-focused policies address a specific type of fire sale risk, the risk of a broader fire sale of assets by repo investors, who keep securities collateral after a dealer defaults (see Begalle and others, 2013). These include requirements on the quality of collateral in repo transactions and floors on haircuts to limit the buildup of leverage and mitigate potential losses in an event of a fire sale.

In October 2014, the Financial Stability Board (FSB) published a regulatory framework on minimum haircuts on securities-financing transactions that are not centrally cleared (see FSB, 2014c). The framework sets standards for haircut calculation methods, as well as minimum haircuts for some assets that are not government securities.

For some countries, the framework is a step forward. By raising the cost of short-term secured funding, haircut floors may encourage borrowers to extend the maturity of their liabilities. However, the FSB's haircut floors are below levels currently prevailing in the U.S. triparty repo market, which are published by the Federal Reserve Bank of New York on a monthly basis and used by many market participants to gauge their risk management practices.

Although not binding today, minimum haircuts could reduce procyclicality in haircuts during credit expansions. Under the FSB framework, market participants still would be expected to conduct their own analysis in setting haircuts, taking into account counterparty and collateral characteristics.

Large haircuts may be needed on assets where the collateral is illiquid or its price is volatile, but excessive haircuts could also exacerbate asset fire sales. This is because a holder of collateral subject to a large haircut could have little incentive to liquidate collateral in an orderly fashion. Instead, the large haircut allows the collateral holder to effectively pass losses incurred during an asset fire sale on to the pledging institution, an unfortunate incentive that could have negative systemic implications (see Duffie, 2014).

At a recent workshop on wholesale funding risks conducted by the Federal Reserve banks of New York and Boston, participants discussed the possibility of eliminating preferential treatment of repos backed by nongovernment securities in bankruptcy to help prevent collateral fire sales and limit spillovers to the broad market. However, possible unintended consequences may include a rapid contraction of the repo market and a reduction in the availability of credit. Domestic repo market participants also could have an incentive to migrate their repo funding overseas, where they would be able to access their collateral without having it delayed by a lengthy bankruptcy resolution process.

Addressing Risks in Securitization Markets

Today, because the vast majority of residential mortgage securitizations are originated by the government-sponsored housing enterprises (GSEs), risk in private residential mortgage securitizations is not a current financial stability issue. As housing markets recover, private securitization may revive and require careful assessment of potential risks to financial stability.

Flaws in the securitization process and loan underwriting standards, especially in mortgage lending, contributed to a buildup of risks in securitized products before the financial crisis. Reforms have sought to address investors' over-reliance on credit ratings of asset-backed securities and to improve disclosures by securitization issuers. But part of the problem may also have been that the issuers of securitized products lacked sufficient incentives to scrutinize the products they created (see FCIC, 2011; and FSOC, 2011). Risk retention rules mandated by the Dodd-Frank Act seek to correct this by requiring securities issuers to have "skin in the game" by retaining unhedged exposures equal to at least 5 percent of the value of the collateral underlying any issuance.

Regulators issued the final credit risk retention rule in October 2014 (see OCC and others, 2014b). For a number of types of securitizations (for example, collateralized loan obligations) this rule may help align banks' incentives as loan originators with those of investors in securitized products. In the case of residential mortgage-backed securities, the Dodd-Frank Act required regulators to define a qualified residential mortgage (QRM) as a loan with relatively low expected default risk that would be exempt from risk retention. In an earlier QRM definition proposed by regulators, a mortgage would not qualify for the exemption if, among other things, the loan-to-value (LTV) ratio was above 80 percent, the borrower was currently delinquent on other obligations, or the borrower had recently been seriously delinquent or bankrupt (see OCC and others, 2011).

In addition, the Dodd-Frank Act required that the definition of a QRM may be no broader than that for a qualified mortgage (QM), which is a standard set by the Consumer Financial Protection Bureau (CFPB) to provide a lender safe harbor from the borrower's-ability-to-repay requirement under the Truth in Lending Act. The final QM definition excludes the types of mortgage products with the worst performance during the crisis, such as interest-only loans, negative-amortization loans, and hybrid adjustable-rate mortgages underwritten with low initial "teaser" rates.

Under the final risk retention rule, the additional credit standards on LTV and borrower creditworthiness were removed, and QRM was defined as equal to the definition

Figure 3-12. Historical Mortgage Defaults by LTV and Credit Score

FICO Score		Loan-to-Value Ratio							
		<40	40	50	60	70	80	90	100+
	<580	22.2%	22.3%	24.8%	27.4%	32.7%	39.9%	46.2%	66.2%
	580	16.7%	19.9%	20.3%	26.4%	31.7%	42.9%	41.8%	59.3%
	590	17.6%	17.5%	20.3%	22.5%	28.5%	40.7%	40.1%	53.9%
	600	15.6%	19.9%	19.3%	23.6%	28.2%	39.2%	37.9%	45.9%
	610	15.3%	15.5%	18.8%	21.5%	28.0%	36.9%	34.2%	43.4%
	620	14.5%	17.6%	16.0%	20.8%	25.6%	34.5%	33.1%	38.8%
	630	9.9%	15.2%	19.1%	20.5%	24.4%	31.7%	31.6%	37.8%
	640	10.2%	12.2%	16.4%	18.2%	22.4%	29.5%	30.3%	32.1%
	650	11.9%	10.8%	13.3%	17.8%	20.8%	28.4%	29.2%	28.3%
	660	10.8%	11.7%	12.1%	15.3%	18.5%	26.3%	29.4%	29.8%
	670	6.6%	7.6%	10.9%	12.6%	17.1%	25.3%	27.7%	24.5%
	680	6.5%	5.2%	9.6%	12.2%	15.3%	23.6%	27.5%	23.2%
	690	5.5%	4.1%	5.5%	10.3%	14.1%	21.7%	26.7%	22.5%
	700	2.6%	4.2%	7.2%	9.6%	11.6%	18.8%	25.7%	18.9%
	710	6.4%	3.2%	5.7%	6.1%	10.7%	18.2%	24.9%	19.8%
	720	5.8%	3.5%	5.3%	7.2%	10.3%	16.3%	22.6%	19.2%
	730	3.2%	4.5%	3.3%	5.1%	9.2%	14.0%	24.8%	17.5%
	740	1.0%	2.2%	2.6%	4.3%	8.1%	11.4%	23.1%	13.6%
	750	1.1%	2.0%	1.9%	3.5%	5.2%	10.2%	18.3%	11.8%
	760	1.1%	1.0%	1.8%	2.3%	5.1%	8.3%	18.2%	14.0%
	770	0.2%	1.3%	1.3%	2.8%	4.6%	7.0%	18.5%	15.1%
	780	0.6%	0.2%	2.1%	2.0%	3.7%	6.0%	14.8%	12.1%
	790	0.2%	0.7%	0.9%	2.3%	2.7%	6.3%	15.2%	16.5%
	800+	1.4%	2.0%	2.1%	2.5%	4.2%	6.5%	12.2%	18.4%

Note: This sample consists of first-lien mortgages on single-family homes originated in the years 2003-06 and included in pools backing private-label mortgage-backed securities. Qualified mortgage (QM) eligibility is represented here by excluding interest-only and negative-amortization loans and including only full-documentation loans that fully amortize over a term of 360 or fewer months and have at origination a back-end debt-service-to-income ratio of 43 percent or less. Default is defined here as a loan being 90 or more days delinquent, written off, or sold in a foreclosure sale, real estate owned sale, or short sale. To be conservative in assumptions, loan-to-value (LTV) is defined as first-lien LTV, excluding pledged assets. Missing second-lien data in any case make comprehensive calculations difficult. LTV ratios and Fair Isaac Corporation, or FICO®, scores are rounded down; for example a 749 FICO® score is categorized here as a 740.

Source: CoreLogic, Inc.

of QM. Due to the QM's debt-to-income ratio test and product feature requirements, QM-qualifying mortgages should have lower expected default rates on average than non-QM loans. However, the QM rule is an ability-to-pay standard designed to protect consumers; it is not a broader credit risk standard designed to protect lenders or investors (see Cordray, 2013).

Historical default rates can provide some insight into the impact of setting the QRM standard equal to QM. Figure 3-12 shows default rates for securitized loans made before the crisis that roughly met the QM standard. The figure illustrates with historical data that LTV and borrower credit history (represented by Fair Isaac Corporation, or FICO®, scores) differentiate between high-quality and high-risk mortgage loans. The differences in default rates for loans with different LTV ratios and borrower credit scores can be dramatic. OFR calculations, which use more than half a million privately-securitized loans that met an approximation of the QM standard, show that loans originated before the crisis with LTVs over 80 percent and FICO scores below 640 defaulted during the crisis more than four times as often as loans that had LTVs less than 80 percent and FICO scores higher than 640. Under the final risk retention rule, future securitizations of loans similar to those in Figure 3-12 would all be exempt from risk retention, despite the wide variation in historical default rates.

Regulatory measures taken since the crisis will partly mitigate these concerns by helping to ensure that investors have sufficient information to evaluate securitizations. In particular, the QM rule included income documentation requirements, and the SEC's Regulation AB II required loan-level disclosure requirements for registered public offerings of mortgage-backed securities. However, these loan-level disclosure requirements do not apply to non-public offerings to institutional investors, which comprise the bulk of non-GSE issuance.

Both theory and empirical evidence in the academic and policy literature support the notion that "risk retention, if properly structured, can address some of [the risks in securitization revealed in the crisis] by requiring an originator or securitizer to have ongoing exposure to the credit risk of the underlying assets" (see FSOC, 2011, p. 3). The risk retention rules have only recently been finalized and have not yet gone into effect, and private residential mortgage securitization activity is dormant, limiting the ability to evaluate the impact of the rules on securitization markets or on financial stability. However, in the event that this activity picks up, it will be important to monitor volumes, pricing, and the risk embedded in securitizations, especially for mortgages because of their importance in the capital markets. Looking across the chain of mortgage activity from origination to securitization, it will also be important to study the alignment of incentives for borrowers, investors, loan originators, and securitizers.

Regulators and the OFR will be monitoring whether or not a robust non-QM eligible market develops and what that implies for QRM. The rule requires the agencies to review the QRM definition within four years after it is implemented, and every five years thereafter. This could result in revisions to the rule if all six agencies responsible for the rule agreed that changes were needed.

If non-QM loans remain a small part of the market, the risk retention requirement will not apply for nearly all mortgages, including many that performed poorly during the crisis.

3.4 Structural Policies to Promote Resilience in Clearing Infrastructure

The Dodd-Frank Act mandated that over-the-counter derivative trading and clearing shift from an opaque and complex network of bilateral trading to organized trading platforms and centralized clearing mechanisms subject to supervision. As the industry adjusts to this new infrastructure, supervisors should monitor potential risk implications arising from the implementation of new regulatory requirements.

Over-the counter (OTC) derivatives can allow firms to manage economic and financial risk, but also may create risks for financial institutions and for financial stability in some cases. Firms are unable to observe the risk concentrations of their trading counterparties' derivatives positions and might not properly evaluate the risk a counterparty poses. Derivatives also allow entities to take on leveraged exposures. These risks were realized during the financial crisis, when counterparties to insurer AIG stood to lose billions of dollars had AIG failed to meet payments due on credit default swaps written by a subsidiary.

The Dodd Frank Act introduced key changes in the OTC derivatives market, including: (1) mandated central clearing through central counterparties (CCPs), (2) an organized trading platform, (3) required reporting to a trade repository, (4) new margin requirements for both cleared and uncleared swaps, and (5) heightened supervision and regulation of financial market infrastructures, such as CCPs the Council designates as systemically important.

The New Framework

Mandatory central clearing of swaps under the Dodd-Frank Act began in the U.S. when the CFTC implemented its rule for OTC derivatives under its jurisdiction (referred to as "swaps") in 2013. The CFTC initially mandated central clearing for a narrow range of interest rate derivatives and credit default swap index products for most market participants but will likely extend the clearing mandate to additional products. The SEC has regulatory authority over security-based swaps, which are defined as swaps based on a single security or loan, a narrow-based group or index of securities, or events relating to a single issuer or issuers of securities in a narrow-based security index. The timeline for an SEC final rule phasing in central clearing for security-based swaps is uncertain.

REDUCED COUNTERPARTY RISK THROUGH CENTRAL CLEARING

Before the Dodd-Frank Act, most derivatives in over-the-counter swap markets were bilaterally netted. Central clearing was standard primarily in exchange-traded derivatives markets, such as futures and options, but only occurred with certain interest rate swap and credit default swap products on a voluntary basis.

Bilateral markets create substantial risks that are complex to manage. Every dealer, for instance, interacts directly with every other counterparty (another dealer or client), incurring market risk on the open position and credit exposure to the counterparty. A single firm's failure could have systemic impacts if a large number of bilateral swaps form a complex, interlinked network of counterparties.

But in centrally cleared markets, central counterparties stand between the counterparties to every contract, becoming the buyer to every seller and seller to every buyer. The CCP guarantees settlement for both parties, so each is no longer exposed to the other's default. But central clearing is not a solution to the problem of a firm building up an excessive market risk concentration in derivatives, as occurred with AIG. Monitoring firms' derivative positions both within and across CCPs can help identify when a firm has developed a risk concentration.

The CCP nets or clears transactions between members on a multilateral basis, resulting in much smaller net exposure than bilateral netting. In bilateral netting, parties can only net transactions with the same counterparty. Despite its advantages over bilateral netting, the effectiveness of multilateral netting is still limited by lack of netting across different product lines and different CCPs. Eventually, cross-margining across CCPs may provide further opportunities for netting, but it will have to be supported with adequate margin, taking into account cross-product correlations to protect against risks of default.

ORGANIZED TRADING PLATFORM

To provide greater transparency and foster efficient markets, the Dodd Frank Act also created a new type of marketplace called a swap execution facility.

Through swap execution facilities, multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants via multilateral execution methods such as request-for-quote and central limit order book. The CFTC has temporarily registered 22 swap execution facilities since it introduced rules in October 2013. Under these rules, swaps mandated for central clearing, offered for trading on a swap execution facility, and determined to be appropriate for organized platform trading by the CFTC, must be traded through a swap execution facility.

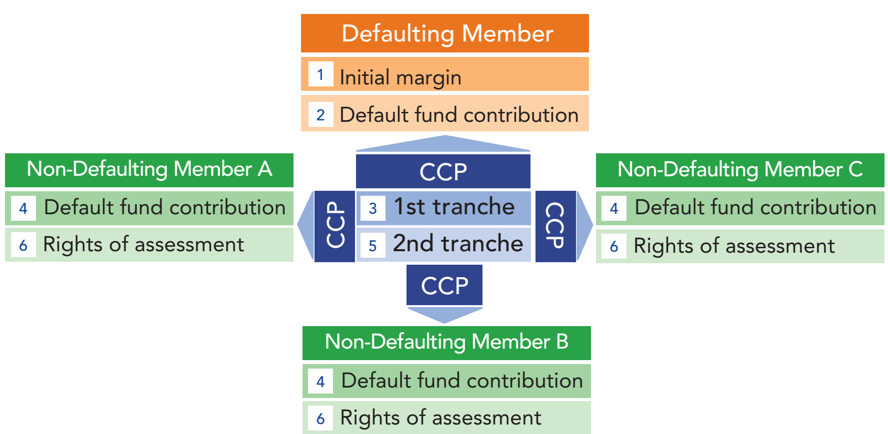
Swap execution facilities, central counterparties, and swap dealers are required to submit trade data to swap data repositories for access by regulators and the public (see **Chapter 6**).

ENHANCED MARGIN REQUIREMENTS

Margin requirements are an important part of the new regulatory framework. Under the Dodd-Frank Act, margin is required to be posted both for cleared and uncleared swaps. Specifically, the Dodd-Frank Act required central

Figure 3-13. Default Waterfalls in the Event of a Member Default

Default waterfalls are designed to strengthen CCP resilience, but they can transmit risk to nondefaulting members



Source: OFR analysis

counterparties to collect margin from clearing members to protect against potential price movements and member default. Similarly, the Dodd-Frank Act imposed margin requirements on uncleared swaps to reduce counterparty risk in those markets and promote use of standardized swaps that can be centrally cleared.

The CFTC and SEC have issued proposed rules for margin and capital requirements that would apply to swap entities not regulated by another regulator (see CFTC, 2014; SEC, 2012). In September 2014, the CFTC and banking regulators released revised proposed rules on margin requirements for swaps not centrally cleared (see CFTC, 2014; OCC and others, 2014a). The rules outline specific collateral eligible to be used to satisfy initial margin requirements and limit variation margin payments to cash. Under the proposed rules, a swap entity's transactions with nonfinancial firms, municipalities, or sovereigns do not require initial and variation margin; only those with financial firms do.

DEFAULT WATERFALL

In the event of a member default, central counterparties manage their obligations to each party to a swap by tapping a predetermined sequence of resources known as the default waterfall (see **Figure 3-13**). These waterfalls are broadly similar across CCPs, although the details vary.

Funds collected in advance from the defaulting party in the form of initial margin are the first to be drawn in the event of a default. The initial margin is used to offset losses for the CCP when it unwinds the swaps or auctions off the defaulting party's swaps to other members.

An optimal waterfall structure would balance the incentives for CCPs to manage their own risks and for clearing members to monitor the credit risk of their counterparties, even when transacting through a CCP.

Heightened Supervision and Regulation of Central Counterparties

The new central clearing system concentrates risks in a small number of large central counterparties, transforming the network to a hub-and-spoke system that can better manage a larger number of dealer failures but is highly vulnerable to the failure of a CCP that can transmit risk to all members. Because of that vulnerability, the Dodd-Frank Act authorized the Council to designate certain central clearing counterparties as systemically important financial market utilities, subject to heightened prudential supervision and regulation, including capital and liquidity requirements. To date, the Council has designated eight financial market utilities, five of which are CCPs. Two of these companies centrally clear OTC derivatives, ICE Clear Credit and the Chicago Mercantile Exchange. CCPs must register with the CFTC or the SEC or both, depending on the type of products they clear.

The Dodd-Frank Act required regulators to take into account relevant international standards when setting rules for designated CCPs. Subsequently, international standards were issued in April 2012 by a joint committee of global regulators as the Principles for Financial Market Infrastructures. The international standards were supplemented by consultative reports that focused on resolution and recovery issues specific to these companies (see CPSS-IOSCO, 2012b; CPSS-IOSCO, 2012c; CPSS-IOSCO, 2013). In November 2013, the CFTC issued a final rule establishing enhanced risk management standards for designated derivatives clearing organizations, consistent with those principles.

Banks and some bank regulators have called for more meaningful levels of capital at the CCP as an incentive to strengthen risk management, because there has been no proof of the ability to request additional funds from clearing members in the event of a member default. Banks and bank regulators have expressed concern that CCPs facing a member default can transmit large quantities of risk to CCP members that do not default. It is challenging for banks and bank supervisors, given available data, to determine the resiliency of CCPs, which is an issue relevant to monitoring and managing banks' CCP exposure (see Clearing House, 2012).

A critical benchmark in CCP risk management is the ability of the CCP to cover the default of its two largest counterparties, which is called the "cover 2" standard. A recent Bank of England working paper illustrated that where the risks are distributed more uniformly among clearing members, the cover 2 standard may not be sufficiently prudent (see Murphy and Nahai-Williamson, 2014).

Remaining Challenges

The transition to central counterparties has several unresolved issues important for financial stability. Most major dealers are subsidiaries of bank holding companies and also clearing members of multiple CCPs. Basel III encourages banks to use central clearing by assigning a relatively low capital risk weight of 2 percent for swaps cleared through qualifying CCPs and a relatively high risk weight for bilaterally cleared swaps for counterparty risk (see CFTC, 2013).

Although central clearing reduces risks for clearing members, some bank regulators have expressed concerns about the concentration of counterparty credit risk and potential contagion risks, since the largest banks are members of multiple CCPs (see OCC, 2014a). Banks could face significant losses if a CCP experienced losses and transmitted them to clearing members. In addition, some U.S. banks are also members of foreign CCPs, where less may be known about risk management practices.

Additionally, margin requirements for swaps enhance financial stability by reducing counterparty risk, but they can increase liquidity demands on market participants. As prices fluctuate, a party to a swap subject to margining may need to quickly post additional cash or other high-quality collateral, which is known as "variation margin." CCPs themselves can also decide to increase margins for a specific firm or product, which could also be a source of liquidity demands. To guard against this risk, financial institutions and supervisors should analyze firms' ability to handle variation margin calls. A shock to initial or variation margin requirements could alter participants' willingness to enter into new derivative transactions and, in turn, affect derivative prices.

Margin requirements for CCPs vary across jurisdictions and countries, increasing the incentive for companies to move their trading to jurisdictions with weaker standards. Companies that are unable to meet strict margin requirements may decide to transact business through CCPs with weaker requirements, concentrating risk in those CCPs least able to bear the risk. Concentration may pose a financial stability risk in the event of a participant's failure. These issues highlight the need for continued coordination among domestic and international regulators as new CCPs are established.

Figure 3-14. Examples of Cyclical Macroprudential Policy Tools in Other Countries

Regulatory Policy	Countries	Impact
Reserve requirements	3 OECD 18 non-OECD including the BRIC group	Results are mixed.
Differentiated or time-varying capital requirements or risk weights	11 OECD 9 non-OECD	Some countries have sizeable slowdowns in credit growth rates, although this decline is often followed by a reversal to higher rates. Generally seen to improve banks' capital positions.
Liquidity requirements	4 OECD 5 non-OECD	Generally seen to have improved liquidity positions; not a clear impact on credit growth.
Dynamic or increased provisioning	3 OECD 9 non-OECD	Some countries have shown a limited effect on credit growth rates. Generally seen to improve banks' capital positions.
Limits on credit growth or new loans	5 OECD 11 non-OECD	Effects seen as muted, as lending shifted to foreign banks or less-regulated financial intermediaries.
Limits on loan-to-value ratios or debt-to-income ratios	11 OECD 10 non-OECD	Asian countries have curtailed real estate price appreciation and reduced defaults, although the evidence is less clear on these tools' ability to control leverage by households and banks. Evidence is limited in other countries where implementation is more recent.
Limits on exposures, credit concentrations, net open positions, or maturity mismatch	10 OECD 16 non-OECD	Direct impact on aggregate credit growth rate is difficult to detect, but positive effect on the resilience of financial institutions seems to exist. Circumvention problems have been reported, especially in the case of exposure or credit concentration limits.

OECD = Organisation for Economic Co-operation and Development
BRIC = Brazil, Russia, India, China
Source: Crowe and others (2011)

3.5 Policies to Address Cyclical Financial Excesses

Countercyclical macroprudential policy tools, or simply, cyclical policy tools, are designed to address potential cyclical excesses in credit growth, leverage, and maturity transformation or liquidity transformation. This section describes the countercyclical capital buffer, discusses how regulators could use existing policy levers to moderate a hypothetical residential housing boom, and analyzes the supervisory response to the current boom in leveraged lending.

Central banks may face difficult choices if they attempt to use monetary policy alone to achieve price and financial stability, because the two objectives may conflict. For example, when inflation is low, achieving price stability may require monetary policy settings that encourage excessive risk-taking and foster future financial instability. In addition, monetary policy affects credit provision across the economy and is too blunt an instrument to address excesses in specific credit markets (see Stein, 2013; Yellen, 2014).

In such circumstances, either policymakers must trade off current and future objectives or draw on additional tools to help. As noted in our 2013 annual report, effective policymaking requires at least as many tools as objectives. Cyclical macroprudential tools may be needed to limit credit booms or excessive risk-taking.

Many countries have experimented with cyclical macroprudential policies in recent years to address perceived excesses in specific sectors (see **Figure 3-14**). Studies have produced mixed results on the success of such policies. The effectiveness of cyclical macroprudential policy may be blunted as a result of its interaction with monetary policy (see Wang and Sun, 2013) and it may "leak" as financial activities shift to institutions and markets not directly affected (see Aiyar, Calomiris, and Wieladek, 2014; Ono and others, 2014; Bank of England, 2014).

Macroprudential policies are sometimes difficult to implement, because one of their purposes can be to restrict credit to less creditworthy borrowers. As with monetary policy, market participants may disagree with policymakers about potential long-term risks when asset prices are rising and credit risk seems low (see Fischer, 2014). Although the United States has a long history with such tools, it has not put in place a cyclical macroprudential policy regime since the financial crisis (see Elliott, Feldberg, and Lehnert, 2013).

Countercyclical Capital Buffer

So far, the only new cyclical tool the United States has introduced since the crisis is the countercyclical capital buffer for large and internationally active banks, part of the Basel III risk-based capital standard discussed in Section 3.2.

Under Basel III, bank regulators can require banks to hold an additional capital buffer up to 250 basis points of risk-weighted assets during booms to protect against losses and limit credit excesses in specific markets. The easing of a countercyclical capital buffer could, by contrast, boost lending and economic activity during a downturn.

Since 2010, at least 12 countries have implemented a version of the buffer and as many as 25 countries will likely have a rule implemented by the end of 2015. Several countries' regulators have taken first steps in determining not only the triggers, but also a timeframe. Three have activated it (see **International Experience with Countercyclical Capital Buffers**).

In 2013, the Federal Reserve and OCC implemented the buffer only for advanced approach banks and bank holding companies (see OCC and Board of Governors, 2013).

The countercyclical buffer also enhances banks' safety and soundness, but it is clearly a cyclical tool. For example, if the primary purpose of the buffer were to enhance safety and soundness, then all insured U.S. banks would be required to hold additional capital buffers during periods when supervisors determined risks of credit shocks could be high.

U.S. regulators have not announced specific metrics or thresholds that could trigger the activation of a countercyclical capital buffer. Under the final rule, regulators may activate the buffer based on a "range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk" (see OCC and Board of Governors, 2013). Federal Reserve officials have mentioned the possibility of using the buffer to target overheating sectors, although the final rule did not specifically mention that (see Yellen, 2014).

An unresolved question is whether the countercyclical buffer would affect lending as intended. A recent Bank of England working paper found that microprudential changes in capital requirements do affect bank lending (see Bridges and others, 2014). The authors found that this

Three of the 25 countries that have made the countercyclical buffer part of their macroprudential toolkit have already activated it in response to perceived market excesses. Their experiences provide the first evidence about the potential for this cyclical macroprudential tool. In every case, policymakers said they were using the buffer primarily to promote bank resilience to a downturn, not to "pop" a credit "bubble."

SWITZERLAND

Switzerland was the first country to activate a countercyclical capital buffer under Basel III. Between 2008 and 2013, Swiss housing prices rose more than 35 percent and mortgage volumes increased by 23 percent. In February 2013, the Swiss National Bank said it would activate a countercyclical capital buffer of 100 basis points of risk-weighted assets — but only for exposures to residential mortgages.

The central bank gave banks nine months to comply with the higher capital requirement. Mortgage markets continued to boom and in January 2014, the Swiss National Bank raised the buffer to 200 basis points and gave banks five months to comply (see **Figure 3-15**).

NORWAY

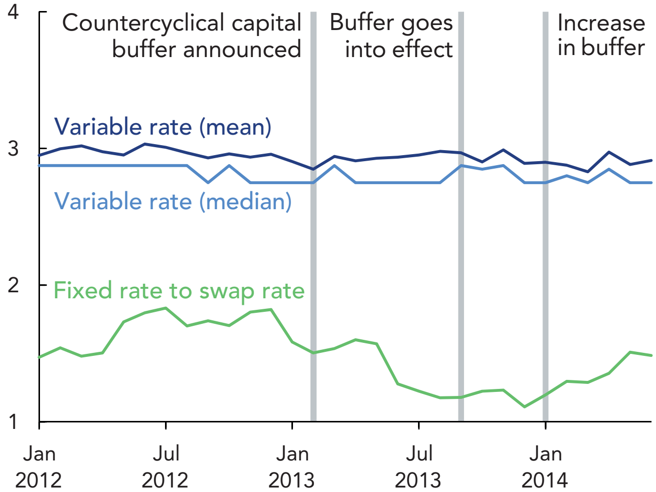
Norway's Ministry of Finance activated a countercyclical capital buffer of 100 basis points in December 2013 on the recommendation of the Norwegian central bank, responding to rapidly growing residential and commercial property prices and the rising ratio of private sector debt to gross domestic product (GDP) (see **Figure 3-16**). High private sector credit–to-GDP ratios are a concern for regulators, because high debt burden increase the likelihood of loan defaults. Banks have 18 months to adjust their balance sheets. Unlike in Switzerland, the Norwegians placed a capital surcharge on all types of bank loans, not just one sector. The ministry said it expected the buffer to help prepare banks for high future loan losses.

SWEDEN

After Sweden's Stability Council expressed concern about historically high household debt, the Swedish Financial Supervisory Authority (FSA) announced in May 2014 that it would activate a countercyclical capital buffer to address credit growth in the residential mortgage market. The FSA announced in September 2014 the buffer will be 100 basis points and take effect in summer 2015. The Swedish regulator also said it will increase the capital risk weight floor for Swedish mortgages from 15 percent to 25 percent.

Figure 3-15. Swiss Mortgage Rates (percent)

The first Swiss CCB activation had little effect on mortgage rates

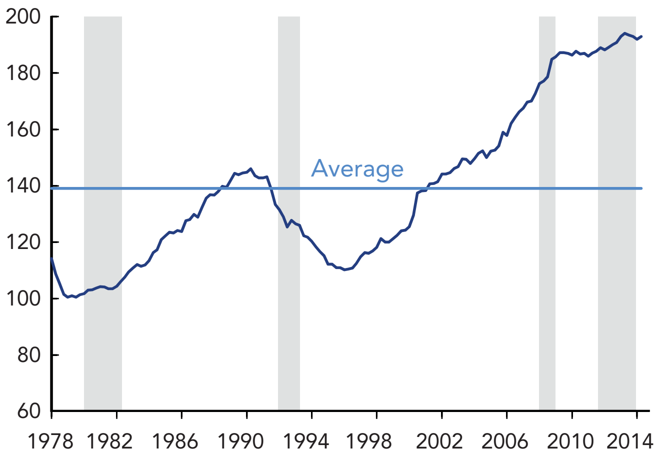


Note: The fixed rate is the 10-year fixed mortgage rate, and the swap rate is the 10-year Swiss swap rate.

Sources: Haver Analytics, Swiss National Bank

Figure 3-16. Norway Private Sector Debt to GDP (percent)

Norwegian private sector debt-to-GDP is high



Note: Gray bars signify recessions in Norway.

Sources: Center for Economic Policy Research, NorgesBank response varied based on the lending sector, with secured household loans decreasing relatively less and commercial real estate loans decreasing more.

Another question is whether nonbanks not affected by the capital buffer requirement could merely serve as alternative sources of credit to overheating sectors. Basten and Koch (2014) did not find evidence of macroprudential policy leakage after the activation of the buffer in Switzerland — banks subject to the buffer raised mortgage rates, but insurance companies unaffected by the regulation raised mortgage rates by an even greater amount. OFR will continue to study other countries' experiences with the countercyclical capital buffer and other cyclical macroprudential policy tools.

Cyclical Macroprudential Policy in Housing

How would the United States respond to another housing boom? None of the cyclical tools described in Figure 3-14 have been adopted in the United States. The creation of a new policy tool could take a long time if a rulemaking were needed. In theory, in the face of unexpected housing market excesses, it might be easier for regulators to vary existing fees to change the incentives of market participants and influence the rate of credit growth.

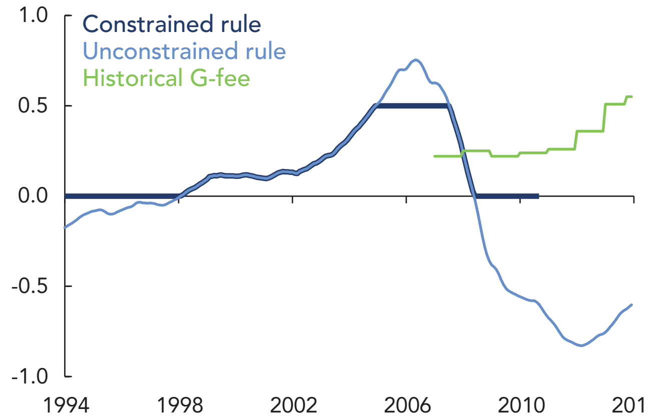
This section focuses on two existing tools that could be used this way in the United States: (1) the assessment rates that FDIC-insured banks pay for deposit insurance; and (2) the guarantee fees the GSEs charge lenders to guarantee loans, currently set by the FHFA. In both cases, policymakers could adjust the pricing of guarantees to influence borrowing costs in the housing market. This discussion is hypothetical and the results of OFR researchers' analysis it is based on are preliminary.

For example, the FDIC could increase the weights of housing-related assets in its deposit insurance assessments in response to signs of housing market excess. Facing higher weights, banks would have an incentive to reduce their exposure to housing credit or face higher assessments. Although the FDIC already varies these risk weights across assets, this approach would allow the FDIC to also vary them cyclically.

Similarly, the FHFA could adjust guarantee fees, called G-fees, in response to financial conditions. A key advantage of using G-fees is that the impact on mortgage prices would be relatively transparent, because an increase in

Figure 3-17. Proposed and Historical G-Fees (percent)

Both alternative countercyclical G-fee rules would suggest current G-fees are too high



Sources: Federal Housing Finance Agency, OFR analysis

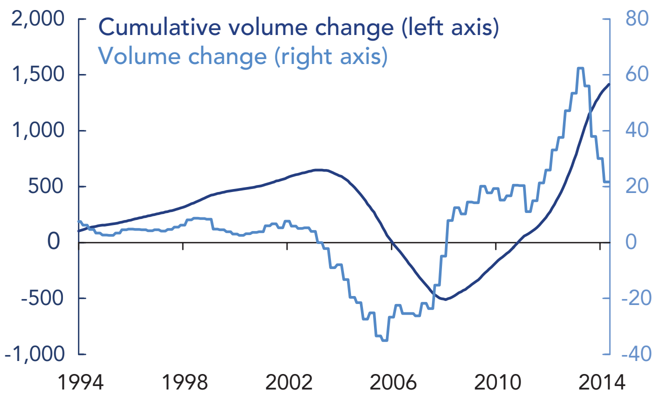
borrowing costs can have a direct and material effect on borrowing. Studies have shown that an increase of just 1 percent in interest rates — in other words, a 4 basis point increase based on current rates of about 4 percent — would reduce loan demand by roughly 2.5 percent (see Gross and Souleles, 2002; Čihák, Iossifov, and Shanghavi, 2008). This relationship suggests a 25 basis point reduction in G-fees would result in a 15 percent increase in lending at current mortgage rates, assuming G-fees changes fully pass through to interest rates. Green (2013) estimates that for every basis point increase in G-fees, mortgages rates increase by 2.5 basis points, in which case the effects would be even larger.

A forthcoming OFR paper develops a housing conditions index and proposes a policy rule for setting G-fees to implement countercyclical macroprudential housing policy. The index, which combines a large number of housing data series, is normalized to a value of 100 in March 2003, when housing finance conditions were relatively stable and healthy.

OFR staff members calculated how countercyclical changes to G-fees might have been adjusted historically to achieve conditions similar to those in 2003 in housing finance. For example, in the early 1990s, this countercyclical rule suggests the G-fee could have been lower to stimulate housing finance. But in the mid-2000s, countercyclical G-fees should have been significantly higher to offset excessively easy credit conditions in housing. To illustrate, the middle line (in dark blue) in Figure 3-17 depicts this proposed method, and the line to the upper right (in green) reflects G-fees from 2007 to 2013. The difference in G-fees between the

Figure 3-18. Estimated Effects of the Proposed G-Fee Policy Rule ($ billions)

The proposed G-fee policy could reduce the boom-bust cycle in housing credit



Sources: Federal Housing Finance Agency, Freddie Mac, Mortgage Bankers Association, OFR analysis

...a 25 basis point reduction in G-fees would result in a 15 percent increase in lending at current mortgage rates...

historical and proposed policies is roughly 25 to 50 basis points over this timeframe.

EFFECTS

OFR staff estimate that this method would have increased lending by $640 billion between 1992 and 2003. After that, as the market heated up, lending would have been $1.1 trillion lower through the middle of 2008. Since then, the method would have stimulated $1.8 trillion in additional borrowing to assist in the recovery. This would have represented a substantial increase relative to the current total outstanding conforming mortgages of about $5 trillion (see Board of Governors, 2014).

Figure 3-18 presents estimates of the results of following a G-fee countercyclical policy on conforming loan issuance. The lower line (light blue) reflects monthly estimates of the changes in loans. The upper line (in dark blue) reflects estimates of the cumulative effects of following such a policy.

Based on this analysis, the current policy of raising G-fees to invigorate private mortgage markets appears to lessen housing credit. Specifically, the 10 basis point increase mandated in the Temporary Payroll Tax Cut Continuation Act of 2011 appears to have reduced mortgage demand by about 6 percent. Because G-fees were already 6 basis points higher in 2011 than 2007, reducing G-fees back to 2007 levels could have increased mortgage demand by about 9 percent.

The total effect of varying the weights of risk factors in FDIC assessment rates could be much greater than varying G-fees. G-fees affect only new mortgages, but FDIC assessment rates are levied on banks' total balance sheets, including all new and existing holdings. However, the G-fee method is more targeted on new housing credit and would also apply to nonbank mortgages sold to the GSEs. For that reason, it is likely to have fewer unintended consequences.

Responses to Leveraged Lending

Banking regulatory agencies that are members of the Council have launched a coordinated response to identified excesses in leveraged lending, which is lending to corporations that already carry considerable debt. The response includes updated, more aggressive supervisory guidance and escalating actions to curtail risk-taking by banks. Concern centers on the deteriorating credit profiles of borrowers and the capital and liquidity implications for banks if a sudden stop in the leveraged lending market forced banks to hold the leveraged loans they originated to distribute.

Although bank regulators have taken action, a significant amount of this risk continues to migrate to asset management products, such as high-yield bond funds, exchange-traded funds, hedge funds and other private funds, and collateralized loan obligations (CLOs). Regulators have limited ability to stop this migration and there is no consensus that they should. The new risk retention rules for securitizations could dampen CLO origination activity. Still, the growing role of asset management products in funding leveraged lending adds urgency to discussions about structural vulnerabilities, such as redemption, fire sale, and maturity transformation risks in credit funds, and whether and to what extent they can contribute to financial stability risks.

SUPERVISORY ACTIONS

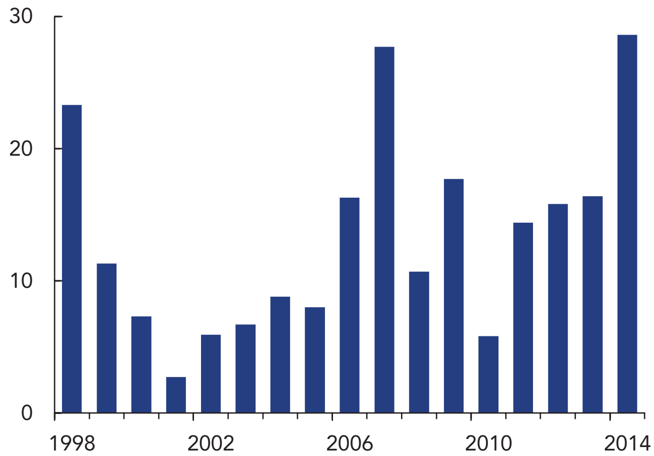
The Federal Reserve, FDIC, and OCC issued updated guidance in March 2013 to banks and bank holding companies intended to reduce risk in leveraged loans, both for those retained on banks' balance sheets as well as those repackaged for sale to other parties (see Board of Governors, FDIC, and OCC, 2013). The guidance recommended banks follow heightened risk management when the borrower's debt exceeds six times its earnings before deducting interest expenses, taxes, depreciation, and amortization, commonly referred to as EBITDA.

Unlike the agencies' previous leveraged lending guidance in 2001, the inclusion of the EBITDA ratio in the 2013 guidance introduced a specific risk metric that would raise supervisory concerns. The guidance also recommended risk management measures, such as periodic stress tests conducted by banks on their leveraged loan portfolios, and noted systemic concerns when banks sell leveraged loans to other banks or asset managers. The guidance noted that "a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system" (see Board of Governors, FDIC, and OCC, 2013).

The guidance does not appear to have curbed banks' risk-taking in this sector. Underwriting standards have continued to deteriorate and the volume of leveraged loans has risen. Before the guidance was issued, new large corporate loans with leverage higher than six times EBITDA accounted for about 15 percent of total issuance. So far in 2014, new loans with higher leverage have made up one-third of corporate bank loans (see **Figure 3-19**).

Figure 3-19. New Leveraged Loan Deals with Total Leverage Greater than 6 Percent (percent)

Leveraged loans above the supervisory metric are rising



Note: Includes large corporate transactions, which are defined as issuers with earnings before interest, taxes, depreciation, and amortization (EBITDA) greater than $50 million. Data for 2014 are through June 20, 2014.

Source: Standard & Poor's

The results of the Shared National Credit program, an annual interagency review of large syndicated corporate loans, showed gaps between industry practices and expectations in the 2013 guidance.

Supervisors have followed up the 2013 guidance with supervisory actions at individual institutions and more frequent and intensive reviews of leveraged lending activities at the largest banks. The results of the Shared National Credit program, an annual interagency review of large syndicated corporate loans, showed gaps between industry practices and the expectations articulated in the 2013 guidance (see Board of Governors, FDIC, and OCC, 2014). Thirty-one percent of leveraged transactions originated within the past year exhibited structures that were cited as weak, up from 24 percent last year and 13 percent five years ago. The three bank regulators also released a frequently asked questions document in early November to clarify how banks should interpret the 2013 guidance.

NONBANK ACTIVITIES

Asset managers are purchasing an increasing share of leveraged loans on behalf of investors in hedge funds, high-yield bond mutual funds, and collateralized loan obligations. Many banks reduced their holdings of CLO securities after regulators announced the final rule in December 2013 implementing the Volcker Rule, which restricts proprietary trading by banks and limits their role in private funds.

In an example of risk migration, as banks stepped away, asset managers and pension funds stepped in. One result of this movement is a decline in the ability of regulators to address reaching for yield and herding behavior. There is debate about whether and how best to influence investment behaviors, particularly whether policy guidance to banks is more effective than measures aimed at addressing structural vulnerabilities in asset management products.

Increasing investment in corporate bond funds — more than $1 trillion by retail investors since 2009 — may pose a threat to financial stability, because investors expect liquidity within one day, even though it might take fund managers longer to liquidate assets.

One way to counter this threat is to impose withdrawal fees on certain types of funds to discourage sudden mass redemptions, or runs, by investors. Officials at the Federal Reserve discussed this possibility earlier this year. Former Federal Reserve Governor Jeremy C. Stein noted that corporate bond funds are "bank like" because their assets are illiquid but they offer investors the same quick redemption as a typical mutual fund (see Braithwaite and others, 2014). The liquidity mismatch would be particularly worrisome during a crisis. The SEC has jurisdiction to decide whether to require withdrawal or exit fees. In reviewing such policies, it would have to consider the cost to retail investors.

Meanwhile, the final risk retention rule, issued in October 2014, required that unhedged exposures of at least 5 percent be held by the CLO manager or the lead arranger of the underlying loans. Because the rule could mean banks have to retain some economic exposure, it may moderate banks' leveraged lending originations and temper credit excesses in this sector.

RESEARCH ON FINANCIAL STABILITY 4

This chapter highlights the OFR's research, which aims to create a solid foundation for our financial stability policy analysis and monitoring work. The chapter summarizes the range of research we published in the past year, including a new series introduced in 2014.

4.1 Fundamental Research Agenda

The OFR's fundamental research agenda supports our mandate to: (1) develop financial stability metrics, (2) assess the causes and consequences of financial instability, (3) evaluate policies related to financial stability and risk management practices, and (4) improve the quality and scope of financial data.

Chapter 4 focuses on three multiyear research projects. The first uses agent-based models to understand contagion in financial networks, which will help analyze how shocks can be transmitted across the financial system. The second project investigates visualization techniques to support financial stability monitoring, and the third analyzes risks in credit markets using credit default swap data.

A final section summarizes our 2014 research agenda and discusses research published since our last annual report. It also describes one new research product we introduced in 2014, OFR Staff Discussion Papers, and another product forthcoming, OFR Briefs. OFR Briefs are designed to reach a broad audience. OFR Staff Discussion Papers are a venue for OFR staff members to produce academic papers that contribute to our understanding of financial markets, financial data, and financial institution risks — topics that are the building blocks of financial stability analysis.

This chapter focuses on three research products: agent-based models to understand contagion; visualization techniques; and using credit default swap data to analyze credit market risk.

Our fundamental research activities focus on the following four areas:

1. **Developing tools and metrics to support our monitoring and analysis of the financial system.** Our fundamental research supports our financial stability monitoring activities, described in Chapter 2. Research projects include: (1) the preliminary Financial Stress Index, (2) a project to contribute to the understanding of market liquidity, and (3) the visualization project described in Section 4.3.
2. **Assessing the causes and consequences of financial instability.** Projects include: (1) network analysis that explains how financial contagion can spread through the financial system, (2) mapping projects that describe the funding durability of broker-dealers (see Aguiar, Bookstaber, and Wipf, 2014) and the movement of funds through the shadow banking system (see Pozsar, 2014), and (3) the agent-based modeling project described in Section 4.2.
3. **Analyzing policies related to financial stability and risk management practices.** Our fundamental research supports our analysis of macroprudential policy, described in Chapter 3. Research projects include: (1) a program to promote a macroprudential approach to stress testing

(see Bookstaber and others, 2014), (2) research to analyze the design and implementation of regulatory policy (see Glasserman and Kang, 2014), and (3) an assessment of the historical use and effectiveness of macroprudential policy in the United States (see Elliott, Feldberg, and Lehnert, 2013).

4. **Identifying and filling gaps in data for financial stability analysis and helping to ensure data are usable to support assessment and monitoring of threats to financial stability.** Our fundamental research also supports our efforts to address data gaps and promote financial data standards, described in chapters 5 and 6. Recent projects include: (1) analyzing the costs and benefits of standard identifiers — for example, see McCormick and Calahan (2013), highlighting the need for a unique mortgage identifier and describing how it would improve aggregation, comparability, and analysis in the mortgage industry, while protecting individual privacy, and (2) analyzing new datasets and assessing their use for financial stability analysis, such as the derivatives data described in Section 4.4.

4.2 Agent-Based Models

Financial crises involve chains of complex events, with multiple transmission channels across diverse market participants. They often include widespread losses, sharp declines in asset prices and liquidity, a rapid loss in market confidence, breakdowns in financial services, and consequent disruption of economic activity. However, every crisis is different because financial instruments and institutions change and vulnerabilities evolve. These changes make predicting and managing financial crises extraordinarily difficult. The OFR is using agent-based models as a means of addressing such changes to explore the dynamics and key transmission channels of financial crises. Such modeling helps us take an overall view of the dynamic interactions of agents in the financial system by considering the different roles each agent plays.

Stress tests are valuable for identifying potential vulnerabilities of individual institutions to the impacts of financial crises, at least as currently employed. But today's stress testing methodology doesn't reveal financial crisis dynamics and feedback effects.

Agent-based models (ABMs) have the potential to complement supervisory stress testing and address these issues. ABMs follow the dynamics of agents (market participants), assessing their reactions to events period-by-period and updating system variables accordingly. Unlike in typical economic analysis, agents' reactions in ABMs can be based on heuristics, or rules of thumb, rather than on calculations designed to maximize their own utility.

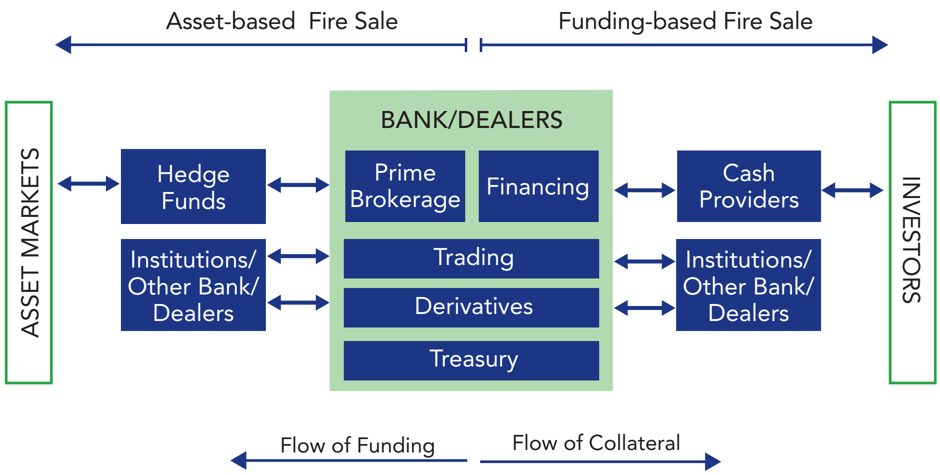
A key OFR initiative employs agent-based models to assess vulnerabilities in the financial system and resilience of the system as a whole. Parts of the project include developing models to: (1) study fire sales, (2) measure the market impact of large liquidity events, and (3) assess how the configuration of a financial network can affect financial stability.

These three related parts of the project illustrate ways to assess the resilience of the financial system by looking at its components and the transmission and amplification of shocks among them. For example, if an agent (such as a broker-dealer) experiences losses that affect its capital, it may be forced to sell assets quickly, potentially causing a fire sale. If those sales are large enough, they could have an impact on the availability of liquid assets, resulting in a large liquidity event, and the drop in liquidity could spread to other agents linked directly or indirectly through the market network. These dynamics might then lead to more losses and price drops, creating a feedback loop that worsens the impact on financial stability.

Scientists have been using ABMs for more than a decade to explain how the behaviors of individual agents can affect complex phenomena such as traffic jams and the spread of epidemics. But the use of ABMs is relatively new in finance and economics. An early OFR working paper discussed the use of agent-based modeling to assess financial vulnerabilities (see Bookstaber, 2012). Academics have proposed broader use of ABMs in financial and economic modeling (see Farmer and others, 2012) and described the potential advantages of ABMs compared to standard economic models that attempt to show what conditions lead to market balance (see Farmer and Geanakoplos, 2009).

Agent-based models are at the core of several European initiatives for evaluating crisis risk, most prominently the Complexity Research Initiative for Systemic Instabilities, or CRISIS, a consortium of universities and policymakers sponsored by the European Commission.

Figure 4-1. Model Relationship Diagram



Source: OFR analysis

Assessing the Dynamics of Fire Sales

Agent-based modeling was the subject of an OFR working paper released in July 2014 (see Bookstaber, Paddrik, and Tivnan, 2014), which focused on three types of agents operating in asset and funding markets:

1. Cash providers that act as funding sources by pooling investors' assets;
2. Banks and dealers (bank/dealers) that provide funding to hedge funds and other bank/dealers and participate in asset markets through several subagents, such as the prime brokerage and the finance desk; and
3. Hedge funds and other asset managers that participate in asset markets and may require funding.

Figure 4-1 shows the components of the bank/dealer and its links to borrowers and lenders. The figure is a simplified version of the funding map presented in a recent OFR working paper (see Aguiar, Bookstaber, and Wipf, 2014).

Figure 4-1 depicts the connections among a bank/dealer, hedge funds, and cash providers. In reality, the network is much broader. A complete picture would require a larger number of each type of agent.

As funding, collateral, and securities flow through the system, they are not simply shuffled from one institution to another — the institutions take the flows and transform them in various ways. For example, credit quality changes as funding moves from the cash providers through prime brokers to the hedge funds. Some assets, such as mortgages, are structured into more targeted debt instruments. Market making (the service of matching buyers and sellers) enhances liquidity.

Example of the Fire Sale Model

Figure 4-2 shows the progression of one simulation of the agent-based model over time. The simulation is based on 1,000 runs of the model. The figure shows a simplified setup with two bank/dealers, two hedge funds, three types of assets, and one cash provider (denoted in the figure as CP). In Figure 4-2, Bank/Dealer 1 (B1) and Hedge Fund 1 (HF1) hold equal weights in Asset 1 (A1) and Asset 2 (A2) and Bank/Dealer 2 (B2) and Hedge Fund 2 (HF2) hold equal weights in Asset 2 (A2) and Asset 3 (A3).

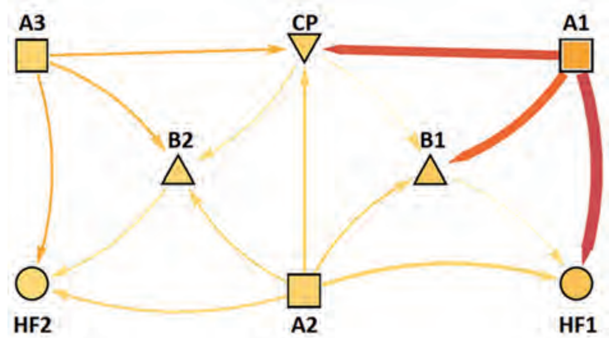
In the agent-based modeling of these relationships, the network structure changes period-by-period as the agents' actions change the environment and the agents adapt accordingly. In the progression, the dark outline for each of the nodes shows the agents' relative size through the course of the scenario. The shrinking of the solid area within the node is proportionate to the decline in capital in the case of the hedge funds and bank/dealers, the reduction in funding in the case of the cash provider, and the drop in prices in the case of the assets. If the node is empty, then that agent has defaulted. Similarly, the width of the edge shows the cumulative effect of transmission from one node to another. For example, as the selling of HF1 leads to more and more of a decline in the price of A1, the thickness of

Figure 4-2. Network Shock Propagation

Description	Network Graph of Three Assets, Two Hedge Funds, Two Bank/Dealers, and One Cash Provider

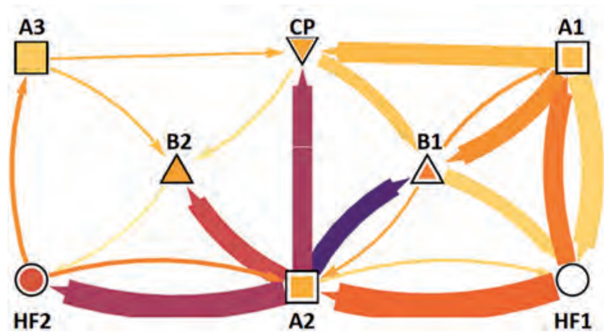
Period 0

Asset 1's (A1's) price declines sharply. Because Bank/Dealer 1 (B1) and Hedge Fund 1 (HF1) hold A1, they face losses due to the shock. The Cash Provider (CP) is also affected because the value of collateral declines. In a static stress test, the analysis ends at this point.



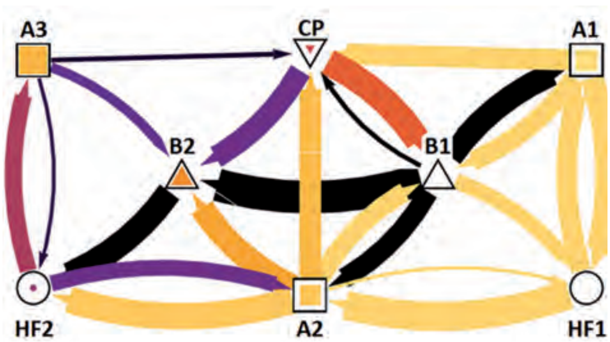
Period 2

B1 and HF1 must sell assets to cover losses on A1. They sell A1 and A2, causing a drop in the price of A2. This in turn affects other agents with holdings in A2, in particular, B2 and HF2. CP1 is affected because it holds collateral in A2 as well as in A1.



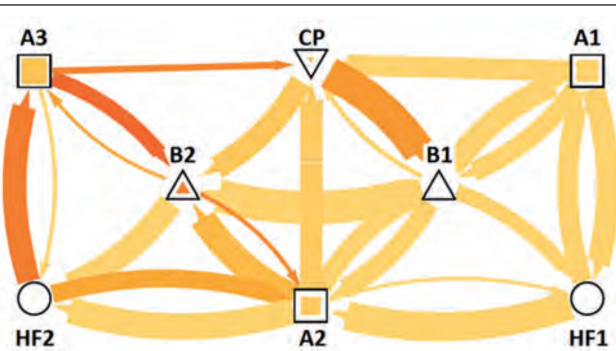
Period 4

The propagation from the shock leads to a default of HF1 and B1. Credit exposure that B2 has to B1 spreads problems through the credit channel. The drop in A2 affects HF2, and its forced sale spreads the shock to A3. Note that no firms holding A3 also hold the asset that was originally shocked, A1, but they have losses because of contagion. CP markedly reduces its funding due to the drop in the value of its collateral.



Period 6

The system finally settles down with funding all but shut off, and both hedge funds and B1 in default. A2 ultimately has a greater price drop than A1, the shocked asset.



A1 = Asset 1	B1 = Bank/Dealer 1	HF1 = Hedge Fund 1
A2 = Asset 2	B2 = Bank/Dealer 2	HF2 = Hedge Fund 2
A3 = Asset 3	CP = Cash Provider	

Source: OFR analysis

the edge will increase. The color of the edge in the figure shows the intensity of the interaction in the current period — a darker color means greater intensity or change in the system relative to other runs and periods.

Stress tests have become a standard tool in the macroprudential toolkit, but they do not address the follow-up effects of a stress event — that is, how the losses incurred by the individual banks might feed through the financial system in the face of forced selling and withdrawn liquidity. The ABM fire sale model extends stress testing by analyzing the pathways for the initial stress to spread through the financial system. Network diagrams such as Figure 4-2 visualize the severity and the sequencing of this dynamic. The model is designed to be applied to a wide range of stress scenarios. The triggering event in the figure is a price shock, but the model also allows for shocks based on a reduction in funding by the cash provider, a drop in the creditworthiness of the bank/dealer, or a sudden increase in redemptions by the hedge fund clients.

Measuring the Market Impact of Large Liquidity Shocks

The OFR is also using ABMs to gauge the market impact of large asset liquidations. Academic research and risk monitoring often focus on analyzing the day-to-day functioning of market microstructure and related liquidity measures, such as bid-offer spread and daily volume. But these analyses yield limited insights into the market effects of large-scale liquidations. During periods of sudden, outsized liquidity demand, normally sufficient liquidity suppliers may be overwhelmed. Deep pockets of liquidity beyond the short-term suppliers may be slow to respond and might even head to the sidelines after sudden, large price drops.

Two recent OFR working papers used ABMs to help measure the market impact of large asset liquidations that occur during forced selling and financial crises. One paper demonstrated the application of ABMs in a market with an electronic order book. Using actual order flow data with user identifications provided by the CFTC, the authors analyzed the stability of the order book after sharp price changes. They examined the trade-offs of different levels of microstructure data and the ability to predict sudden price changes (see Paddrik and others, 2014a).

A second working paper focused on an aspect of market behavior first discussed in Duffie (2010) — the market impact when liquidity suppliers are slower in responding to market signals than those who are demanding liquidity (see Bookstaber, Foley, and Tivnan, forthcoming). We also used the fire sale model to analyze how important it is that investors have different decision cycles — in other words, a hedge fund manager may make many buy and sell orders in the course of a few minutes, while a pension fund manager may take days or weeks to adjust positions.

Evaluating the Stability of Financial Networks

The role of financial interconnections among market participants in the 2008 crisis has prompted a surge in network-related financial system research. Network depictions can give a startling visualization of the magnitude of interrelationships. But one problem with the network approach is that it does not capture the dynamics of how the nodes transform the flows, how the flows carry risk from one node to another, and how the nodes in turn change the structure of the network.

A financial network is dynamic. Although a snapshot at any point in time can give a sense of a network's current stability, what matters is how the network evolves. Interconnections can diversify risk, but can also be pathways for shocks. The common-sense view that diversification reduces risk may be correct when failures are infrequent, but there may be a tipping point. If failures move above some threshold, a highly interconnected and diversified system may actually be a more fragile system (see Acemoglu, Ozdaglar, and Tahbaz-Salehi, forthcoming).

We are using ABMs in our research to follow the evolution of financial networks over time and assess the resilience of those networks to shocks. ABMs work well because each period of an ABM simulation depicts a network, which can change as each agent's actions affect the network environment.

In one working paper, we looked at how various agents — the nodes of a network — react to changes in the network (see Bookstaber and Monin, forthcoming). The agents collect data from other agents and those data improve their success. However, relying on connections to other agents reduces resilience if an agent drops out of the network. The result is a system that can generate boom-bust cycles. As agents create a broader network, it becomes increasingly successful over time but then suffers a greater loss when a shock causes some connections to fail. The paper looked at the characteristics that mitigate the cycles and evaluated metrics to assess the stability of the financial system.

In another forthcoming paper, we apply techniques used by chemical plant managers to the assessment of risks in the financial system (see Bookstaber and others, forthcoming). Process hazard analysis (the standard risk assessment tool in the chemical engineering industry) can help identify loops of interactions within the financial system that might be subject to positive feedback and instability. From a systemic risk standpoint, the network characteristics and stability concerns are surprisingly similar. The plumbing of a chemical plant allows flows in and out between processes that transform inflows into outflows, often based on complex, nonlinear interactions — in other words, the output is difficult to predict because it is not proportional to the input. Although the processes of the financial system are different from those of a chemical plant (maturity, liquidity, and credit transformations, for example), the complexity of interconnections and the potential for propagation due to leverage and liquidity lead to striking similarities from the standpoint of risk control.

To assess vulnerabilities, we have to consider the financial system as a wide and varied set of agents, each acting according to its own objectives and interacting in an environment that changes largely because of the agents' actions. Individual agents can act prudently, only to have the combined effect of their actions cascade to create instability for the system as a whole. The system can manifest stability during typical day-to-day levels of risk only to careen out of control when a shock reaches some critical threshold. Because agent-based modeling has the ability to incorporate the behavior of varied, dynamic, and interacting agents, it is well-suited for assessing these vulnerabilities.

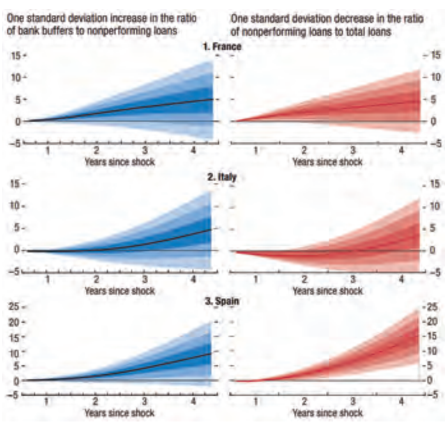
4.3 Visual Tools for Understanding Financial Stability

Financial stability analysts face a daunting challenge to make sense of a seemingly infinite stream of data. The OFR is experimenting with visualization techniques to reveal trends and relationships in data and transform massive raw data streams into useful information for analysis. The recent crisis demonstrated that need.

Good visualizations reveal key patterns and connections in complex data. Typically, visual attributes such as distances, areas, and color intensities correspond to attributes of the data. However, poorly crafted visualizations can be

Figure 4-3. Examples of Financial Data Visualizations

Small-multiple Layouts

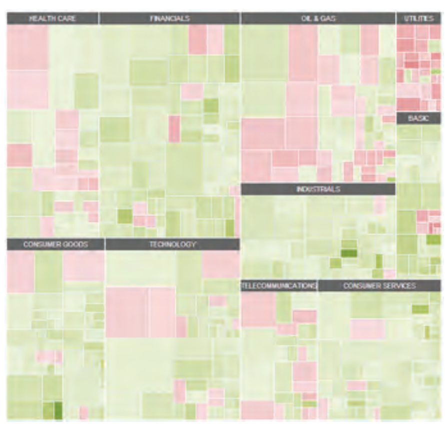


Source: IMF (2014b)

Repeated variations of similar plots differing in isolated ways, with the small plots organized into a larger grid for easy comparison

Other example: Schreck and others (2007 and 2009)

Tree Maps



Source: MarketWatch (2014)

Hierarchical data, shown as nested rectangles, with color, size, and category representing key data attributes

Other examples: Rank and Filed (2014); Merino and others (2006); Jungmeister and Turo (1992)

Radial Plots

Source: Lei and Zhang (2011)

Data depicted in polar coordinates or a circular arrangement, often to accommodate data points by placing densely populated clusters of observations near the exterior of the circle

Other examples: Wu and Phillips (2010); Sawant (2009) confusing, distracting, and even misleading (see Lemieux, Fisher, and Dang, 2013; Sarlin, 2013; and Sarlin, 2014). Researchers and graphics experts at the OFR are exploring whether innovative visualizations can improve on the standard bar charts and time-series plots that tend to dominate presentations of financial data.

Choose the Right Tool

Visualization encompasses a range of techniques with varying strengths and weaknesses. Choosing the right tool for the task is important (for an overview of approaches, see Plaisant, 2004; and Munzner, 2009).

Selecting an appropriate graphic should include:

- **Identifying the task.** Who will see the visualization and what tasks are they performing?
- **Selecting the data.** Which particular data should the visualization depict to support the task?
- **Choosing visual forms.** How should the visualization render or represent the data?

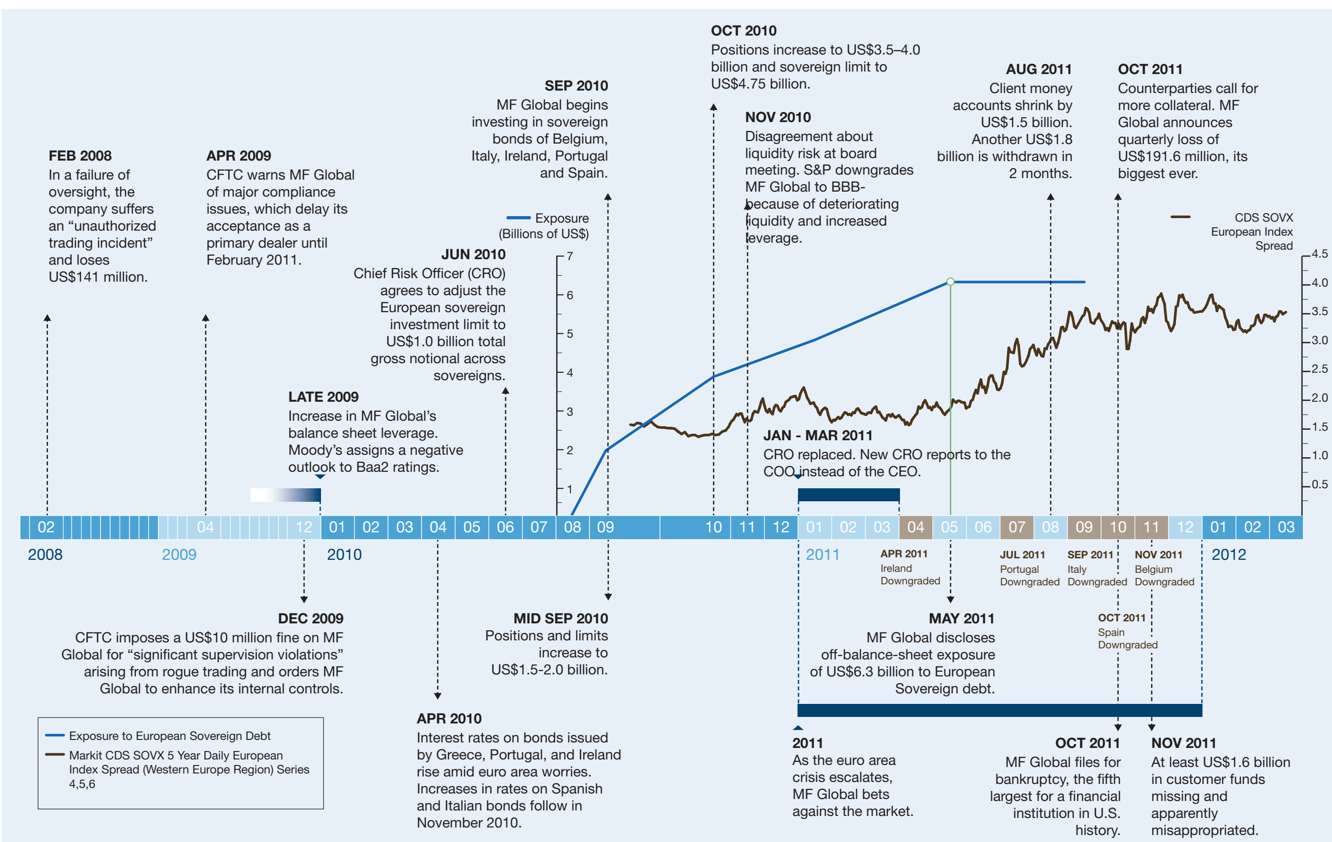
Each of these considerations can involve a large range of possibilities. Creativity, judgment, and consideration for whether users are viewing the analysis in print or on a computer screen should help guide the choice of a particular visualization. Figure 4-3 illustrates a few possibilities.

Visualization researchers have documented various aspects of such analysis. For example, Wilkinson (2005) presents a framework for assembling most of the common scientific graphics from modular visual building blocks. Ware (2012) discusses how to craft images that people can understand, given the significant strengths and weaknesses of human vision. Tufte (2001) sets out graphic design principles for well-crafted scientific visualizations. Lemieux, Fisher, and Dang (2014) survey the use of visualization tools in the financial domain.

Figure 4-4, which originally appeared in the OFR *2012 Annual Report*, shows the lead-up to the collapse of MF Global Holdings Ltd. (see OFR, 2012, pp. 66-67). This figure is a narrative visualization, a technique that tells the story of an interconnected sequence of decisions and events over

Figure 4-4. The Lead-Up to the Collapse of MF Global Holdings Ltd.

Narrative visualizations relate a sequence of unfolding events



Sources: Markit Group Ltd., Haver Analytics, Congressional hearings, news reports, OFR analysis time (see Segel and Heer, 2010). The depiction illustrates the story line by placing events on a horizontal timeline, accompanied by renderings of two key time series, credit default swap (CDS) spreads on European sovereign debt and MF Global's exposures, measured against separate vertical axes.

Narrative visualizations like Figure 4-4 are well suited for case studies or forensic timelines, where the sequence of individual decisions, actions, and events plays a central role. These visualizations are less useful in supporting unbiased supervisory decision-making, because they emphasize the roles of particular firms and people in the sequence of events. Visualizations that support policymaking should focus viewers' attention on the broader goals and principles that underlie policy choices.

Task Orientation

The foundation for an effective visualization is a clear identification of the needs and tasks of the intended audience.

Figure 4-5 illustrates the importance of tailoring the visualization to the context of its use. A recent OFR working paper identified four high-level tasks for visualizations that support financial stability monitoring (see Flood and others, 2014):

- **Sense making.** Integrating noisy perceptions into a coherent understanding (making sense) of a situation.
- **Decision making.** Choosing from a set of available options.
- **Rule making.** Creating formal processes or boundaries to constrain behavior.
- **Transparency.** Sharing information with others in an accessible way.

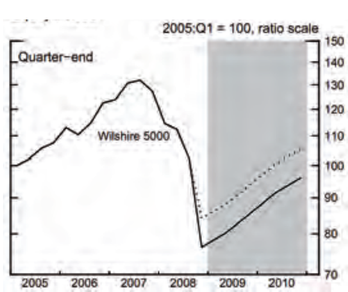
Figure 4-5 shows two different perspectives on equity markets, highlighting the distinction between decision making (on the left) and sense making (on the right). As a rule, visualizations to support decision making should avoid suggesting narratives that might bias a decision one way or another. For example, the left panel shows an excerpt from a briefing book for a meeting at the Federal Reserve Board to determine monetary policy (see Board of Governors, 2008). The chart is a familiar time-series plot — concise, smoothed, and uncluttered — of the recent behavior of a single equity-market index. The uncertain future is shaded in gray, and the shift in projections since the last meeting provides context.

In contrast, the right panel of Figure 4-5 is a parallel-coordinates plot over eight years summarizing hundreds of thousands of monthly observations on roughly the same set of stocks as in the line graph on the left side of the figure (see Alsakran, Zhao, and Zhao, 2010; and Inselberg, 2008). Each observation is plotted on five dimensions, represented as five parallel vertical axes: return, price, volume, shares outstanding, and industrial classification. For example, the distribution of volume (the middle axis) is highly skewed, with a large cluster of the low-volume stocks (the bright green patch at the bottom) and a long tail of higher volume stocks spreading upward. Many of the low-volume stocks are clustered in three industry categories, indicated by the three green pathways extending to the rightmost axis.

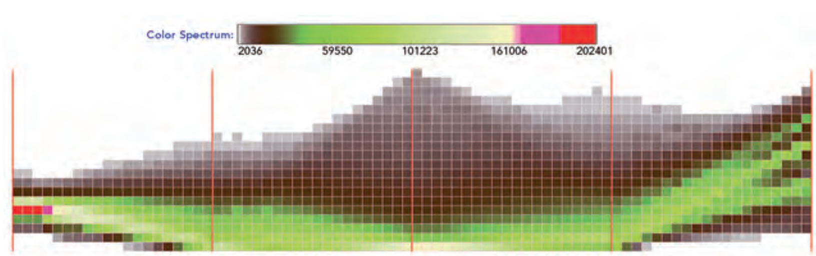
A standard parallel-coordinates plot would connect each data point across the five parallel axes with a distinct line (see **Figure 4-7C**). In the right panel of Figure 4-5, however, the number of observations is much higher, making the display of information extremely dense. For that reason,

Figure 4-5. Examples of Task-Oriented Visualization

Decision making:
A familiar time-series plot



Sense making:
A large number of multidimensional data points in a single picture



Sources: Board of Governors (left); Alsakran, Zhao, and Zhao, 2010 (right) the authors chose a custom mosaic coloring scheme to convey the varying density of the histogram rather than rendering individual data points. The intense information density of the graph is typical of sense-making plots, which are often not immediately intuitive as a result. This is not a shortcoming, but simply a by-product of capturing as much information as possible in a single image.

Data Selection

Selecting information that supports the identified task can be a challenge for financial stability analysis because data gaps may prevent direct observation of emerging problems. For example, historical context may be lacking for new financial products or trading venues.

The researcher must choose the appropriate observation frequency, level of aggregation, and data attributes or dimensions for the scope of analysis — for example, the set of firms or transactions to consider. Analyzing systemic threats to treat one component of the system in isolation is not likely to yield sound results. The analyst needs to understand the relationships between that component and the other parts of the system. Getting all of this right may require many versions of data selection and charting choices.

For example, OFR researchers are experimenting with interactive visual analytics to illuminate the workings of the CDS market (see Haynes, Paddrik, and Rajan, forthcoming).

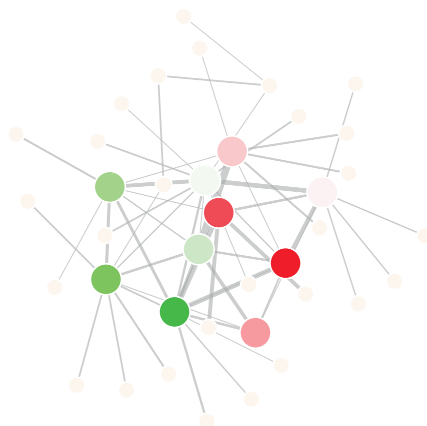
Figure 4-6 shows three views of CDS risk exposures. The top panel, Figure 4-6A, is a traditional node-link diagram (see Ghoniem, Fekete, and Castagliola, 2005) depicting the network of bilateral trade, using link thickness to indicate the proportion of bilateral trading volume and color (green or red) for dealers' net long or short activity. Although this overview gives a clear sense of the central nodes in the network, it does not reveal the details of the contracts traded.

The center panel, Figure 4-6B, is a bipartite (two-part) diagram (see Brandes, Raab, and Wagner, 2001) depicting connections from buyers and sellers on the left to the reference entities of the CDS contracts they trade on the right. The thickness of the lines indicates the net position a buyer or seller has against a specific reference entity; green entities have net long exposures and red entities have net short exposures. Here only the largest few exposures for the selected broker-dealers are included, prioritizing the holdings likely to have the largest risk impact. Although this

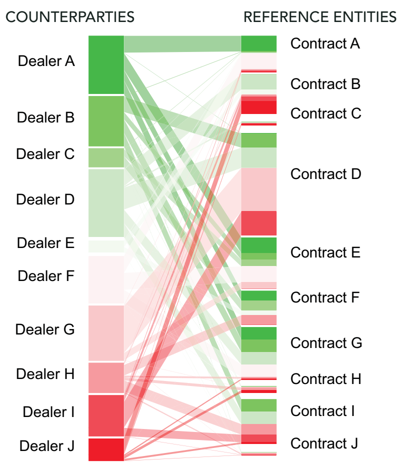
Figure 4-6. Different Perspectives on One Market

Visualizations A and B show who trades with whom and who owns certain risks. The hive plot (C) incorporates both types of risk into a single visualization

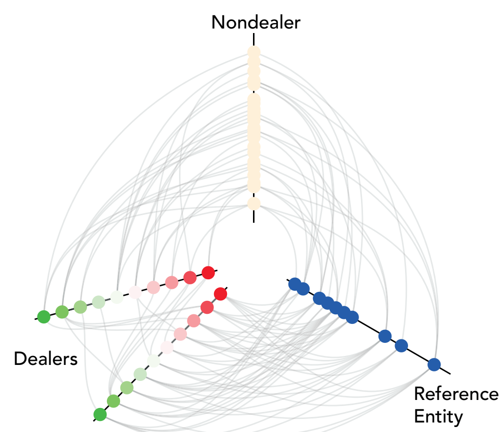
A. Top CDS Participants



B. Connecting Dealers to Risks



C. Interacting Risk Networks



Note: These figures do not use actual market data and are for representative purposes.

Source: OFR analysis

overview illustrates exposures to specific underlying credits, unlike the node diagram it does not expose the details of whom they were traded with.

Much like network metrics, these visualizations focus primarily on a single type of risk, though more comprehensively than in individual metrics. The node-link diagram depicts existing counterparty risk between entities and the bipartite diagram summarizes held reference entity risk. Both visuals efficiently capture and usefully communicate relative and absolute importance to a user. Because the market for credit contracts involves a diverse set of risk sources, visuals can be even more effective than simple numerical metrics in communicating the intricate relationships involved.

Figure 4-6C displays detailed interactions among different types of participants for a set of CDS transactions on a particular reference entity. This type of network visualization is called a "hive plot" (see Krzywinski and others, 2012). The hive plot includes two elements of traditional network diagrams, vertices and edges, representing firms and financial transactions. However, additional information is included in the hive diagram, which highlights some of the peculiar aspects of the CDS transactions.

The hive plot groups vertices on four separate axes, two of which are paired. The north axis includes all non-dealer institutions which participate in the credit market. Positioning along the axis is determined by the entity's net outstanding CDS exposures. The southeast axis includes all credit reference entities, distributed along the axis relative to the entity's total gross outstanding CDS exposure. Note that some reference entities may overlap with financial firms located on the other three axes. Finally, the two southwest axes include all of the active dealers. Each dealer is included twice — once on each of the paired axes.

The division of financial entities into three axes, two of which are equivalent, tries to mirror traditional credit transaction activity. As in the previous network diagrams, transactions are usually executed first between nondealer entities and dealers and then between dealers.

The hive diagram attempts to reflect this two-stage level of credit intermediation, allowing a user to concentrate on the first or the second set of transactions, or institutions, with little distraction. It also broadens the scope of interest from an individual reference entity to a whole suite of entities to summarize exposure or concentration across sectors. This allows for a much fuller, and much more product specific, depiction of risk transfer between and across entities that should not all be considered the same.

Visual Rendering

Visual renderings of the data should convey with appropriate visual emphasis the scope (type and number), granularity (specific attributes and level of detail) and interconnections (relationships and their attributes) for the data points. The possibilities for combining visual elements into a coherent graphic are infinite, and a deep understanding of the data and the tasks to be performed is essential.

Figure 4-7 illustrates some of the possibilities for visual rendering in the context of financial stability maps. The top panel, Figure 4-7A, is a "heat map" from the OFR's *2013 Annual Report* (see **Figure 2-6** in **Section 2.2** for a description of the five main categories here).

In Figure 4-7B, distances from the center correspond to measured attributes. It is a type of radial chart known as a spider chart, taken from the International Monetary Fund's *Global Financial Stability Report* (see IMF 2014b; Dattels and others, 2010). The two loops — red and green — each represent the state of financial stability as of the publication of an issue of the IMF stability report.

The three examples in Figure 4-7 capture the multifaceted nature of threats to financial stability by simultaneously depicting high-level measures in multiple dimensions. The charts group the dimensions in higher-level categories — five in the heat map, two in the spider chart, and five in the parallel coordinates plot.

Other techniques, such as Sarlin's (2013) "self-organizing financial stability map," avoid presenting all the data and dimensions simultaneously (not shown). He clusters many data points into a smaller number of representative clusters and projects high-dimensional data (data with many variables) into a two-dimensional plane. The result is abstract but condenses a large amount of information into a single two-dimensional picture.

Next Steps in Visualization Research

One direction for our future research involves tailoring new visualizations to specific use cases in macroprudential analysis. The OFR paper by Haynes, Paddrik, and Rajan (forthcoming) is one example. In that work, we combine experience in visualization with access to an important confidential data source from the CDS markets.

USABILITY TESTING

Usability testing is an important step in developing new visualizations (see Plaisant, 2004).

For example, in response to research on visual perception, we are experimenting with alternate renderings of the financial stability data shown in Figure 4-7. These charts present key facts in a concise and attractive way, but improvements are possible. The use of color to convey magnitudes in heat maps can be problematic, in part because of differences in viewers' perceptions, for example, as a result of color blindness (see Ware, 2012, chapter 4).

In addition, recent research indicates that users' perceptions of magnitudes are less accurate and slower when data are shown radially, in contrast to the standard layout, which uses perpendicular coordinates. For an overview of radial visualization, see Draper, Livnat, and Riesenfeld (2009). For an analysis of potential weaknesses, see Diehl, Beck, and Burch (2010).

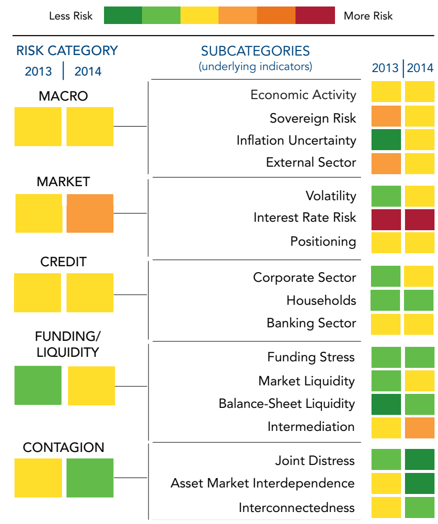
INTERACTIVE VISUALIZATION

Another area where the OFR is exploring new possibilities is interactive visualization. A number of organizations publish interactive online tools for exploring data of macroprudential interest (see IMF, 2014a; World Bank, 2014; FRB-St. Louis, 2014; ECB, 2014). One of the simplest forms of interactivity allows the user to select dates and filter out (or in) particular data. Another common type of interactivity gives the user "details on demand" (see Shneiderman, 1996) in the form of temporary pop-up information triggered by mouse-overs or similar user actions. The hive-plot visualizations of Haynes, Paddrik, and Rajan (forthcoming) incorporate this feature.

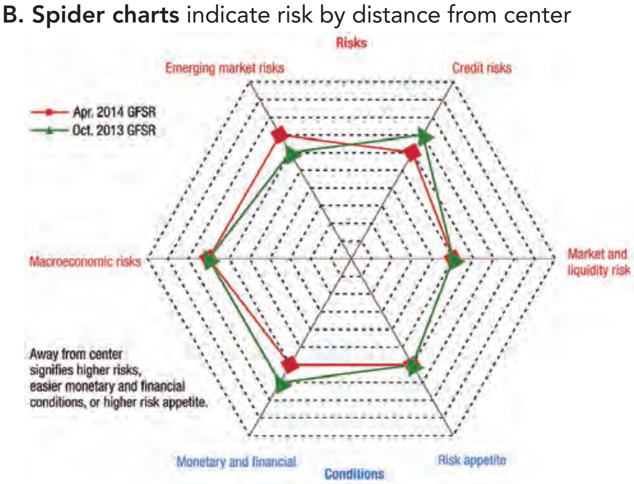
A recent OFR working paper by Flood and others (2014) discusses the other extreme of interactivity, known as "visual analytics." In visual analytics, a software application recalculates and redisplays new derived results in response to user choices. The recalculation must occur quickly to avoid distractions in user attention. The OFR is also developing a "RiskMapper" prototype (Lemieux and others, forthcoming) to allow analysts to explore the interactions of a range of systemic risk measures with different rules for portfolio selection.

Figure 4-7. Examples of Financial Stability Maps

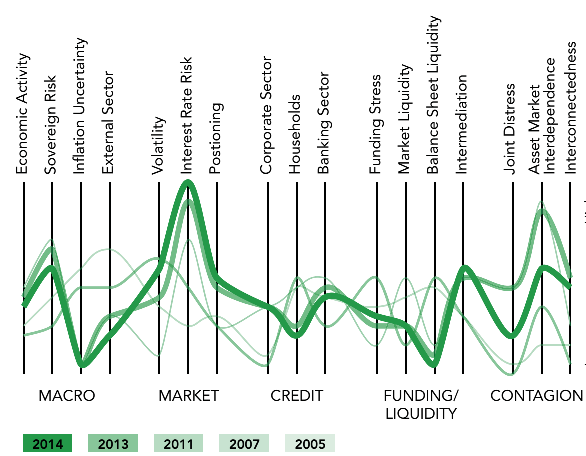
A. Heat map indicates risk by color



B. Spider charts indicate risk by distance from center



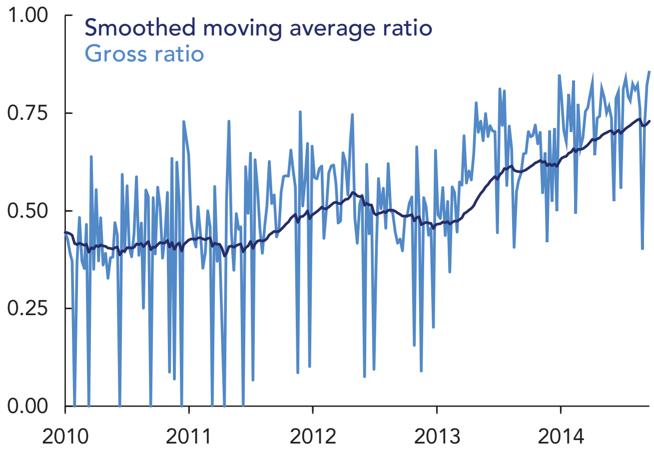
C. Parallel coordinates plot indicates risk by the position on each vertical axis



Sources (top to bottom): OFR analysis, IMF (2014b), OFR analysis

Figure 4-8. Central Counterparty Share of Transactional Volumes

CCPs' market share has grown, measured by transactions



Sources: Depository Trust & Clearing Corp., OFR analysis

OFR researchers are interested in understanding the flow of information in markets and how this flow drives the behavior of market participants. We consider sources of information available to participants and the relationship between information, market characteristics, participants' behavior, and the effects on markets.

4.4 Credit Markets

OFR's financial stability research on CDS markets has four goals:

1. understanding market characteristics,
2. identifying risks,
3. analyzing risk management practices, and
4. developing monitoring tools to inform policymakers.

This section describes that research and then focuses in detail on what we have learned about the growing role that central counterparties play in these markets.

Market participants use credit default swaps to buy and sell exposure to the default of underlying reference entities, which could be governments, corporations, or credit-linked securities. The amount of the exposure in a CDS contract is called its notional value. Since the financial crisis, reforms have sought to make these markets more transparent and to require standardized CDS contracts to clear through central counterparties (see **Section 3.5**).

Central counterparty (CCP) clearing activity continued to grow in 2014 and is nearing two-thirds of transactional volume in CDS markets on a notional basis (see **Figure 4-8**), reflecting regulatory objectives and market concerns following the financial crisis.

CDS Research Agenda

The OFR is working with data from the Depository Trust & Clearing Corp. (DTCC)'s Trade Information Warehouse on CDS positions and transactions to understand the risks these products may pose and to analyze the evolving role of CCPs. DTCC data provide insight into market concentration, size, and distribution of exposures by reference entity, counterparty, and date. A clear understanding of participants, their characteristics, and their behavior is necessary for evaluating the effectiveness of policy tools and monitoring potential risks.

UNDERSTANDING THE ROLE OF INFORMATION IN CDS MARKETS

OFR researchers are interested in understanding the flow of information in markets and how this flow drives the behavior of market participants. We consider sources of information available to participants and the relationship between information, market characteristics, participants' behavior, and the effects on markets. Sinha and Dong

(2011) demonstrated the different roles played by options versus equity markets in price discovery. Understanding the role of CDS markets relative to others (for example, bonds, equities, options) during different market conditions will help drive a better understanding of the market's functions and susceptibilities.

Using DTCC data going back to 2010, OFR researchers are studying how transaction sizes affect prices and liquidity under different market conditions. The 2012 so-called London Whale incident, in which an investment bank lost billions on large positions in the CDS market, demonstrated the effect that large transaction sizes and information flow can have on shifting market values of CDS (see U.S. Senate, 2011).

We are also looking at how external factors, such as regulations and news about firms, affect CDS prices and market depth. In addition, we are examining tools that will help us understand how different market participants originate and react to information. For example, we are asking whether customers of smaller broker-dealers routinely trade after customers of larger firms. We are also looking for patterns in the timing of market-moving trades (such as between morning and afternoon) that could interest policymakers.

ANALYZING THE RISKS OF CLEARING-MEMBER PORTFOLIO SELECTION

Hedging of credit exposures is increasingly cleared through CCPs, supported by financial regulatory reform. This development leads to research questions: How might dealers' outside exposures result in centrally cleared hedging activities? What are the implications of this connection?

OFR researchers and collaborators are analyzing the dynamics of clearing members' portfolio selection within CDS markets. OFR researchers are asking how individual clearing members' hedging portfolio values evolve and how the growth in central clearing presents new considerations for risk management. Central clearing changes the risk profile of cleared hedging portfolios and presents a possibly greater level of risk for clearing members. This research borrows from foundational work of Eisenberg and Noe (2001), which specifies systemic risk in interbank networks, but also proposes specific linkages and considers the feedback effect of negative shocks in the spirit of Acemoglu, Ozdaglar, and Tahbaz-Salehi (forthcoming).

As central clearing volumes increase and fulfill the intentions of financial reform, should policymakers be concerned about the implications for financial stability? Does the volatility of hedging portfolios threaten the solvency of clearing members and the CCPs they constitute? If so, how should policymakers balance clearing member solvency with inclination to hedge risks? OFR researchers are using data supplied by DTCC on counterparty exposures between clearing members and with CCPs, along with price histories of cleared reference entities, to try to answer these questions.

IDENTIFICATION OF COUNTERPARTY RISK MANAGEMENT

Counterparty risk management is important in derivatives markets because in periods of crisis, parties to financial contracts may come under stresses that jeopardize their ability to deliver on contractual obligations. Counterparty failure can threaten financial stability when hedges fail and market participants take losses. Consequently, counterparties must manage their exposures to each other by adjusting prices to account for contractual risk, setting aside risk buffers to offset costs of counterparty loss, and imposing limits on exposure to risky counterparties.

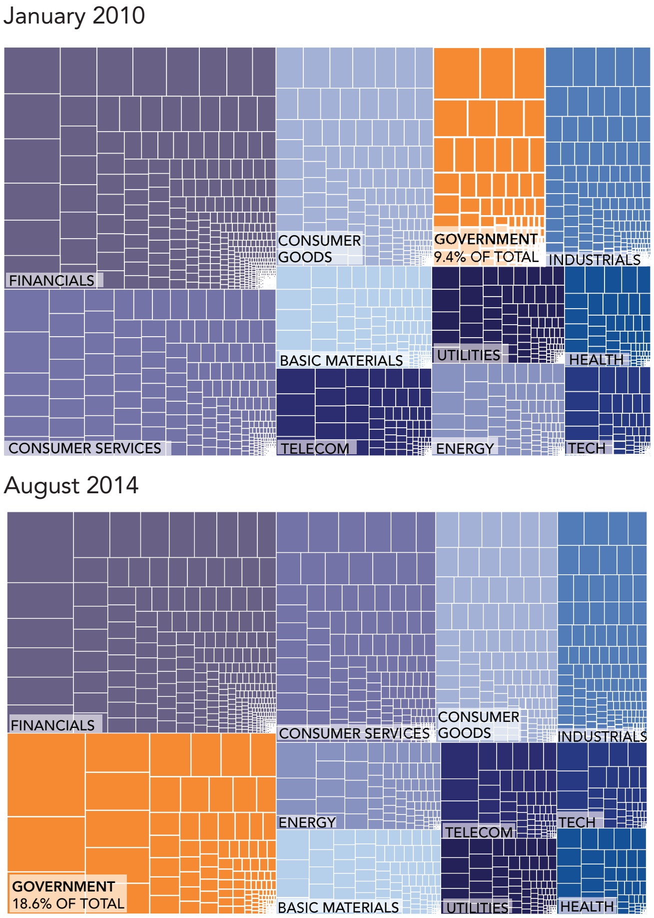
Counterparty risk management is a concern across a number of asset classes and markets. OFR researchers are studying counterparty risk within credit derivatives markets, where buyers and sellers face each other in bilateral CDS contracts. Buyers of CDS protection are concerned about default of the protection seller over the life of the contract. Sellers of CDS protection are concerned with contractual failure of protection buyers to pay predetermined premiums.

Recent academic work on counterparty risk has focused on how buyers and sellers price protection as a way to account for counterparty risk. Arora, Gandhi, and Longstaff, (2012) studied prices at which dealers are willing to sell protection and whether the prices varied with dealers' credit risk. More specifically, they found that the price at which dealers are willing to sell protection falls as the market perceptions of dealer default increase. Although the relationship was small, it was significant.

OFR researchers are studying whether transactional history corroborates the academic findings in indicative quotes and whether other mechanisms are employed in counterparty risk management. If counterparty risk is a commonly shared concern in OTC markets, what other ways besides pricing are used to manage contractual risk? Do protection buyers reduce the initial margins they pay to protection

Figure 4-9. Composition of Risks Traded in CDS Markets

Sovereign default risk emerges as a major market focus



Sources: Depository Trust & Clearing Corp., OFR analysis

sellers when sellers are more risky? And do buyers set risk limits based on notional or mark-to-market exposures with protection sellers?

DEVELOPMENT OF MONITORING TOOLS

OFR researchers are also developing monitoring tools to make complex data on exposures and transactions accessible to policymakers. During the past year, we have focused on understanding developments in counterparty risk, distribution of credit risk, and overlap of counterparty and credit risk.

Our ongoing research highlights counterparty risk and the risks of a central counterparty clearinghouse, which helps clear and settle market transactions. This role is a recent development in credit derivatives markets and lent momentum by the Dodd-Frank Act. Central clearing puts in place clearing requirements similar to those of futures markets where exchanges are connected to a proprietary central counterparty.

Monitoring margin requirements is critical to understanding how central counterparties manage risk (see Adrian, Covitz, and Liang, 2013). Identification of CCP counterparty concentration is also important, because failure of a clearing member may pose a systemic risk. Are central counterparty clearinghouses exposed to certain clearing members disproportionately by CDS product type, transactional size, settlement currency, or status as an end-user or dealer?

The OFR is developing market monitoring systems that policymakers can use to study these considerations interactively, to assess the transition to central clearing. We have developed additional visualization tools to understand credit markets at large without exposing confidential position or transaction information. One example is a tree map to illustrate changes in the constitution of the CDS market over time. The market is increasingly a reflection on sovereign default risk and proportionately less on corporate default risk, as it was before the financial crisis. Figure 4-9 illustrates the increase in the proportion of the market related to sovereign and governmental credit risk, from 9.4 percent in January 2010 to 18.6 percent in August 2014. At the same time, indexes that were issued during the financial crisis remain significant, in terms of notional exposures, and may pose liquidity risk in a period of credit deterioration.

The Evolving Role of CCPs

The Dodd-Frank Act mandated that clearing of the most liquid over-the-counter (OTC) derivatives contracts would migrate to central counterparty clearinghouses. CCPs are expected to reduce systemic risk through centralized netting of exposures and separation of portfolio risk management from counterparty risk management. However, some policymakers and market participants are concerned about the potential concentration of risk in CCPs (see **Chapter 3**).

A CCP should always be able to net risk more effectively than dealers can in the bilateral over-the-counter market. For example, assume that three dealers transact business in the bilateral market with no central counterparty. There is one type of CDS contract on Company A. Each dealer sells to the other two dealers $10 million of protection on Company A in the CDS market. After three periods, each dealer is a buyer and seller of credit risk — in other words, they all have a "net zero" risk exposure to Company A. But counterparty exposures remain. If Company A defaults, each dealer is obliged to deliver on its protection sale and expects to be paid on its protection purchase. For any dealer that fails, another dealer purchasing protection is at a loss. This market structure creates a chain of dependencies, which when not met, can spread losses throughout the system.

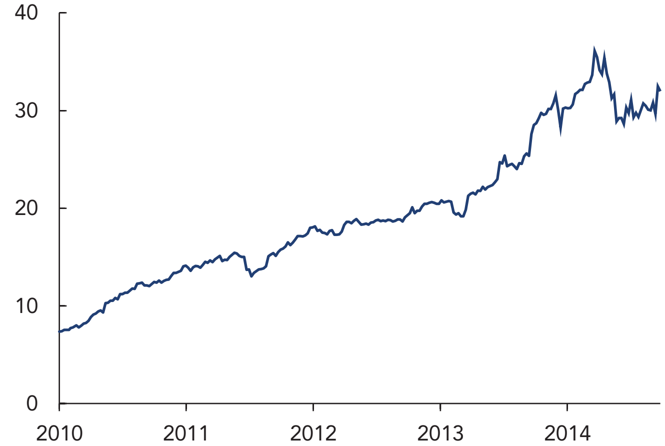
When a CCP is involved, the clearinghouse acts as counterparty to every market participant. When each dealer adds up its contingent assets and liabilities, it counts them against the same contractual entity, the CCP. The CCP intermediates the risk for each dealer-to-dealer transaction, so by the third period, all the dealers have a net zero risk exposure on the underlying risk and to their counterparties.

CCPs net the risk of counterparties, but they are at the same time exposed to the risk of any counterparty's failure. The CCP assumes the net liabilities of the counterparty. If the counterparty representing a large proportion of the CCP's liabilities fails, the CCP may be unable to pay out on cleared CDS contracts. This risk is a potential threat to financial stability.

As of October 2014, U.S.-based CCPs are counterparty to approximately $4 trillion in notional exposure, compared to the roughly $12.5 trillion of gross notional exposure outstanding in the bilateral market. Because significant netting occurs in the cleared market, the fraction of exposures CCPs are counterparty to is less than the fraction of transactional

Figure 4-10. Cleared Positions as a Percentage of All Outstanding CDS Positions

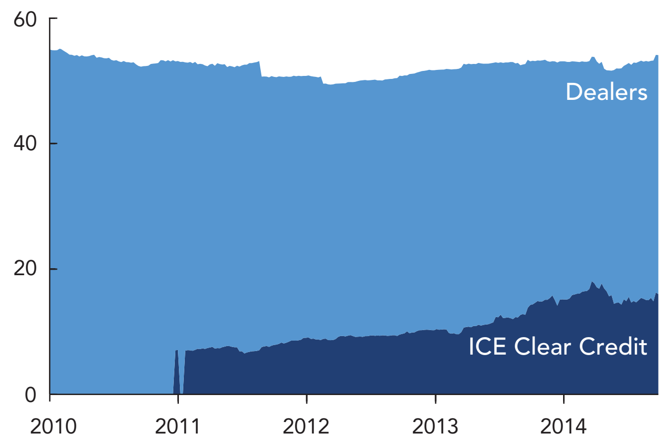
CCPs' market share has grown, measured by outstanding positions



Source: Depository Trust & Clearing Corp., OFR analysis

Figure 4-11. Top Five Counterparties for All Outstanding CDS Positions

ICE Clear Credit has been one of the top five CDS counterparties since 2011



Source: Depository Trust & Clearing Corp., OFR analysis

Figure 4-12. Top Five Reference Entities for Cleared CDS Indexes, January 2010 to May 2014

CDX.NA.IG.9	$179,113,684,096
CDX.NA.IG.19	$123,208,324,318
ITRAXX EUROPE SERIES 20	$106,620,317,497
CDX.NA.IG.22	$96,953,694,900
ITRAXX EUROPE SERIES 21	$92,919,341,812

Source: Depository Trust & Clearing Corp.

volume they clear. Nonetheless, gross notional exposures involving CCPs have risen rapidly (see **Figure 4-10**).

In 2010, dealers accounted for the top five counterparties and represented 55 percent of exposures by total volume in the CDS markets the OFR observes (see **Figure 4-11**). However, by 2011 ICE Clear Credit, LLC, had emerged to displace one among these top five entities. ICE Clear Credit's fraction of the market has only grown since 2011. By 2014, ICE Clear Credit had become the largest CDS counterparty and has reached more than 15 percent of total notional exposures. The relative proportion of the remaining four dealer-participants has diminished. CCPs already constitute the greatest source of counterparty concentration in the CDS market.

One major concern for policymakers that is also a potential threat to financial stability is the possibility of joint default of a CCP and one or more clearing members. Clearing member default can arise in several ways, one of which is stresses on its credit portfolio. Some stresses may result from the default of reference entities clearing members are exposed to and which the CCP clears.

Figure 4-12 shows that the most recent versions of the U.S. and European investment-grade credit indexes constitute the largest risk exposures among reference entities that are centrally cleared. These indexes are broad, but closer inspection reveals a degree of risk concentration that may concern policymakers. Credit indexes include reference entities from a variety of credit-sensitive sectors in the economy. When the reference entities contained in these indexes are categorized into sectors, financials emerge as the sector with the second highest exposure. A total of $182 billion resides in financials.

Policymakers are concerned about possible scenarios in which multiple stressed clearing members could strain the CCP because of common dealer exposure to financial sector risk. As of May 2014, 21 dealers held exposures to 65 financial reference entities through 12 cleared indexes that ranged from $2 billion in protection purchased to $3 billion in protection sold. Market participants could come to question the creditworthiness of several dealers concurrently in a crisis, which would present a challenge for the CCP, because the guarantee fund may not be large enough to settle losses arising from the default of several dealers at once. CCPs could require larger guarantee fund commitments from clearing members to improve safeguards in a crisis, but financing those buffers also increases the costs of central clearing in normal times.

Clearing member exposures to financial entities also introduce wrong-way risk. For example, clearing members may not be sound protection sellers at a time when the financial sector as a whole is under stress. For that reason, CCPs' protection purchases from clearing members would be least reliable when they are needed most.

Clearing member risk exposure to CCPs will continue to grow as the movement to central clearing proceeds. CCPs now account more than 15 percent of gross exposure in the CDS market, and that share has increased during a time when volumes in credit derivatives fell. As the importance of CCPs in the credit derivatives markets grows, policymakers must pay close attention to the counterparties these institutions transact with and the risks they clear.

4.5 Recent and Forthcoming OFR Research

The OFR has three research publication series: Working Papers, Briefs, and Staff Discussion Papers. These publications are designed to trigger lively discussion among researchers, market participants, and the regulatory community, and generate feedback that can help us achieve our statutory mission.

OFR Working Papers

The OFR launched the Working Paper Series in January 2012 for staff researchers to collaborate with outside research experts, expanding our virtual research community and leveraging the expertise of our staff. The OFR Working Paper Series has sparked interest and discussion in the academic and regulatory communities. The papers have been presented at conferences and cited in the press and academic literature. About half have also been published in academic journals.

Through November 2014, the Office had published 21 working papers, including the following nine since our last annual report:

- *Effects of Limit Order Book Information Level on Market Stability Metrics* by Paddrik and others (2014a) used an agent-based model of the limit order book to explore how the levels of information available to participants, exchanges, and regulators can be used to improve our understanding of the stability and resiliency of a market (see Section 4.2).
- *Hedging Market Risk in Optimal Liquidation* by Monin (2014) explored the optimal strategy for a financial institution seeking to sell a large block of securities. In these situations, an institution would attempt to minimize the price impact of the large sell order by spreading it out over time. The paper describes the optimal strategy for hedging the resulting market risk.
- *Structural GARCH: The Volatility-Leverage Connection* by Engle and Siriwardane (2014) proposed a new model of volatility in which financial leverage amplifies equity volatility by what the authors call the "leverage multiplier." GARCH stands for "generalized autoregressive conditional heteroscedasticity." The model estimates daily asset returns and asset volatility.
- *Design of Risk Weights* by Glasserman and Kang (2014) investigated the design of risk weights used to set minimum levels of regulatory capital for banks and introduced a formula for regulators to set weights by analyzing banks' portfolios.
- *An Agent-Based Model for Financial Vulnerability* by Bookstaber, Paddrik, and Tivnan (2014) developed an agent-based model that uses a map of funding and collateral flows to analyze the vulnerability of the financial system to fire sales and runs (see Section 4.2).
- *Shadow Banking: The Money View* by Pozsar (2014) presented an accounting framework for measuring the sources and uses of short-term funding in the global financial system. The paper also introduced a dynamic map of global funding flows to show how dealer banks emerged as intermediaries between two types of asset managers: (1) cash pools searching for safety through collateralized cash investments, and (2) levered portfolio managers searching for yield through funded securities portfolios and derivatives.
- *A Map of Funding Durability and Risk* by Aguiar, Bookstaber, and Wipf (2014) presented a funding map to illustrate the primary business activities and funding sources of a typical bank/dealer. The authors used the map to trace the paths of risk through four financial institutions during historical crises and to identify gaps in data needed for financial stability monitoring. They also introduced the concept of "funding durability," defined as the effective term of funding amid signaling and reputational considerations during periods of stress.
- *The Application of Visual Analytics to Financial Stability Monitoring* by Flood and others (2014) presented an overview of visual analytics — the science of analytical reasoning enhanced by interactive visualizations produced by data analytics software — and discussed its potential benefits for monitoring financial stability (see Section 4.3).
- *Competition in Lending and Credit Ratings* by Ahmed (2014) related corporate credit rating quality to competition in lending between the public bond market and banks. The author showed that the quality of credit ratings plays an important role in financial stability because strategic behavior by the rating agency in an issuer-pays setting dampens the influence of macroeconomic shocks. The paper also explained the use of informative unsolicited credit ratings to prevent unrated bond issues, particularly during good times.

OFR Briefs

OFR Briefs are less academic than working papers and allow us to describe our research to a broader audience. The first brief to be published later in 2014 is *Systemic Importance Indicators for Large U.S. Bank Holding Companies: An Overview of Recent Data* by Allahrakha, Glasserman, and Young (forthcoming) which uses a new dataset collected by the Federal Reserve to evaluate the systemic importance of the largest U.S. bank holding companies. The authors compared the banks' scores on several measures of systemic importance and showed that a financial connectivity index introduced in an earlier OFR working paper can be useful for measuring and monitoring interconnectedness. Overall, their analysis shows the need for monitoring multiple aspects of systemic importance.

Future briefs may:

- profile specific financial stability metrics and monitoring tools;
- provide technical primers or reference guides on key topics, such as secured finance transactions and high-frequency trading;
- offer a digest for a broader audience of the OFR's published academic research;
- summarize ongoing research programs;
- describe the OFR's progress in addressing gaps in data for financial stability monitoring; and
- describe and promote progress on the implementation of financial data standards.

OFR Staff Discussion Papers

OFR Staff Discussion Papers are academic papers by the OFR research staff that contribute to our understanding of financial markets, financial data, and financial institution risks. These topics are the building blocks of financial stability analysis. The papers may be preliminary versions of work intended for the OFR Working Paper Series or research papers intended for submission to external academic publications in economics or finance. Staff Discussion Papers in 2014 included the following:

- *Clustering Techniques and their Effect on Portfolio Formation and Risk Analysis* by Lemieux and others (forthcoming) illustrated how the choice of a clustering technique — the method used to group similar data objects into clusters — in a large financial dataset can affect analysts' perceptions of the riskiness of different asset portfolios. The authors argued that a poor choice of technique could result in misinterpretations of the data and adversely affect the quality of financial stability analysis.
- *Trade Credit and Cross-Country Predictable Firm Returns* by Albuquerque, Ramadorai, and Watugala (2014) investigated whether trade credit links between firms are an important factor in predicting returns in international equity markets. The authors found that the propagation of shocks across borders from customers to suppliers via this mechanism is stronger when the availability of credit is lacking, such as during financial crises.
- *A Flexible and Extensible Contract Aggregation Framework (CAF) for Financial Data Stream Analytics* by Ball and others (2014) presented a framework that uses the financial contract as the common denominator to enable financial data integration and aggregation from a wide range of sources to support financial stability monitoring.
- *The Role of Visual Analysis in the Regulation of Electronic Order Book Markets* by Paddrik and others (2014b) described visualization techniques to help financial stability analysts understand investor behavior in electronic markets (building on the agent-based model of the order book described in Section 4.3). The authors argue that the prevalence of automated trading and the growing incidence of "flash crashes" highlight the need to understand not just completed trades but the underlying details of order flow and the evolving order book. The paper proposed visualizations to help with surveillance and enforcement and also to help academics interpret the data in a manner that can be conveyed to nonexperts.
- *On the Optimal Wealth Process in a Log-Normal Market: Applications to Risk Management* by Monin and Zariphopoulou (2014) described a technique for evaluating individual investors' risk preferences based on their stated willingness to lose specific amounts, as expressed through the value-at-risk and expected shortfall measures. Such models provide a direct link between risk management and the dynamics of the financial system.

ADVANCING DATA STANDARDS 5

The OFR has a mandate to promote and develop financial data standards that are critical for improving the quality and usability of those data. To fulfill this mandate, we are encouraging regulators around the world to require the use of existing standards, such as the Legal Entity Identifier (LEI), in regulatory reporting. We are also leading in the development and implementation of new standards, such as identifiers for products and transactions.

5.1 Data Standards Agenda

Data standards are basic building blocks for creating quality financial data needed for accurate reporting, quality analysis, and performance assessment. They define precisely who is involved in a financial transaction, what securities or other products are traded, how market participants report their transactions, and how listed companies report their earnings and balance sheets (see **What are Financial Data Standards?**).

The financial crisis illustrated what can happen when standards are weak or nonexistent and investors are unable to track losses, for example, from the mortgage market to their mortgage-linked securities, or calculate their exposures to failing counterparties.

Without appropriate data standards, the quality of financial data will suffer, market participants and policymakers will be misinformed, and markets will function less efficiently. Data standards are essential to create consistent, comparable, and reliable data. Standards help companies share data with investors, investors compare data across companies, and regulators combine and aggregate data to track market trends and monitor financial stability.

> We provide support and leadership in developing, using, and integrating data standards that help investors and regulators by reducing data collection costs and facilitating data aggregation analysis.

Why have standards not become ubiquitous? Standards are often a classic public good, with costs borne by a few and benefits accruing over time for many. To solve the collective action problems created by these disincentives, government organizations such as the OFR must take a leadership role.

That is why Congress mandated the OFR to standardize data reported and collected on behalf of the Council and the public. The OFR can play any of three roles in a standards project: lead, collaborate with a regulatory agency, or participate in organizations that work through consensus (see **Figure 5-1**).

This chapter examines trends in information standards and then discusses the four important data standards initiatives in which the OFR is playing one or more of those roles:

What Are Financial Data Standards?

Financial markets rely on data standards to function smoothly.

Entity identifiers identify specific legal entities such as parent companies, subsidiaries, and off-balance-sheet vehicles.

Instrument identifiers identify financial instruments like stocks, bonds, and loans. For example, there is the International Organization for Standardization (ISO) standard for individual securities known as the International Securities Identification Number. The project to create a universal loan identifier is another example.

Product identifiers provide commonly accepted definitions of products like "equities" and "swaps."

Standards for financial and business reporting describe information reported by companies to the public on financial disclosures and regulatory reports. An important initiative is XBRL, or eXtensible Business Reporting Language, which enables free and open exchange of business and financial information.

Transaction standards describe information used in financial transactions. For example, the Mortgage Industry Standards Maintenance Organization developed a language that enables consistency in describing mortgage transactions.

Legal Entity Identifier (LEI). The LEI project to precisely identify each legal entity involved in a financial transaction reached two important milestones in 2014. First, approximately 300,000 LEIs had been issued as of September 30, 2014, triple the count a year ago (see FSB, 2012a). Second, the Global LEI Foundation and its new board began to assume operational management of the LEI system in June 2014. The foundation oversees 19 local operating units authorized to issue LEIs, up from five in 2013.

But widespread use of the LEI by both the public and private sectors will be the true measure of its success (see **Section 5.3**). In the United States and Europe, LEI use has been driven primarily by swaps regulation. The OFR urges all financial regulators to mandate use of the LEI in all regulatory reporting, beginning with large, complex financial companies and market participants.

Standards for Derivatives Markets. The OFR is working with the CFTC and other regulators to improve financial reporting standards for swap data repositories (SDRs). SDRs were mandated by the Dodd-Frank Act to promote transparency in over-the-counter derivatives markets (see **Section 5.4**).

Internationally, the OFR is assisting the CFTC and its global peers in developing shared taxonomies for categorizing derivatives products for analysis and regulatory action. We have developed a set of principles and requirements for derivatives product identifiers, which we continue to fine-tune in collaboration with international regulators. The OFR also contributed to a report on how to aggregate data on derivatives, released in 2014 by the Financial Stability Board, an international group of finance ministries, market regulators, and central banks. We continue to work on these initiatives.

Universal Loan Identifiers. The OFR is providing technical support to the CFPB and other regulators to create a universal mortgage loan identifier to promote transparency, data aggregation, comparability, and analysis in the home mortgage market. The Dodd-Frank Act authorized the CFPB to collect more data about individual mortgage loans and to mandate that entities reporting data under the Home Mortgage Disclosure Act (HMDA) provide a universal loan identifier for each loan or application that they are required to report. The OFR published a working paper on this subject in late 2013 (see McCormick and Calahan, 2013) and the CFPB issued a proposal in July 2014 to require a

Figure 5-1. How the OFR Sets Data Standards Priorities

The OFR considers three issues when setting data standards priorities

		Identifiers			
		Legal Entity **(LEI)**	Unique Transaction **(UTI)**	Unique Product **(UPI)**	Universal Loan **(ULI)**
Is it within the OFR's mission and scope?	Improve Council data collection	✔	✔	✔	✔
	Support financial stability analysis	✔	✔	✔	✔
	Promote regulatory data sharing	✔	✔	✔	✔
	Promote financial stability	✔	✔	✔	✔
Does it meet standardization criteria?	Uniform characteristics	✔	✔	✔	✔
	Large volume of data to exchange	✔	✔	✔	✔
	Sufficient info about data	✔	✔	✔	✔
	Multilateral exchange	✔	✔	✔	✔
	Ease of execution	✔	✔	✔	✔
What is the OFR's strategic role?	Leader	✔			
	Partner		✔	✔	
	Advisor				✔

Source: OFR analysis

universal loan identifier in data reported under HMDA (see **Section 5.5**).

Reference Databases. The Dodd-Frank Act requires the OFR to prepare and publish reference databases for financial entities and financial instruments. The global LEI system will meet the requirement for an entity reference database (see **Section 5.6**). The OFR is examining ways that open-source algorithms, symbologies, and collections of codified background knowledge could be used to build a cost-effective and useful reference database for financial instruments.

The diversity and complexity of data reporting mandates among U.S. financial regulators makes agreement critical on standards for data collections. As technologies improve, regulators increasingly seek to collect raw data that can be analyzed more easily than data reported in text, spreadsheets, and document formats. The OFR works with other financial regulators to develop standards whenever appropriate.

5.2 Trends in Data Standards

There is growing acceptance among regulators and market participants about the need for financial data standards. Our standardization work has shown that early collaboration with industry to develop standards is a key step before launching new data collections. Regulators should also identify and adopt best practices to manage datasets that are rapidly growing in size and complexity.

As the volume of financial data increases, so does the need for data standards.

Data standards can be driven by industry, government, or both. Private companies and industry groups often reach consensus on standards without government involvement when benefits are clear.

However, consensus on standards may be difficult to achieve when costly upfront work is required or where proprietary interests exist. In many cases, regulators work with industry groups on voluntary standards that build on existing industry practices and reflect industry input. Early collaboration with industry can be critical for success. Regardless of who creates a data standard, the industry will encourage its use if it gives them a tangible benefit.

Financial data standards and collections must keep pace with technology and market developments. Data requirements are continually becoming more demanding in scope, size, and complexity. For example, some high-volume, high-velocity data, such as data generated by high-frequency trading, are based on market orders that are executed in fractions of seconds. These types of very large and complex datasets might be described as "big data," but even datasets that are merely large can pose technical and organizational challenges.

As financial transactions become more complex, market participants often recognize the need to agree on precise and consistent definitions in a contract. An example is the Financial products Markup Language (FpML) used in derivatives markets. Different technologies are advancing to address the need for common meanings for financial terms. For example, XBRL is being used to document accounting definitions, while the Internet standard Resource Description Framework (RDF) is also being used to document terms in a variety of industries, including finance.

Users and owners of data standards must also keep the standards up to date as financial markets change. Revision cycles need to match the speed of financial and technological innovation. A standard that falls behind and no longer meets the needs of its users is likely to be abandoned.

Implications for Data Collection

Financial data standards contain specific definitions, formats, and content that lead to accurate and consistent data understood by all users.

Standardized Definitions used across the public and private sectors improve the value of data for analysis. When key terms are not clearly defined, financial analysts are unable to accurately interpret and compare data, resulting in a lack of confidence in the results. Standards are particularly needed when data include a common term that can be understood in various ways. Ambiguity in simple terms such as "delivered" or "annual" can be particularly troublesome.

Standardized Formats help analysts aggregate and compare data, and automate processes for storing, reporting, and processing data. It is important to consider how data may be used and to apply a standard format, even to routine information. If calendar dates are entered in a free-form text field rather than in a consistent date format, they can be difficult to analyze. For example, does "4/6/2010" mean April 6 or June 4 in 2010?

Without a standard format, some companies may report their entire address in one text field, while others report street address, city, state, and ZIP code in separate fields. When planning a data collection, regulators should examine the standards available, evaluate potential uses of the data, and choose the most appropriate standards.

Standardized Content is information produced by creating a finite list of acceptable data choices that can be entered in a particular field. This requirement reduces the data cleaning needed to remove inaccurate, corrupt, or inconsistent information from a dataset and facilitates comparison among datasets. For example, requiring a state name to be entered as a two-digit postal code eliminates the use of unstructured text such as "Calif" or "California."

Standardization also makes combining datasets easier. In the postal code example, standard content creates a one-to-one link in which "CA" always equals "California." Without that standard, combining datasets requires matching a variety of state abbreviations and spellings to "CA."

5.3 Legal Entity Identifier

The OFR is a leader in the global initiative to develop, implement, and encourage industry adoption of a unique Legal Entity Identifier for financial market participants. The LEI — a 20-digit alphanumeric code that precisely identifies parties to financial transactions — will help market participants and regulators in many ways. Regulators around the world are using a combination of regulatory mandates, international regulatory coordination, and consensus standard setting to promote the use of the LEI.

The need for a common global entity identifier became apparent in 2008, when market participants and their regulators were unable to gauge exposures to Lehman Brothers and its many legal entities. The LEI, once fully implemented and adopted worldwide, can help address these problems by acting as a common reference point — a unique, universally recognized code for every party in financial markets, including every legally distinct subsidiary or affiliate (see **Evaluating the Benefits and Costs of the LEI**). The private sector and international regulators have also collaborated to create a standard format for LEI data files so the issuers of LEIs — known as local operating units (LOUs) — can easily share and compare LEI data.

The LEI has earned support from regulators and market participants in a relatively short time for two reasons: the financial crisis plainly illustrated the need for a universal identifier, and there are no viable alternatives.

BENEFITS

The LEI will eventually allow analysts to combine and analyze multiple public and proprietary datasets (see **Section 6.4**).

Currently, companies face a costly, labor-intensive and mistake-prone process to accurately align and maintain different identification systems as companies and relationships change. This may include manually cross-referencing identifiers issued by vendors, private companies, and regulators; validating legal entity information; and maintaining an internal system of legal entity hierarchies and networks. If all companies were required to report LEIs, analysts could link related entity reports, aiding both company risk management and government oversight.

The LEI will also help reduce or eliminate confusion about counterparty identification, one of the most common reasons for errors and failures in derivatives trades (see ISDA, 2013). An International Swaps and Derivatives Association survey found an error rate above 10 percent in 2012 for the two largest categories of swaps — interest rates and foreign currencies (see **Figure 5-2**). The LEI allows financial market participants to know the identity of every counterparty throughout the life of their transactions.

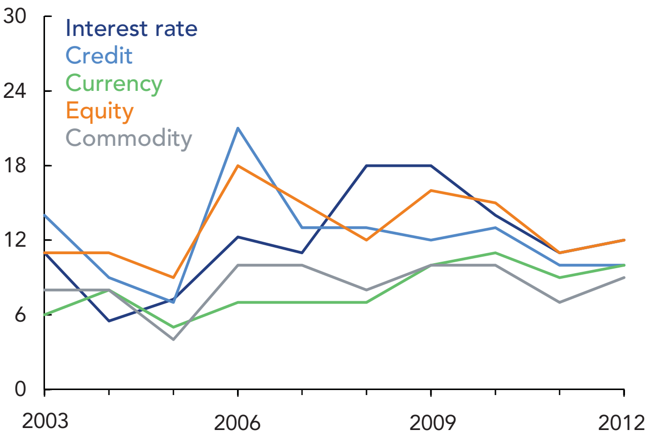
COSTS

To obtain an LEI in any country, a company pays an initial registration fee of approximately $200 (or equivalent), followed by an annual maintenance fee of approximately $100 (or equivalent). All fees are paid to the local operating unit (LOU) that issued the identifier to cover its operating costs. Each LOU is required to share a portion of those fees with the Global LEI Foundation, the nonprofit group that is now taking over management of the global LEI system.

Some have argued that the costs of obtaining LEIs, in addition to new regulatory requirements since the financial crisis, represent an unfair burden for small firms and subsidiaries that are relatively inactive in financial markets. They contend

Figure 5-2. Trading Errors by Swap Category (percent)

Swap traders surveyed from 2003 to 2012 ranked wrong names as a common error



Sources: International Swaps and Derivatives Association Operational Benchmarking Surveys, 2003-2012; OFR analysis. The 2013 survey did not include swap trading error rates.

the benefits of the LEI system will accrue disproportionately to large and complex companies facing many counterparties in derivatives and other markets. To address these concerns, a phased approach may be appropriate, with larger companies required to adopt the LEI before smaller companies.

It is premature to estimate how much the financial industry will save by adopting the global LEI system. Industry estimates of the annual savings range from $300 million to $10 billion (see Chan and Milne, 2013).

In general, the LEI system is expected to improve industry efficiencies and reduce costs for data collection, cleaning, and aggregation; transaction processing; data management; business operations; compliance monitoring; regulatory reporting; research and analysis; information sharing; and intra- and inter-organization communication.

Another benefit of the LEI once it is more broadly adopted by Council authorities will be a reduction in reporting burden. Companies spend significant time and resources managing their identification systems for reporting purposes, for themselves and their counterparties. Benefits of the LEI will grow rapidly as more companies get one.

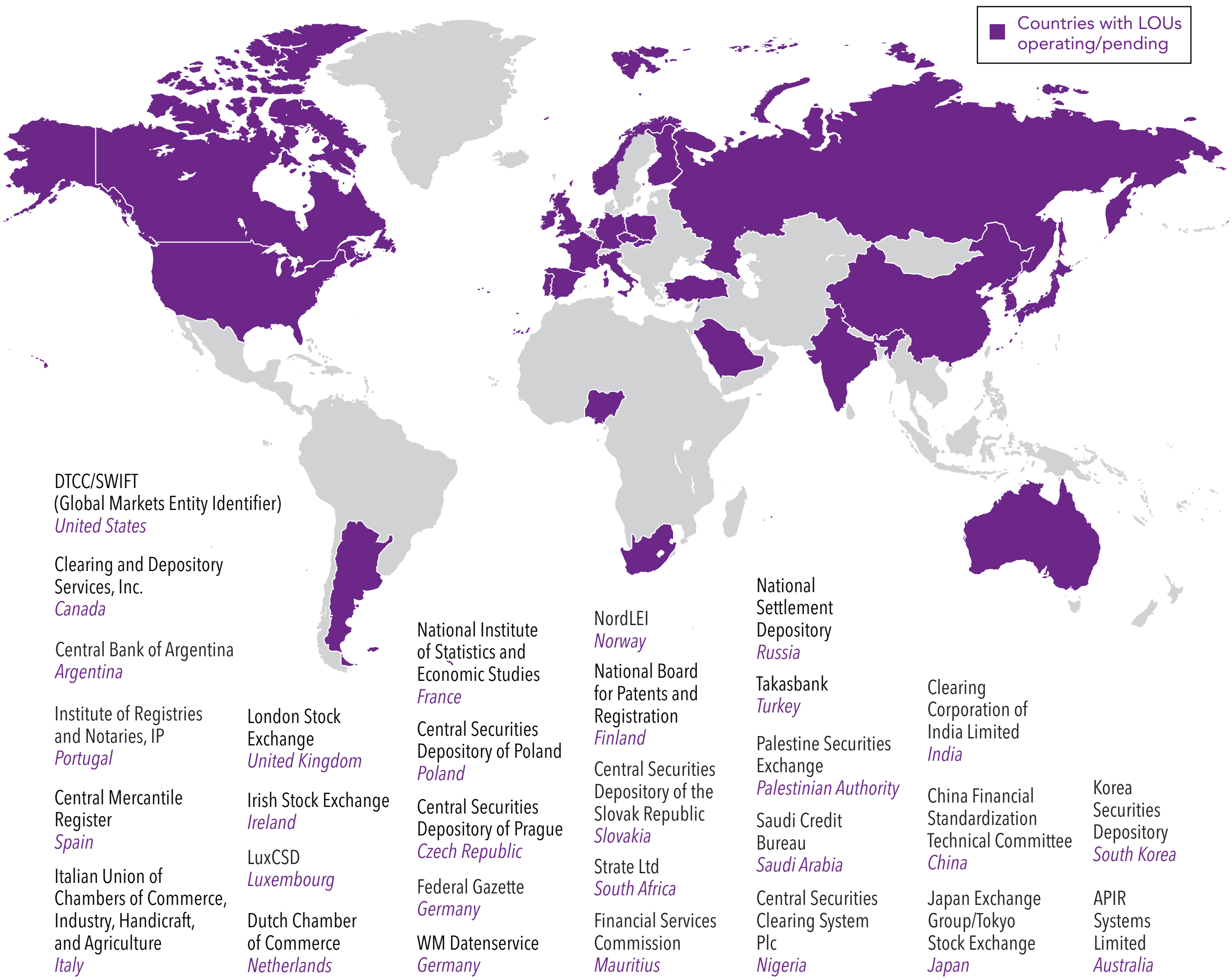
The global LEI initiative has made extraordinary progress since 2010, when the OFR issued a policy statement calling for the LEI and noting the potential benefits if regulators required its use (see OFR, 2010). The LEI Regulatory Oversight Committee, currently chaired by the OFR's Chief Counsel, ensures that the LEI system works for the public good. It consists of more than 60 international members representing market and prudential regulators as well as international organizations.

In June 2014, the new Global LEI Foundation held its first board of directors meeting. The Swiss-based foundation is assuming operational management of the global LEI system and overseeing construction of the LEI system's technology infrastructure, under the oversight of the Regulatory Oversight Committee. The foundation will also be responsible for ensuring adherence to LEI governing principles and standards, including the reliability, quality, and uniqueness of LEIs (see FSB, 2012a). The foundation plans a central database of LEIs that will be free to the public and all market participants, although privately-sponsored databases already exist.

The global reach of the LEI system significantly expanded in 2014. Approximately 300,000 LEIs had been issued to entities in more than 190 jurisdictions as of September 30, 2014, up from 100,000 LEIs at the time of our last annual report. The number of LOUs authorized to issue identifiers rose from five last year to 19 on September 30, 2014. Eleven others were in earlier planning stages (see **Figure 5-3**).

Figure 5-3. Issuers of Legal Entity Identifiers

As of September 30, 2014, 19 local operating units were issuing LEIs and 11 others were preparing to do so.



Sources: LEI Regulatory Oversight Committee, LEI local operating units

Figure 5-4. Where Is the LEI Required for Regulatory Reporting?

	Regulator	Effective Date	Purpose
Required by Regulator	U.S. Federal Reserve System	Nov. 3, 2014	Annual reports of domestic and foreign holding companies on Forms Y-6, 7, and 10
	European Insurance and Occupational Pensions Authority	Dec. 31, 2014	Annual financial report and reports filed with regulators
	Canadian Securities Administrators	Oct. 31, 2014	Swap transactions reported to trade repositories
	European Securities and Markets Authority	Feb. 12, 2014	Swap transactions reported to trade repositories
		Jan. 1, 2014	Alternative investment fund reports
	Monetary Authority of Singapore	Oct. 31, 2013	Swap transactions reported to trade repositories
	Australian Securities and Investments Commission	Oct. 1, 2013	Swap transactions reported to trade repositories
	National Association of Insurance Commissioners	March 31, 2013	Annual and quarterly investment reports filed by insurance firms
	U.S. Commodity Futures Trading Commission	March 13, 2012	Swap transactions reported to data repositories
Recommended or Listed as an Option by Regulator	U.S. Securities and Exchange Commission	June 15, 2015	Credit rating firms' disclosures of issuer ratings
		Oct. 14, 2014	Monthly Form N-MFP reports filed by money market funds
	U.S. Municipal Securities Rulemaking Board	Aug. 10, 2014	Registration Form A-12 filed by municipal securities dealers and advisors
	U.S. Commodity Futures Trading Commission	Feb. 18, 2014	Ownership Form 102 filed by futures clearing merchants, clearing members, and foreign brokers
	European Banking Authority	Jan. 29, 2014	All regulatory reports filed by EU banks
	U.S. Commodity Futures Trading Commission	June 26, 2012	Annual Form TO filed by counterparties to unreported trade options
		March 31, 2012	Annual and quarterly Form PQR reports filed by private fund managers
	U.S. Securities and Exchange Commission	March 31, 2012	Annual and quarterly Form PF reports filed by private fund managers
		Sept. 19, 2011	Annual Form ADV reports filed by investment advisors
		n/a	Effective date not yet set for Rule 613 requiring Financial Industry Regulatory Authority to maintain a consolidated audit trail
Pending Proposals by Regulators to Require LEI	European Securities and Markets Authority	n/a	Credit rating firms' reports of issuer ratings
			Market trading data reports
	U.S. Consumer Financial Protection Bureau	n/a	Home Mortgage Disclosure Act submissions
	U.S. Securities and Exchange Commission	n/a	Swap transactions reported to data repositories under Regulation SBSR

n/a = Not applicable

Sources: Regulators in United States, Europe, Canada, Hong Kong, Singapore, and Australia; OFR analysis

LOUs can be organized by public or private sector organizations and must meet certain requirements set by the global LEI system.

The LEI system's data are updated regularly. Currently, individual LOU websites provide information on which companies have obtained LEIs. Third-party websites are also available that combine this information globally.

So far, derivatives regulators have driven LEI adoption across the world. The CFTC has required use of the LEI for reporting derivatives transactions to swap data repositories since 2012 (see CFTC, 2012). Swap regulators in Europe, Canada, Australia, and Singapore also now require companies to use the LEI (see European Commission, 2012).

In the United States, required use of the LEI is expanding beyond the initial focus on swap transactions. The Federal Reserve announced that bank holding companies which have already acquired an LEI will be required to report it on several annual forms after October 31, 2014.

In other sectors, regulations recommend or allow the LEI to be used in data submitted to the government, but stop short of requiring it. For example, the LEI is now optional for reporting by private funds that file annual reports to the SEC and municipal advisors that register with the Municipal Securities Rulemaking Board (see **Figure 5-4**).

The OFR is encouraging Council member agencies and regulators around the world to require the LEI in all new data collections. The Securities Industry and Financial Markets Association has called for "more fulsome adoption and use" by U.S. regulators (see SIFMA, 2014b). In July 2014, the CFPB proposed requiring lenders to use the LEI in data reported under the Home Mortgage Disclosure Act (see CFPB, 2014).

Voluntary use was understandable when the LEI was in its formative stages but mandating that reporting entities obtain an LEI will be far more effective in propagating the LEI and helping it become ubiquitous in the long run. The OFR has also argued that several key datasets — including call reports for banks and securities financial reports and offering materials (including those for asset-backed securities) — should be modified to require use of the LEI.

> Because of the global nature of derivatives markets, the OFR is working with foreign regulators to promote international consistency in SDR and trade repository reporting.

Using LEIs to Map Corporate Hierarchies

As the global LEI system expands, one of its most important uses is to help regulators and market participants understand and document complex corporate structures or hierarchies. Some of the largest multinational banks have thousands of legal entities, many with similar names, operating around the globe. Data about the relationships among corporations' legal entities can show networks of control, ownership, liability, and risks, giving financial regulators deeper insights into how financial market participants are connected to each other.

The OFR is helping a working group established by the LEI Regulatory Oversight Committee examine ways to add corporate hierarchy information to the global LEI database.

5.4 Standards for Derivatives Market Data

An important global regulatory objective is to make derivatives transactions more transparent by requiring market participants to report them to swap data repositories, whether or not those transactions are centrally cleared. The OFR is assisting domestic and international efforts to promote data standards at these trade repositories. Use of the LEI in these markets is a crucial first step, but standards will also be needed for derivatives products, transactions, and reporting.

Global regulators agreed after the financial crisis to make derivatives markets more transparent, a step requiring high-quality and comprehensive post-trade data that can be aggregated, compared, and analyzed. The United States, Europe, and a growing number of countries now require companies to report over-the-counter derivatives data to trade repositories, also known in the United States as swap data repositories (SDRs) (see **Figure 5-5**). The reporting covers most of the global derivatives market, as measured by notional (face value) amounts outstanding. Mandatory reporting of accurate and well-defined data will help regulators and market participants assess counterparty exposures and other risks.

Figure 5-5. Trade Repositories for Swap Data

As of September 30, 2014, 23 trade repositories were operating or planned.

Repository Name	Parent Company	Country	Regulator	Types of Swap Reported				
				Commodities	Credit	Equities	Foreign Exchange	Interest Rates
Banco de Mexico	n/a	Mexico	Banco de Mexico					
Bank of Korea	n/a	South Korea	Financial Services Commission					
BM&F Bovespa S.A.	BM&F Bovespa S.A.	Brazil	Banco Central do Brasil					
BSDR LLC	Bloomberg LP	U.S.	Commodity Futures Trading Commission					
Cetip S.A.	Cetip S.A.	Brazil	Banco Central do Brasil					
Clearing Corporation of India	n/a	India	Reserve Bank of India					
CME European Trade Repository Ltd	CME Group Inc.	U.K.	European Securities and Markets Authority					
CME Swap Data Repository[a]	CME Group Inc.	U.S.	Commodity Futures Trading Commission					
DTCC Data Repository (Japan) KK[b]	Depository Trust & Clearing Corp.	Japan	Japan Financial Services Agency					
DTCC Data Repository (Singapore) PTE Ltd[b]	Depository Trust & Clearing Corp.	Singapore	Monetary Authority of Singapore					
DTCC Data Repository (U.S.) LLC[a]	Depository Trust & Clearing Corp.	U.S.	Commodity Futures Trading Commission					
DTCC Derivatives Repository Ltd.[b]	Depository Trust & Clearing Corp.	U.K.	European Securities and Markets Authority					
Financial Supervisory Service	n/a	South Korea	Financial Services Commission					
Hong Kong Trade Repository[b]	n/a	Hong Kong	Hong Kong Monetary Authority					
ICE Trade Vault Europe Ltd.	Intercontinental Exchange, Inc.	U.K.	European Securities and Markets Authority					
ICE Trade Vault LLC[a]	Intercontinental Exchange, Inc.	U.S.	Commodity Futures Trading Commission					
KDPW Trade Repository	Central Securities Depository of Poland (KDPW)	Poland	European Securities and Markets Authority					
Korea Exchange	Korea Exchange	South Korea	Korea Financial Services Commission					
National Settlement Depository CJSC	Moscow Exchange Group	Russia	Bank of Russia					
OJSC Saint Petersburg Exchange	Moscow Exchange Group	Russia	Bank of Russia					
REGIS-TR S.A.	Deutsche Borse Group and Bolsas y Mercados Espanoles	Luxembourg	European Securities and Markets Authority					
SAMA Trade Repository	n/a	Saudi Arabia	Saudi Arabian Monetary Agency					
UnaVista Limited[b]	London Stock Exchange Group	U.K.	European Securities and Markets Authority					

n/a Not applicable
[a] Also authorized to operate in Australia and Canada
[b] Also authorized to operate in Australia

Sources: Financial Stability Board, trade repositories

In the United States, mandatory reporting to SDRs for transactions regulated by the CFTC began January 1, 2013. The CFTC has primary jurisdiction over interest rate swaps, credit index swaps, foreign exchange swaps, and commodities swaps. The smaller market in security-based swaps is regulated by the SEC, which has not finalized its rules for reporting those instruments to a swap data repository. Mixed swaps that involve both commodities and security-based components are regulated jointly. In Europe, over-the-counter derivatives reporting to trade repositories began on February 12, 2014, as required by the European Market Infrastructure Regulation.

We are also assisting the CFTC in efforts to improve data quality in SDRs in the United States.

Successfully converting data from the SDRs and foreign trade repositories into useful information for regulators depends on new or enhanced data standards, including unique identifiers for entities, products, and transactions, as well as mapping the relationships among corporate subsidiaries, and reporting standards.

Although over-the-counter derivatives regulators in the United States, Europe, Canada, Australia, and Japan have mandated use of the global LEI system, other important steps are necessary. Regulators and market participants need to develop and use product taxonomies to define product categories, such as cross-currency swaps or interest rate options, and to use unique transaction identifiers to efficiently match counterparties and prevent double-counting of transactions.

International Collaboration

International adoption of data standards is essential for over-the-counter derivatives data to be aggregated accurately across jurisdictions to monitor exposures in financial products (see CPSS-IOSCO, 2012a). Consistent reporting standards are also needed so market participants operating in multiple financial markets around the world can use the same set of reference data and processes, reducing errors and regulatory reporting requirements.

Since July 2013, the OFR has participated in the FSB's Aggregation Feasibility Study Group, which has recommended continued work to reach international agreement on unique product identifiers and transaction identifiers, among other things.

Establishing a unique transaction identifier is particularly important to help prevent the inadvertent duplicate counting of over-the-counter derivatives transactions. With data repositories around the world and evolving reporting requirements, parties in an over-the-counter derivatives deal may be required to report a transaction to more than one repository, or both parties may report the swap to the same repository. In Europe, for example, where regulations require both counterparties in a transaction to report the same data, a unique transaction identifier is critical to prevent double counting. Without a transaction identifier, regulators will face difficulty in spotting duplicate transactions, raising questions about the quality of aggregated data.

The FSB study group in September 2014 recommended the FSB launch a formal project to develop global product and transaction identifiers. It also recommended authorities and SDRs collaborate to harmonize data elements for aggregation. Developing a long-term aggregation solution will require a combination of technology, changes in business processes, and protocols for sharing data across national borders, according to the study group (see FSB, 2014a). In the near term, the group urged regulators to assess the costs and governance structures required to aggregate data from multiple countries and propose solutions to potential legislative and regulatory challenges, especially those regarding data security and privacy, among others. The group also urged regulators to continue developing bilateral agreements to share data.

Collaboration with the CFTC

In the United States, the CFTC requires regulated platforms for swap trading, known as swap execution facilities, to report data about transactions and prices to an SDR, which must publicly disseminate those data in real time. Three SDRs began reporting data to the CFTC in 2013, joined by a fourth in 2014. The CFTC aggregates regulatory data with the SDRs' real-time transaction-level data and publishes a weekly summary on its website.

However, the lack of shared standards in defining and collecting the swap data means market participants have submitted fragmented and inconsistent data to the SDRs. The four SDRs in the United States have different system architectures and technologies that result in data being reported differently. The differences hinder efforts by U.S. regulators to accurately aggregate and compare data. Inconsistent data reporting is also occurring in other jurisdictions.

The CFTC has taken several steps to improve SDR data quality during the past year. In January 2014, the agency asked for public comments on how to improve the SDR data and announced the formation of a new internal working group to review certain swaps reporting provisions. On March 31, 2014, the CFTC and the OFR announced a plan to assess the quality of data submitted to the CFTC and jointly pursue solutions to improve it (see U.S. Treasury, 2014).

Our partnership with the CFTC consists of three initiatives:

1. **Assess and improve the quality of data collected.** Members of the CFTC Technology Advisory Committee concluded at a meeting on February 10, 2014, that missing, incomplete, and inaccurate data made SDR data unfit to use in regulatory oversight. The committee said the CFTC's definitions for SDR reporting were not sufficiently precise and that standards must be applied when data are collected instead of trying to harmonize data later in the process. The OFR and the CFTC are collaborating to address these data quality issues with the data already collected.
2. **Develop unique product identifiers and unique transaction identifiers.** To address data quality concerns on a prospective basis, the CFTC and the OFR are examining benefits, complexities, and possible solutions for identifiers of products and transactions. Standards exist for both, and work is underway to determine if these standards can be extended to meet SDRs' current and future reporting needs. A unique product identifier is essential for each category of swaps, such as fixed-for-floating interest rate swaps, so data can be aggregated. CFTC regulations allow SDRs to use their own internal identifiers until the CFTC approves a unique product identifier (see CFTC, 2012). The first step in creating unique product identifiers is to develop a product taxonomy showing the relationships among complex swap instruments (see **What are Taxonomies?**). Unique transaction identifiers are also needed, and the OFR has begun discussions with the CFTC and European regulators to implement international standards in this area.
3. **Develop other swap data standards.** The OFR is also helping the CFTC develop precise definitions of swaps-related terms, conditions,

What Are Taxonomies?

A taxonomy is a way to classify and organize elements in a hierarchy.

One well-known taxonomy is the "Tree of Life," which shows the diversity of plants, animals, and other living organisms. It organizes species by shared characteristics. The class of mammals, for example, includes only animals that have hair, give milk, and bear live young. Within the class of mammals, canines can be distinguished from felines by characteristics they do not share.

The same principle of shared characteristics can be applied to financial instruments. The choice of taxonomy can vary, depending on the purpose. For example, convertible corporate bonds — which have characteristics of both debt and equity securities — could be grouped with debt instruments for one purpose, and with equity instruments for another.

A unique product identifier is essential for each category of swaps, such as fixed-for-floating interest rate swaps, so data can be aggregated.

and relationships that can be updated as markets change in the future. Private sector groups have already been working for several years to develop such a dictionary for financial instruments, business entities, and analytic tools. Clear, agreed-upon definitions are the foundation for accurately collecting and comparing data.

5.5 Universal Loan Identifiers

We are applying the best practices learned from our LEI work to other areas, such as universal loan identifiers for the mortgage industry.

Because of the complex and fragmented nature of the U.S. mortgage system, a universal identifier for every mortgage would greatly benefit regulators and financial market participants. We published a working paper in 2013 explaining how a universal loan identifier would improve data aggregation, comparisons, and analysis about the mortgage industry (see McCormick and Calahan, 2013). The CFPB proposed a rule in July 2014 requiring a universal loan identifier for each loan or application reported under HMDA, as authorized by the Dodd-Frank Act, and the OFR continues to support this effort (see CFPB, 2014). A critical component of a universal loan identifier is that it must not include any information that could be used to directly identify the applicant or borrower, such as a Social Security number or date of birth. At the same time, each universal identifier must provide traceability of the loan through its life cycle.

A mortgage loan typically passes through multiple companies as it is originated, sold, packaged for securitization, and serviced. Issuing a universal loan identifier when a mortgage is originated would help protect a borrower's personal information during the life of the loan because the personal information would be isolated from other loan data. A universal loan identifier code would travel with the loan as it is sold and resold.

Expanding Mortgage Standards

The Mortgage Industry Standards Maintenance Organization (MISMO), a nonprofit subsidiary of the Mortgage Bankers Association, is leading efforts to apply its voluntary standards to mortgage origination, underwriting, service administration, and other events in a loan's life cycle. Unlike many data standards, the MISMO standards are exchange standards that not only match data terms with their definitions, but also facilitate mapping an organization's internal data structures to a consensus standard for mortgage businesses and mortgage participants. Use of the MISMO standards has increased since the financial crisis, largely because of the work of the FHFA, which regulates Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks.

The OFR is working with the CFPB, FHFA, and MISMO to advance data-sharing standards. These include the CFPB's Loan Estimate and Closing Disclosure and National Servicing Rule, FHFA's scorecard initiatives for mortgage servicing and securities issuance, and loan-level disclosures for both guaranteed and nonguaranteed securities issuance. The OFR also helped relaunch the MISMO Government Forum, which encourages regulators and industry to share information on mortgage data standards.

MISMO has begun several long-term projects to encourage the adoption of standard industry practices in loan origination and servicing. MISMO also supports mortgage research and publication on subjects from universal identifiers to data reporting templates. MISMO workgroups have published papers calling for regulators and industry to collaborate in developing universal identifiers for loans and parcels of property, as well as a universal document identifier. The OFR has worked with MISMO so that its standard includes the capability to use the LEI to identify each financial firm involved in the origination and servicing of loans. Embedding this information brings the industry a step closer to market transparency and the ability to track mortgage information through the loan lifecycle.

5.6 Reference Databases

The Dodd-Frank Act requires the OFR to prepare and publish reference databases for financial entities and financial instruments. Neither database may contain any confidential data. The Global LEI Foundation plans to create an entity database and offer it to the public for free. The OFR will create an instruments database for the public by using open-source components.

In financial markets, the term "reference data" often refers to the data describing instruments and entities. Some reference data rarely change, such as a company's stock symbol and headquarters location. Other reference data may change frequently, such as daily opening and closing stock prices. Still other data change periodically because of corporate actions or events.

What Is an Ontology?

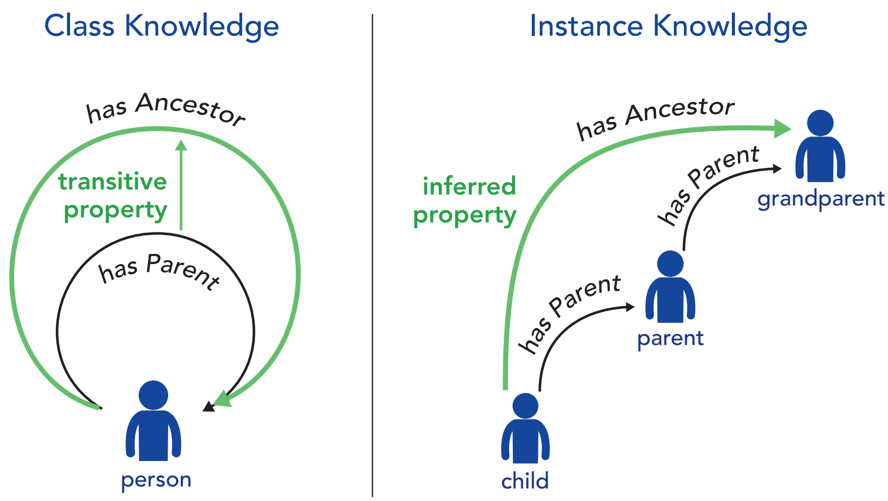
An ontology can be thought of as a combined dictionary and thesaurus to precisely describe data concepts, their roles, and their relationships. It is a powerful tool to use with datasets because it also contains rules of inference to make logical deductions based on definitions and characteristics entered into the ontology. This inference ability adds more knowledge to the ontology and greatly expands its usefulness.

Unlike a taxonomy, which simply lists or classifies elements within a hierarchy, an ontology can express multiple kinds of roles and relationships at the same time.

Figure 5-6 shows how an ontology can describe a simple family tree. On the left is the ontology's class knowledge, showing classes of data in the ontology, the relationships a person can have, and what kind of logical rules can be applied. On the right is specific knowledge inferred about a particular child's ancestors based on the ontology's logical rules.

Figure 5-6. Ontologies Capture Different Kinds of Knowledge

Class knowledge, for example, can create new instance knowledge



Source: OFR analysis

To fulfill the OFR's statutory requirement to establish a reference database of financial industry legal entities, the global LEI system will help by providing data on companies that have acquired an LEI. These data will embody the globally-accepted standards to precisely identify parties to financial transactions around the world.

The OFR has been exploring how to create a reference database for all financial instruments with the greatest benefit and lowest cost to the public and private sectors. Creating this database is a challenging project because so many tradable instruments exist — stocks, sovereign bonds, corporate bonds, commodities, asset-backed securities, loans, exchange-traded funds, foreign currencies, commercial paper, options, futures, swaps, and other structured products.

It is impractical for the OFR to assign a financial identifier and metadata to every known financial instrument. The private sector has established successful proprietary identifiers for some financial products, and those identifiers are already deeply embedded in market operations. In addition, maintaining a new government database would require frequent and expensive updates to keep up with new products and could potentially compete with private vendors that already sell reference data. Finally, much of the data that would be needed for a new government database are available only from primary or proprietary sources. As a result, regulators would have to begin collecting extensive data from industry at significant cost to the industry and the government.

In consideration of the law and in light of feedback from, among others, our advisory committee, the OFR prefers a more efficient and less costly approach that fulfills the societal need. Through various channels, we have invited the industry to suggest open-source or free-to-use components or to contribute components for building a reference database for financial instruments. Regulators, the financial industry, academics, and the public could use the database to calculate the value of an instrument, compare a group of instruments, or link instruments to other datasets that use the same instrument identification.

Our approach recognizes three essential components to create a financial instrument reference database:

1. **Ontology**. An ontology precisely defines terms, conditions, characteristics, and relationships of each instrument in a database. In addition to providing a common language for all users, an ontology also creates a conceptual framework for organizing data (see **What is an Ontology?**).
2. **Identifiers and Metadata.** Identifier systems and comprehensive descriptive data, or metadata, form for each financial instrument a unique identifier that can be mapped to proprietary identifiers widely used in the market.
3. **Valuation and Analytical Tools.** Analytical software will allow users to query, browse, compare, and model financial instrument data. For example, mathematical algorithms could be created to accurately represent each instrument in the database. An algorithm is a process or procedure a computer follows to solve problems or complete calculations. Each algorithm would link daily changes in an instrument's credit risk, market risk, and other risk factors to the instrument's cash flow obligations.

Private sector initiatives are already under way in each of the three component categories. Those initiatives will help the OFR identify the standards — and open-source intellectual property components — useful for constructing a financial instrument reference database. The OFR has begun outlining the acceptance criteria for the components needed to publish a financial instrument reference database. Our objective is to set general criteria, not to preselect or endorse any particular contributor's solution.

We are still in the early planning stages, and expect to develop specific criteria for each category of component. However, we expect that there will be broad criteria that will apply to all components and to the way that components are expected to work together. We expect contributors to agree to provide web access and a high level of availability, so that information will be accessible to the public. We would expect access to be free of charge, at some defined service level. And, we would expect the contributor to use standard interfaces, which the OFR would specify, to allow the components to share data. These, and other criteria to be determined, would drive the acceptance process.

The OFR plans to hold a workshop to share our proposed approach with industry stakeholders and gather feedback. We believe that setting acceptance criteria for each of these three content categories and publishing use cases to validate interoperability is the most direct approach to creating an important public good.

A significant hole in both existing open source and proprietary identifiers is instrument identification for innovative new instruments. Our approach to a reference database would accommodate financial instruments at the leading edge of market innovation. These bespoke or exotic instruments have unique, highly customized contract terms. An ontology can ensure a common understanding of the metadata that describe the instrument. For example, if a bespoke instrument description refers to a coupon, the ontology can be consulted for the precise meaning of that word in relation to the instrument.

Instruments in the reference database could also be defined by their functions. For example, a swap is the exchange of cash flows by two parties to transfer maturities or risks. Common functions and cash flows can be used to organize instruments into groups for analyzing the properties of instruments within and across different groups.

ADDRESSING DATA GAPS 6

Policymakers and market participants have far more detailed, high-quality financial data available to them than before the financial crisis began in 2007. But significant gaps remain, and the OFR has a mandate to fill them. This chapter reviews our progress in 2014 in fulfilling that mandate. We are making it a high priority to fill data gaps in secured funding markets and asset management. More broadly, the chapter discusses how we and financial regulators work to identify, analyze, and fill data gaps that impede financial stability analysis and monitoring.

6.1 Data Gaps Agenda

Improving the quality and scope of financial data on behalf of the regulatory community and the public is the OFR's signature mandate. Those data must be comprehensive, timely, sufficiently detailed, suited for their intended purpose, and available to support in-depth analysis. To implement our data gaps agenda, we seek to: (1) understand the data needed for financial stability analysis, (2) analyze available data and determine where gaps exist, (3) identify the causes of gaps and how those gaps might be filled, and (4) prioritize the needs and determine the feasibility of obtaining the needed data.

Our job is to identify, prioritize, and fill data gaps. As this is an ongoing and iterative process, we work to address the underlying issues that cause gaps in data (see **Figure 6-1**). Our work also includes promoting more efficient data collections through the greater use of standardized protocols, enhancing collaboration and sharing among regulators, and promoting use of data standards, as discussed in Chapter 5.

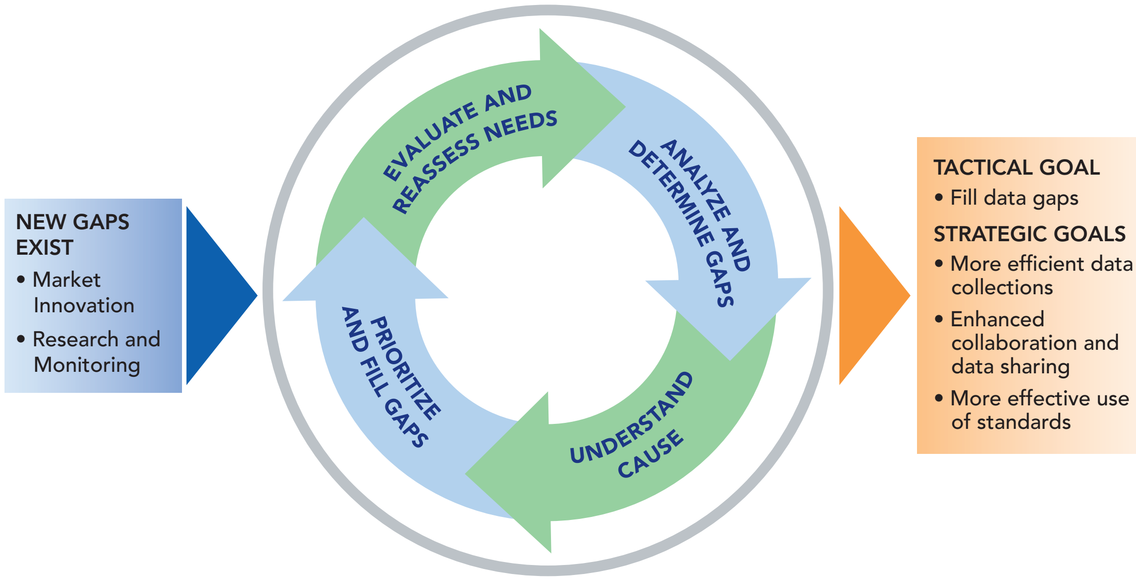
> Data gaps occur for many reasons. As we develop new tools of financial stability analysis, we realize the need for more and better financial data.

Data gaps occur for many reasons. As we develop new tools of financial stability analysis, we realize the need for more and better financial data. Some data might exist but may not be collected systematically by regulators. Other data might be collected, but security needs or laws might restrict sharing. Still others might be difficult to link, to compare with other data, or to aggregate. Existing data may also be unusable if they are not electronically accessible, lack standards, or have had standards inconsistently applied. In addition, financial innovation and regulatory arbitrage (exploiting regulatory loopholes) constantly create needs for new analysis and new data. Consequently, filling data gaps will always be a moving target.

This chapter describes:

Data Gaps Initiatives. Data available to regulators are not currently sufficient to evaluate many of the key risks and policy issues discussed in Chapters 2 and 3.

Figure 6-1. How the OFR Addresses Data Gaps



Source: OFR analysis

Filling data gaps in secured funding markets is a high priority (see **Section 6.2**). The OFR, working with the Federal Reserve Board of Governors and the Federal Reserve Bank of New York, is planning a joint pilot data collection to improve our understanding of bilateral repurchase agreement (repo) activities. The OFR also participates in the Financial Stability Board (FSB) shadow banking workstream on securities lending and repo that is working to address data gaps in these markets across international borders. We highlighted these activities and their risks in past annual reports, and they remain a key focus of our research and analysis.

In addition to these initiatives, the OFR will continue to explore data gaps in areas such as captive reinsurers, mortgage and other markets, and activities engaged in by the asset management industry.

Regulatory Collections. In Section 6.3, we describe new and enhanced data collections by member agencies of the Council and other domestic and international regulators that have already improved our ability to conduct financial stability analysis. We highlight data collections about hedge fund and other private fund activities, systemic risk indicators for large bank holding companies, home mortgage data from banks, and trading activity in off-exchange markets and derivatives markets. We also illustrate how data from the new Form PF can be used to analyze hedge fund leverage across investment strategies.

Collaboration and Sharing Initiatives. Many financial markets and major financial institutions are global. For a clear view of interconnections and exposures, financial supervisors and regulators often need data representing activity beyond their jurisdiction. Data collections are driven by initial business and regulatory needs, but greater domestic and cross-border collaboration and secure data sharing would help meet the need for regulators to develop a global view and minimize reporting burdens. The OFR collaborates broadly when possible to share data.

Although obstacles remain to sharing data, the OFR has initiatives underway, as described in Section 6.4, to promote more extensive collaboration and secure sharing among financial regulatory agencies. During 2014, the OFR and FDIC co-chaired a working group of the Council's Data Committee to enhance the Interagency Data Inventory, which lists data that Council member agencies collect from industry or purchase from vendors.

The inventory, first released in 2013 and described in our 2013 annual report, facilitated several initiatives, including a project to link datasets by connecting (or "mapping") unique identifiers in those datasets. Another OFR pilot project uses the inventory to explore potential overlaps in regulatory reporting to gain insights on the nature and extent of reporting burdens.

The data inventory and related projects are key ingredients in our efforts to meet the Dodd-Frank Act mandate to provide the public with useful data to help increase market transparency and facilitate research on financial stability. We expect the inventory will be useful for identifying data gaps and for establishing more effective data sharing arrangements among Council member agencies to support financial stability analysis.

6.2 Data Gaps Initiatives

The OFR identifies and prioritizes data gaps through our research and monitoring of financial markets and through collaboration with the Council and its member agencies. Addressing data gaps in the repo and securities lending markets is a top priority for the OFR. This section describes these activities and also describes gaps in data related to other secured funding markets, asset management activities, and emerging areas such as captive reinsurance.

Repo and Securities Lending

Availability of data about repo and securities lending activities has improved since the crisis. But much of the available data is not collected in a consistent manner, which would allow for comparison and aggregation, and most is not available to the public. In addition, there are still segments of these markets not covered by existing data collections.

In 2012, the FSB published a consultative document recommending improvements in market transparency in securities lending and repos (see FSB, 2012b). As part of this effort, the FSB set up a data experts group to develop proposed standards and processes for data collection and aggregation at the global level and to ensure consistent data collection by national authorities. The OFR participates in this effort, bringing expertise based on our research on data gaps in short-term funding markets and ideas based on our agenda for improvements in data collections and effective use of standards.

As part of the domestic efforts on this front, the OFR, the Federal Reserve Board of Governors, and the Federal Reserve Bank of New York are planning a joint pilot data collection based on these templates to improve our understanding of bilateral repo activities. These agencies have solicited voluntary participation and feedback on a proposed template from firms that are large participants in the repo market, with an aim to finalize this data template by the end of 2014. We anticipate a voluntary data collection focused on bilateral repo activity will begin in the first half of 2015. These data will also be shared with the SEC. Further work will be done on a securities lending data collection in 2015.

Certain trade and settlement-level data are necessary for analyzing risks in the repo and securities lending markets (see **Figure 6-2**). Trade-level data show the dependence of individual repo market participants on short-term funding, counterparty exposure for repo and securities lending market participants, and interconnections among participants. Settlement-level data show types, loan maturities, haircuts (percentage discounts on collateral value), and quality

Figure 6-2. Critical Elements to Close Data Gaps in Repo and Securities Lending Markets

Level	Bilateral Repo	Securities Lending
Trade	• Identity of dealer and counterparty • Clearing entity • Trade and settlement date • Principal and currency • Type of collateral • Transaction term • Interest rate	• Identity of dealer, securities owner, and lending agent • Clearing entity • Trade and settlement date • Principal and currency • Type of collateral (cash or securities) • Transaction term
Settlement	• Allocated collateral security • Haircut	• For cash collateral: • Description of reinvestment by quality and maturity • Reinvestment income and rebate rate • Haircut
		• For securities collateral: • Allocated collateral security • Lending rate • Haircut

Source: OFR analysis

of the securities used as collateral, as well as exposures of market participants to specific types of securities, market sectors, and geographies.

The OFR plans to publish a working paper in the near future that will serve as a primer on securities financing markets — describing how these markets function, the vulnerabilities and data gaps, and measures that would increase transparency.

REPO MARKETS

The degree of transparency about repo transactions and positions from a market-wide perspective depends on whether trades are settled centrally (triparty) or bilaterally. The triparty market is the most transparent part of the market. These trades are settled using the triparty repo settlement platforms at the clearing banks. Currently only two banks — Bank of New York Mellon Corp. and JPMorgan Chase & Co.. — provide triparty repo services.

The Federal Reserve Bank of New York collects data about trading activities in triparty repo markets from the two clearing banks, identifying the dealers, investors, and collateral by asset class. The Federal Reserve Bank uses this information for its own monitoring and analysis and publishes monthly triparty repo summary statistics on its website (see Federal Reserve Bank of New York, 2014a).

The General Collateral Finance (GCF) market is an anonymous wholesale market that is centrally cleared and netted by Depository Trust & Clearing Corporation's (DTCC) Fixed Income Clearing Corporation with almost exclusively dealer-to-dealer transactions. Trades are settled on the books of the triparty clearing banks. The GCF Repo Service enables dealers, who are required to be netting members of Fixed Income Clearing Corporation, to trade general collateral repos based on rate, term, and collateral type throughout the day.

The Federal Reserve Bank of New York publishes summary information about outstanding repo transactions in the GCF repo market for one day each month (see Federal Reserve Bank of New York, 2014b). In addition, DTCC publishes a repo index, the DTCC GCF Repo Service Index, which reflects daily funding costs for dealers in the GCF repo market.

By contrast, there are limited market data available about repo trades that dealers settle bilaterally outside the triparty clearing banks. Anecdotal and survey evidence indicates this repo market suffered distress during the financial crisis.

The 22 U.S. primary dealers that serve as trading counterparties to the Federal Reserve Bank of New York account for most trading in the U.S. repo market (see Federal Reserve Bank of New York, 2014c). These dealers confidentially report their market activities weekly to the Federal Reserve on Form FR 2004. This form collects information including position, transaction, financing, and fails data in U.S. government securities and other selected fixed-income securities. The Federal Reserve Bank of New York publishes on its website every week consolidated information about primary dealer positions based on Form FR 2004 data.

However, Form FR 2004 does not cover activities of broker-dealers that are not U.S. primary dealers, and it does not differentiate triparty from bilateral trades. In addition, the form does not include important information such as

Figure 6-3. Data Collection Gaps and Overlaps in Repo Markets

	Total	Bilateral Market	Triparty Market		
			Non-GCF	GCF	Federal Reserve reverse repo facility
Primary Dealers	Collectively reported in Form FR2004	Not collected	Included in triparty repo data collection		Aggregated data publicly available
Nonprimary Dealers	Not systematically collected				(not eligible)
	GAP	GAP	OVERLAPS		

GCF = General Collateral Finance

Source: OFR analysis

haircuts, rates, and the identity of the counterparty, and the information it does contain is highly aggregated. As a result, significant data gaps exist at the transaction level of these trades, particularly in the repo activities of dealers who are not primary dealers and the repo activities that are not settled on the clearing banks' triparty settlement platforms (see **Figure 6-3**). We can only produce rough estimates of the size of the bilateral repo market based on these data (see Federal Reserve Bank of New York, 2014d).

Transaction-level data would not only offer insights into the dispersion of pricing across counterparties and asset classes, but with proper identifiers, such as the Legal Entity Identifier (LEI), transaction data can be consolidated with other data sources. This detail is critical for fundamental research projects that attempt to measure the market impact of a large liquidity shock and assess subsequent fire sales, such as our agent-based models described in Section 4.2. More information on repo transactions would also be valuable for our financial stability monitoring and analysis so we can better understand how the markets function, how they interact with one another, and how risks can build and shift in these markets.

SECURITIES LENDING MARKETS

Securities lenders, including mutual funds, exchange-traded funds, insurance companies, and other investors, lend securities in their portfolios to earn additional income. Securities borrowers, mainly broker-dealers, generally relend the securities to their clients for short selling and other permitted purposes.

A substantial amount of data is available about securities lending markets, but those data belong to private vendors. For example, the two largest securities lending data vendors have accumulated substantial databases covering more than $13 trillion of global securities and millions of single-day transactions involving more than 45,000 securities lenders. Industry practitioners, including custodians, prime brokers, asset managers, and hedge funds, provided the information.

However, these data collections are voluntary and do not include essential data elements about counterparties or collateral management. No systematic, targeted data collection is conducted for the benefit of regulators or the investing public. For that reason, these data are not necessarily complete or comparable for analysis. Section 984(b) of the Dodd-Frank Act mandates that the SEC adopt rules to increase the transparency of information available to brokers, dealers, and investors about securities lending. The SEC is still accepting comments and has not yet issued a proposal in this area (see SEC, 2014a).

Enhanced Financial Accounts

The OFR has begun to assist the Federal Reserve Board in its long-term project to enhance the Financial Accounts of the United States, formerly known as the Flow of Funds Accounts (see Gallin and Smith, 2014).

The Federal Reserve has long used the Financial Accounts to measure credit growth and wealth dynamics in the economy and in parts of the financial system. But the recent financial crisis illustrated that policymakers need much more detailed information about such activity in financial markets and about risk-taking — who is borrowing and lending, how financial market participants are changing the aggregate risk profile of the system through derivatives and other products, and where risk concentrations are emerging.

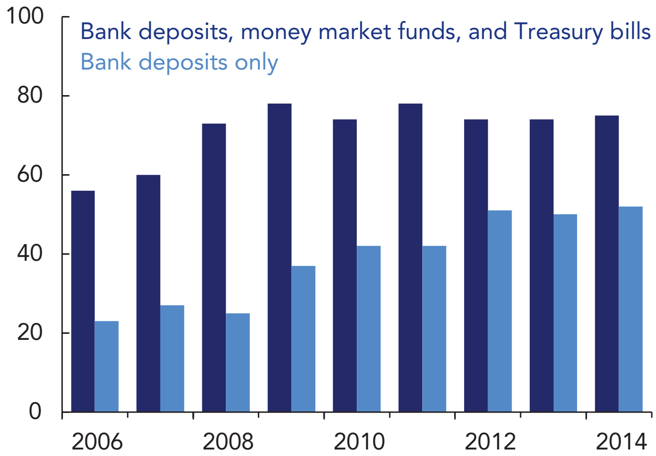
The objectives of the project are to: (1) link the quarterly, highly aggregated data to more detailed (granular) and frequent source data, where available; (2) increase the coverage of financial activity represented in the accounts to include off-balance-sheet and noncash activity; and (3) explore new measures of the flow of collateral and the flow of risks across the financial system.

A number of datasets could be helpful for this project. Those include derivatives data available through swap data repositories and the new data filed by hedge funds and other private funds on Form PF.

A recent OFR working paper suggested the need for additional information similar to that envisioned by the Enhanced Financial Accounts project, and proposed an accounting framework as a first step (see Pozsar, 2014). A key next step will be to document the data gaps identified by the project. We can use that knowledge to help inform our future data collection efforts. The ultimate goal will be to use the information for financial stability monitoring and analysis. That will be possible only when the pilot accounts are established, populated with data, and any remaining gaps identified.

Figure 6-4. Current Percentage of Short-Term Portfolio Allocated to Specific Investment Vehicles

Approximately 52 percent of corporate cash is invested in bank deposits



Source: 2014 Association for Financial Professionals Liquidity Survey

Regulators have limited information about how nonfinancial corporations invest their cash. This represents an important gap in our ability to understand what drives growth and risk in short-term wholesale funding markets. Specifically, we need data to help us analyze the sources and uses of funds in these markets.

Asset Management

SEPARATELY MANAGED ACCOUNTS

Separately managed accounts (or separate accounts) are a type of customized investment product that asset management firms offer to large institutional investors under terms defined in an investment management agreement. The OFR's *2013 Annual Report* pointed out the lack of publicly available and standardized information on separate accounts, and those data gaps prevent regulators from gauging how much risk separate accounts may represent in financial markets.

In response to the identified data gaps, the Securities Industry and Financial Markets Association (SIFMA) conducted a voluntary survey of its members in early 2014 on the separate accounts they manage (see SIFMA, 2014a). The survey provided valuable information and confirmed there is a need to improve transparency on separate accounts.

Nine firms with $11.2 trillion in total assets under management and about $4 trillion in separate accounts responded to the survey. The survey found the majority of separate accounts (97 percent) are long-only portfolios. The firms said they invest in securities such as stocks and bonds — not derivatives — and they do not sell securities short. Only 1.7 percent of the separate accounts surveyed said they use leverage. Separately managed accounts that invest only in short-term assets collectively have about $330 billion under management in 347 accounts, according to the survey. None was involved in securities lending.

Without access to market-level data, regulators cannot evaluate shifts in activities and their impacts on broader markets. For example, a potential shift of cash management away from money market funds in response to regulatory reform could accelerate the growth of separately managed cash accounts. Separate cash accounts could also become significant investors in certain types of securities and accumulate large exposures to certain entities or regions. These market developments cannot be effectively understood and monitored so long as gaps remain.

CORPORATE CASH INVESTMENT ACTIVITIES

Nonfinancial corporations had about $1.8 trillion in cash at the end of the first quarter of 2014, a record according to available data. But regulators have limited information about how nonfinancial corporations invest their cash. This represents an important gap in our ability to understand what drives growth and risk in short-term wholesale funding markets. Specifically, we need data to help us analyze both the sources and uses of funds in these markets, as discussed in the OFR's *2013 Annual Report* and in a recent OFR working paper (see OFR, 2013a, and Pozsar, 2014).

In a recent survey by the Association for Financial Professionals, 81 percent said they expect their cash and short-term investment balances to grow or remain at the current level (see AFP, 2014). Corporations keep cash balances for a variety of reasons, including operating costs, dividend payments, share buybacks, and acquisitions. Interruptions in market access during the financial crisis may also have led some corporate treasurers to keep more liquidity available.

The substantial cash balances have made nonfinancial corporations important investors in banks and the short-term markets (see **Figure 6-4**).

Such surveys are currently the only available data source of corporate cash investments. No complete standardized dataset on corporate investments of financial assets is available to aid regulators and policymakers in monitoring any potential shifts in corporate investment preferences.

Captive Reinsurers

Regulators and market participants need better information about captive reinsurance to evaluate the financial solvency of captive reinsurers and the potential risks to holding companies (see **Section 2.3**). Captive reinsurers are licensed insurance companies created to assume insurance risk transferred from a corporate affiliate.

Captive reinsurance transactions must be approved by state regulators. Captive reinsurers do not always have the same filing requirements as traditional insurance companies, which submit large amounts of data to regulators and the public. Financial statements are publicly available for traditional insurance companies, but not for captives.

In a 2013 report, the New York State Department of Financial Services criticized the disclosure practices of some life insurance companies and their affiliates regarding captives. The state found that New York insurance companies and affiliates outside New York did not disclose in their SEC filings nearly 80 percent of captive reinsurance companies' reserve collateral secured by parental guarantees. Only 10 of the 17 insurers in the survey disclosed any information about guarantees, and the department considered only half of those disclosures sufficient (see NYSDFS, 2013).

The Federal Insurance Office recommended in 2013 that states adopt consistent disclosures and oversight standards for captives, including public disclosure of financial statements (see FIO, 2013). The National Association of Insurance Commissioners (NAIC) is considering broadening its definition of a multistate insurer, which would subject captive reinsurers to the same oversight and transparency requirements as other insurance companies.

Last year, the NAIC adopted requirements for insurance companies to report in their required annual statements the amount of reinsurance transferred to affiliated captives and to offshore affiliated captives. These requirements will provide greater insight into the level and growth of captive reinsurance activities by U.S. insurance companies. However, these changes still may not give regulators a complete picture of the level of captive reinsurance.

Any filing requirements for captive reinsurers would not extend to offshore affiliated captives. If overseas jurisdictions show more leniency than U.S. jurisdictions on either filing or substantive requirements, insurance companies might respond by increasing their use of offshore captives instead of domestic captives.

Mortgage Servicing Information

The most comprehensive information about mortgages is available from servicers. Mortgage servicers have extensive information about mortgages because they handle borrowers' payments and provide services over the life of the loan. However, it is difficult to get a comprehensive view of the mortgage industry from servicers because they are subject to different regulatory frameworks.

For example, the OCC collects mortgage data from large national bank servicers and uses that data to generate the quarterly Mortgage Metrics Report. However, mortgage servicing activities are migrating to nonbank companies not subject to OCC oversight (see **Section 2.3**). Although some nonbank mortgage servicers are publicly traded and fall under the oversight of the SEC, their financial statements do not contain detailed data about the mortgages they service.

To address these issues, the Conference of State Bank Supervisors introduced the quarterly Mortgage Call Report in 2011 to standardize the collection of data on financial condition and mortgage origination through its Nationwide Mortgage Licensing System. The Mortgage Call Report collects and aggregates data from state-licensed mortgage companies and nonbanks that use state-licensed mortgage originators. However, these data provide only high-level information for a subset of states and territories.

Industry participants have attempted to standardize mortgage data by establishing the Mortgage Industry Standards Maintenance Organization reference model, which allows adopters to more readily transmit servicing data between entities using an open-source, XML architecture (a markup language that provides a flexible way to create and share information and format). However, adoption is voluntary and, for some companies, cost prohibitive.

Analysis of potential threats to financial stability would be better supported by a standardized collection of mortgage data from bank and nonbank servicers, reported consistently over time as mortgages are transferred and sold. Such a collection could improve data quality and mapping and help identify risks building in areas with little or no regulatory oversight.

Historical Data Gaps Analysis

It is essential for the OFR to understand past financial crises as we analyze potential policies to reduce systemic risk because the next crisis may not be the same as the most recent one. There have been 17 major banking crises in the United States over the past two centuries (see Reinhart and Rogoff, 2011). It makes sense to take advantage of information about these crises to identify patterns. A broad historical focus also permits researchers to respond to available data.

For some periods and circumstances, data on interbank connections are better and more informative than data available today. For example, in the 19th century, regulators frequently checked details on interbank deposits — deposits that banks held with correspondent banks — in order to verify that banks were meeting reserve requirements.

But historical data are often locked in static, paper forms and not available for electronic analysis. If made available, historical resources — such as bank directories and bank examination reports from an earlier era — could allow us to map in unprecedented detail the interconnections of those historical interbank networks, which banks rely on for liquidity. Although banks in the same location may have faced common shocks, the degree of distress differed depending on the location and financial condition of the banks to which they were connected. However, to benefit from this information, we would need to convert the data into electronic formats.

Several researchers at the OFR are collecting detailed data on interbank connections. The first project is to create a map of interbank relationships for banks in Pennsylvania from 1870 to 1897. The second project is to create a dataset on state chartered banks and trust companies in Illinois to gain insight into the strength of interbank relationships and the effects on bank panics, using detailed information on the amount of deposits at each connected bank. These states were selected because of the availability of data.

Our researchers also are creating a dataset on debit and credit payments of the New York Clearing House and haircuts applied to banks during banking panics to help us understand the flow of liquidity during financial crises.

These projects will broaden our understanding of systematic shocks during financial crises of the past — and possibly of the future.

6.3 Regulatory Collections to Address Data Gaps

Since the financial crisis, regulators have collected new data from previously less-regulated areas of financial markets and expanded existing collections to include more detailed information on financial market activity. Regulators are also using technology and data standards to improve the quality and timeliness of collected data. This section highlights some new and enhanced data for financial stability analysis.

New and Updated U.S. Regulatory Data Collections

PRIVATE FUND DATA: FORM PF

The SEC issued a rule in July 2014 with amendments to the liquidity fund section of Form PF, the primary form for collecting data about private funds (see SEC, 2014b). These amendments align the reporting about liquidity funds in Form PF with the information that money market funds report on the SEC's Form N-MFP and which banks report about their short-term investment funds to the OCC. This realignment will improve the comparability of data collected through the forms, permitting the SEC, OFR, and others to simultaneously evaluate risks in money market funds and private liquidity funds. Firms must comply with the new requirements by April 14, 2016 (see **Hedge Fund Leverage and Strategy**).

MONEY MARKET FUND DATA: N-MFP AND N-CR

The SEC's new rule on money market funds, adopted in July, seeks to reduce the risk of runs on money market funds and includes significant updates to requirements related to disclosure and data collection (see **Section 3.4**). Starting in April 2016, the 60-day lag on public availability of information filed on Form N-MFP will be eliminated. Money market funds will be required to disclose detailed information on their websites daily, including net asset values rounded to the fourth decimal place, daily liquid assets, weekly liquid assets, net inflows and outflows, imposition of fees and gates, and any use of affiliate sponsor support. In addition, the SEC will introduce a new form, Form N-CR, for reporting material fund events.

SYSTEMIC RISK INDICATOR DATA: FR Y-15

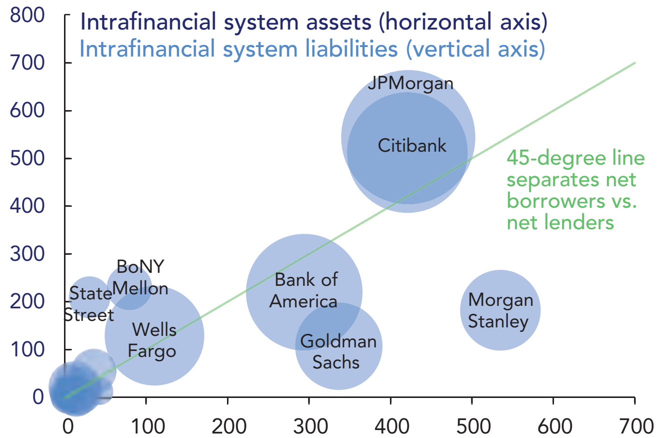
This year, for the first time, data from the Federal Reserve's FR Y-15 data collection on 33 bank holding companies is publicly available, except certain line items and data related to the liquidity coverage ratio. This collection, which began with data as of December 31, 2012, provides insight into the structure of financial networks and the interconnectedness of large financial institutions. Over the past year, minor revisions have been made, including revisions to align the FR Y-15 more closely with the assessment methodology of the Basel Committee on Banking Supervision for global systemically important banks, or G-SIBs.

The FR Y-15 collects information on the Basel Committee's systemic importance categories of size, interconnectedness, cross-jurisdictional activities, substitutability, and complexity from bank holding companies with assets of more than $50 billion. The data are used to help monitor financial stability risks posed by bank holding companies subject to enhanced prudential standards and to determine capital surcharges for G-SIBs.

A forthcoming OFR Brief will present the data used in determining U.S. bank holding companies' systemic importance scores and apply an OFR financial connectivity index to the data (see Allahrakha, Glasserman, and Young,

Figure 6-5. U.S. G-SIBs Vary in Use and Provision of Funding

Companies below the line are net lenders to other financial institutions



Note: Bubble size shows total exposures in billions.

Source: Federal Reserve Form Y-15

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Hedge Fund Leverage and Strategy

In 2012, the SEC began collecting confidential data on hedge funds on Form PF, the primary form for collecting data about private funds. This analysis considers leverage levels across different hedge fund strategies. Hedge funds with higher leverage or debt are typically more vulnerable to adverse events, if all other factors are equal.

Every new data collection initiative has growing pains, and Form PF is no exception. Filling data gaps begins with data collection, but ensuring complete and accurate data takes time and requires an ongoing assessment of data quality. Because Form PF collection is still new, caution is important in interpreting the information collected.

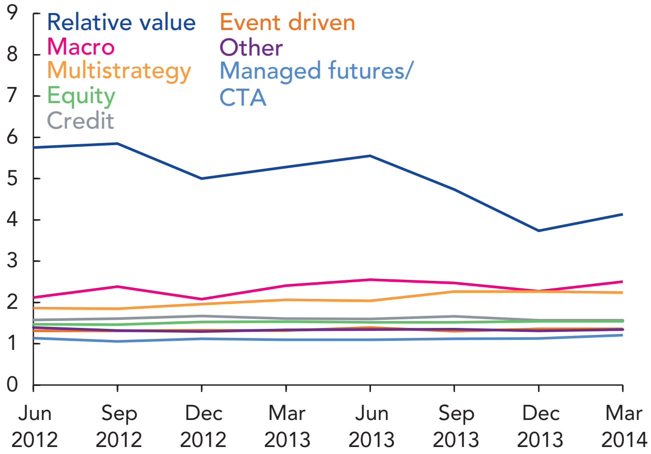
As of May 2014, about 7,800 hedge funds report data through Form PF. Of these, approximately 1,300 are qualifying funds, or funds with net assets of at least $500 million. These funds, which manage more than 80 percent of hedge fund assets, are required to file data quarterly through Form PF.

The analysis presented here is based on data from qualifying hedge funds, which report more detailed information about borrowing and derivative exposures than other funds. Although there are various ways to calculate fund leverage, a commonly used metric is the ratio of gross assets (assets under management based on the current market value of assets and uncalled commitments) to net assets (gross assets under management minus outstanding indebtedness or other accrued but unpaid liabilities).

Figure 6-6 shows this ratio for qualifying hedge funds by strategy type from the beginning of Form PF reporting in June 2012 through March 31, 2014. The figure shows that this ratio has been higher in relative-value funds than in other funds but has been declining since 2012. During the period, leverage levels in macro funds and multistrategy

Figure 6-6. Qualified Hedge Fund Gross/Net Asset Ratios

Relative value funds have reduced leverage



* CTA = Commodities Trading Advisory
Note: All filings within a reporting period are aggregated on the period end date. Funds with 70 percent or more of their strategy allocation in one strategy are labeled with that strategy.

Sources: SEC Form PF, OFR analysis

funds have increased slightly. Gross assets were $4.2 trillion and net assets were $2.1 trillion for all qualifying hedge funds as of March 31, 2014.

Funds typically build leverage through borrowing or use of derivatives. Figure 6-7 shows fund borrowing by strategy type. Borrowing decreased notably in funds after June 2013. Borrowing increased steadily for multistrategy and equity funds between 2012 and 2014.

Figure 6-8 shows that most fund borrowing is obtained through prime brokers, followed by repos and other secured borrowing. Very little hedge fund borrowing is unsecured.

Gross notional exposure is another common measure of leverage. Gross notional exposure represents the sum of the values of long and short positions in a portfolio, including notional values (face values) of derivatives. (The dollar value of interest rate derivatives are based on 10-year bond equivalent value). Multistrategy funds and macro funds managed roughly 60 percent of the gross notional exposures of qualifying hedge funds, on March 31, 2014, largely due to the use of derivatives. The notional values of derivatives represented more than half of the gross notional exposure of qualifying hedge funds. Gross notional exposure for all qualifying hedge funds was more than $14 trillion.

Hedge fund strategies can change rapidly in response to market factors. Leverage levels, even within hedge fund strategy types, can vary significantly over time, depending on individual funds' investment decisions. Monitoring ways hedge funds combine borrowing and derivatives to obtain leverage is essential to identifying potential risks in asset markets.

Figure 6-7. Qualified Hedge Fund Borrowing by Strategy Type ($ billions)

Multistrategy and equity funds borrow the most

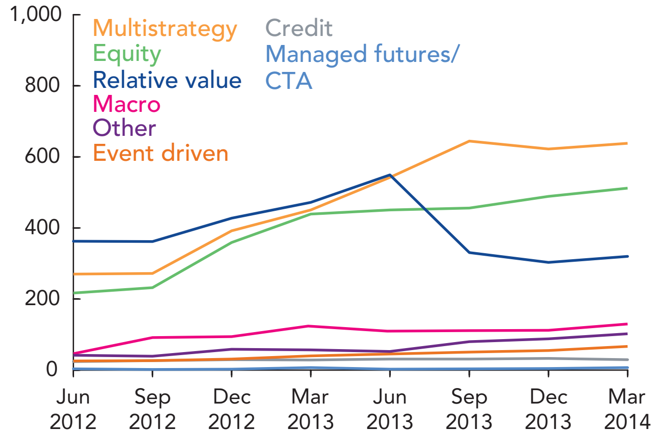
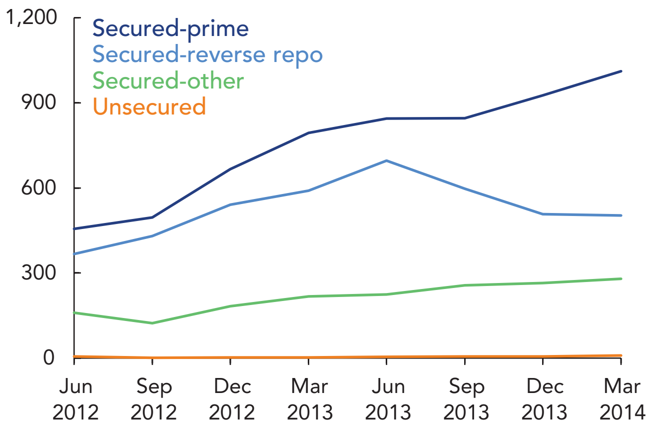


Figure 6-8. Qualified Hedge Fund Borrowing by Source ($ billions)

Most borrowing is secured, with the largest percentage sourced from prime brokers



* CTA = Commodities Trading Advisory
Note: All filings within a reporting period are aggregated on the period end date. Funds with 70 percent or more of their strategy allocation in one strategy are labeled with that strategy.

Sources: SEC Form PF, OFR analysis

forthcoming). For example, two of the interconnectedness indicators — intrafinancial system assets and intrafinancial system liabilities — attempt to measure the amount U.S. bank holding companies lend to and borrow from other financial institutions. As Figure 6-5 shows, companies above the 45 degree line have intrafinancial liabilities greater than intrafinancial assets; these banks use the financial system as a source of funding. In the figure, the size of each company in terms of total exposures is reflected by the area of each circle. The data indicate that size alone does not determine the connectivity of a bank holding company with other financial institution. Data about the interconnectedness of these institutions can help identify potential knock-on effects if one of these companies were to fail.

The FSB and Basel Committee use FR Y-15 data to update the list of firms identified as G-SIBs. In the future, the Federal Reserve may use the data to identify domestic systemically important banks.

RESOLUTION PLAN DATA

The Federal Reserve Board and FDIC continue to receive resolution plans, informally called "living wills," from all bank holding companies and foreign banking organizations with global assets in excess of $50 billion, as well as other institutions the Council has designated for supervision by the Federal Reserve Board (see **Section 3.2**). Pursuant to the Dodd-Frank Act, resolution plans are contingency plans for orderly resolution in the event of a failure. Currently, more than 120 institutions submit plans each year.

The current form of these documents (often more than 1,000 pages in length) is unwieldy, reflecting the complexity and unique nature of the information companies provide. The plans are not reported in a consistent format and data are presented in an unstructured fashion. Although this approach supports supervisors' evaluation of the plans for resolving business operations, greater standardization of this data collection in areas of commonality between the filers could make it easier for regulators to use the information for financial stability analysis.

Some of the information in resolution plans could be useful for monitoring and analyzing threats to financial stability, especially during crises. For example, resolution plans include:

- a map of a bank's ownership structure under its holding company;
- a list of cross-guarantees and major counterparties, as well as the attribution of collateral to those counterparties;
- a list of international operations;
- an explanation of the potential liquidity needs of various unwinding strategies; and
- perspective on the filers' strategies for managing technology, collateral, capitalization, and liquidity.

However, the data would need to be more structured to support macroprudential analysis. Structured data may include standardized formats and metadata tagging and might also incorporate additional detailed forms to capture data consistently.

HMDA DATA

The CFPB is implementing the Dodd-Frank Act changes to the Home Mortgage Disclosure Act (HMDA) and has proposed to change the information banks must provide about home mortgages under Regulation C to include a range of new data variables, including the length of the loan, total points and fees, the length of any teaser or introductory interest rates, and the applicant's or borrower's age and credit score.

In addition, the CFPB is considering expanding disclosures about interest rates, total origination charges, and total discount points for each loan. These changes will help public officials distribute public sector investment, determine whether financial institutions are serving the housing needs of their communities, and identify possible discriminatory lending patterns and enforce antidiscrimination statutes. They also will improve our understanding of threats to financial stability from housing finance because HMDA data are a powerful tool for understanding applications and completed mortgage loans. As these public data become available, they can reach many more researchers than proprietary products from private vendors.

FINRA DATA COLLECTION PROGRAMS

More than 35 percent of the volume of stock trades occurs outside of traditional exchanges. A portion of this off-exchange trading volume occurs in "dark pools," which are a type of alternative trading system. Dark pools comprise approximately 16 percent of overall trade volume (see Schack, Kemmsies, and Upward, 2014). Relatively opaque alternative trading systems raise concerns about the transparency of pricing and the impact of high frequency trading.

To better understand trading taking place in these systems, the SEC and the Financial Industry Regulatory Authority (FINRA) have launched several initiatives, and with these initiatives have demonstrated a shift towards more automated, frequent, detailed (account-level), and structured data collections. These new programs use formats and standards for better timeliness, clarity, and machine readability of the data. The data collected will create opportunities for research on systemic issues, such as market liquidity, concentration, and interconnectedness.

FINRA Rule 4552 requires SEC-registered alternative trading systems to report aggregated transaction data on volume and number of trades for each traded equity security on a weekly basis. For data integration, FINRA requires each alternative trading system to use a unique market participant identifier. FINRA began collecting the data in May 2014 and posts the data on its website after a wait period of several weeks.

FINRA is also developing the Comprehensive Automated Risk Data System (CARDS). In addition, self-regulatory organizations are working to implement the SEC's Rule 613, Consolidated Audit Trail (CAT). CARDS will automate the collection of business conduct information with data on account activity (balance, margin, for example) and customer investment profiles from all supervised institutions. CAT will allow regulators to track stock trading at the account level for forensic purposes.

Combined, CARDS and CAT will provide an almost complete and continuous account-level picture of market activity and status. FINRA has announced plans to have CARDS and CAT online in 2015.

TRADING EXCHANGE DATA: MIDAS

The SEC's Market Information Data Analytics System (MIDAS) provides staff at the SEC with an analytics and data platform geared towards research on equity and equity options market structure. MIDAS joins data feeds from the 11 domestic stock exchanges, as well as the consolidated tapes for equities and options, to report information for exchange-based posted orders, modifications, cancellations, and off-exchange executions.

MIDAS is available to the SEC in near real-time through cloud computing. The SEC uses this information to inform research on equity and equity options market structure and also publicly provides quarterly data metrics and analysis on its website.

Although MIDAS is not a regulatory data collection — it draws exclusively from commercial sources — it demonstrates the use of technology and standards to make existing data more useful and closer to real-time, closing data gaps that impede timely analysis and monitoring.

SWAP DATA REPOSITORY DATA

Swap data are now available through swap data repositories (SDRs) to the public and to regulators, principally the CFTC. However, SDRs have different system architectures, and the data are reported differently to each SDR. The lack of reporting standards across SDRs has created significant data gaps.

The CFTC has begun to address these issues on many levels by, among other things, requesting comments related to swap data reporting. The OFR has also been assisting the CFTC to improve the quality of SDR data (see **Section 5.4**). The SEC has proposed swap reporting rules but they have yet to be adopted. In the meantime, the OFR has access to credit default swap data from the Depository Trust & Clearing Corporation, which is a market utility supervised by the SEC (see **Section 4.4**).

CYBERSECURITY

Concerns over cybersecurity have grown over the past decade because large-scale data breaches have become more common, reflecting the growing volume of data stored electronically and the increasing technical sophistication of cyberattackers. The increased frequency of cyber-attacks has prompted attention from regulators and raises concerns about potential financial stability risks.

The SEC requires public companies to disclose cybersecurity breaches, and many firms note breaches in their public regulatory filings. However, there remains a significant data gap, because firms are reluctant to provide details about the size or impact of cybersecurity breaches due to concerns over potential damage to the confidence of clients and business partners.

Separately, this year the Federal Financial Institutions Examination Council (FFIEC) announced a pilot program to assess the management of cybersecurity risks by community financial institutions. It is undertaking other initiatives to raise awareness of those risks across the financial sector.

International Data Collection Efforts

The global nature of the financial crisis underscored that data gaps, problems in data quality, and a lack of data standards were international problems, not just issues of domestic concern. To resolve cross-border issues, regulators collaborate through international financial forums such as the Financial Stability Board and the Basel Committee on Banking Supervision.

International data-sharing is essential to afford regulators a complete view of financial risks. The OFR recognizes that security concerns can be an obstacle to data sharing, but appropriately constructed and shared security frameworks can lessen those concerns (see **Section 6.4**).

Over the past year, the G-20 Data Gaps Initiative has made progress in expanding data collection on concentration risk and interconnections among G-SIBs, to include data on G-SIB funding dependencies. (The G-20, or Group of 20, is a forum of the world's largest advanced and emerging economies.)

The initiative will continue work during the next year to collect G-SIBs' consolidated balance-sheet data broken down by risk exposures such as sector, instrument, and maturity. These data collections will be valuable for financial stability analysis because they provide an unprecedented set of comparable, detailed data about some of the largest and most complex financial institutions.

The G-20 uses a data hub to pool collected data and provide secure sharing arrangements for analytical reports based on the data. This is an example of how international regulators can cooperate to pool highly confidential cross-jurisdictional data and link and aggregate those data for financial stability analysis.

The Basel Committee on Banking Supervision continues to review issues that surface as jurisdictions implement Basel III. This year, the committee focused on the Basel III leverage ratio to ensure comparability and accuracy of the data (see BCBS, 2014a). Although Basel III was finalized in 2010, problems that emerged during implementation highlight the ongoing regulatory challenge, particularly for internationally agreed standards of data definitions, quality, and comparability in data collections.

Another challenge for international data efforts is the divergence of market infrastructure and its institutional design across jurisdictions. For example, the repo market in Europe is substantially different from the U.S. repo market. The majority of European repos are conducted in the electronic, anonymous interbank market, which relies on a central counterparty. All European repo market participants have access to the European Central Bank's refinancing facilities, which substantially reduces the risk of asset fire sales due to counterparty default. Because of bank participation in the repo market, the European Central Bank has collected a substantial database of repo and reverse repo activities, among other data elements related to monetary statistics and bank operations. Aggregated data are publicly available on the European Central Bank's Statistical Data Warehouse website.

The OFR is closely following developments in Europe's Common Reporting (COREP) and Financial Reporting (FINREP) regimes. These are reporting frameworks mandated by the European Banking Authority to harmonize supervisory reporting standards across Europe. FINREP provides templates for detailed data about income statements, balance sheets, and other areas to improve consistency of scope, granularity, and definition of data elements. This standardized data collection effort leverages new technologies and promises to provide regulators data that can be easily compared, analyzed, and aggregated in a timely manner.

OFR INTERNATIONAL PARTICIPATION

The OFR participates in international efforts because cross-border cooperation is essential for us to serve the Council, promote data standards, fill data gaps, and promote secure international data sharing.

In 2014, we participated in the FSB's *Feasibility Study on Approaches to Aggregate OTC Derivatives Data,* published in September, which studied issues and options for harmonizing derivatives data reporting across jurisdictions (see FSB, 2014a). During the crisis, the complexity and lack of transparency in derivatives trading and markets were debilitating for firms and impaired regulators' ability to understand interconnections and the spread of the crisis.

The OFR also participates in the FSB Workstream on Securities Lending and Repos. We focused on efforts to identify data gaps and develop protocols and standards for collecting data for cross-jurisdictional comparability and aggregation. We provided expertise from user and data management perspectives drawing on our research and monitoring priorities on short-term funding markets and our data policy agenda for more efficient data collections and use of data standards. We hope these data can be more readily and securely shared across borders. Domestic efforts to fill data gaps in repo and securities lending are linked to this work (see **Section 6.2**).

6.4 Collaboration and Data Sharing Initiatives

Sharing information is essential to make the best use of data for effective and comprehensive financial stability analysis, as no regulator has access to all of the data that might help monitor risks across the financial system. It can also help minimize regulatory burden on financial entities whose activities we seek to understand. Of course, sharing information must be done in a secure manner to protect the confidentiality and security of the data being shared.

Because of our mandate to support the Council in its analysis of threats to financial stability, we work to improve data sharing among Council member organizations. We also sponsor research and undertake projects related to collaboration and sharing. This section describes three: the Interagency Data Inventory, sponsored by the Council's Data Committee, a project the OFR has begun to learn about reporting overlaps in new data collections, and a project that the OFR has begun to connect datasets that use different identifiers. It also describes our framework for protecting data that others share and entrust with us.

Data Inventory

The Council's Data Committee sponsored an initiative to develop a catalog of datasets that Council member agencies have available through industry filings or commercially purchased data.

This Interagency Data Inventory does not hold the actual datasets, but rather is a list of the metadata, or information, about the datasets. The metadata include a brief description of each dataset and categorizes the dataset as financial, supervisory, application, complaints, structure, or other (see OFR, 2013a). Basic information, including the collecting agency, name of the form used to collect the data, and form number, are also included.

Over the past year, the OFR and Council member agencies began to transform the inventory from a preliminary catalog into a more searchable, accessible, and information-rich resource, in the following ways:

- We are exploring adding new information, for example, by the legislation or regulation that required the collection, and the dates the data collection began and ended. Other information being considered includes the financial market subsector or instrument of primary focus, based on a classification system we are developing.
- We reconciled inventory records with the Office of Management and Budget's public record of data collections. This marked an important step in improving the accuracy and comprehensiveness of the inventory.
- We developed a visualization tool for use by Council member agencies for easy search and analysis by one or more criteria.

The Data Committee and the OFR will review the inventory on an ongoing basis to evaluate its usefulness and identify ways it can be used and improved for Council member agencies and the public. The public portion of the inventory is on the OFR website (see OFR, 2014).

Reporting Burden and Efficiency Project

Before the crisis, financial activity had grown substantially in less transparent or less regulated markets. In response, Congress has expanded regulatory jurisdictions, and Congress and the agencies have increased data reporting requirements, domestically and internationally. As the depth and type of data collected have expanded, so has the potential for overlapping requests among agencies and their reporting forms.

The OFR has begun a project to better understand potential data reporting overlaps. The experience gained will provide insights for the ongoing dialogue between regulators and market participants concerning reporting efficiency and burden.

For the initial project, we focused on a proposed new collection because the largest expense for firms and regulators in data collection is during startup. We looked for overlaps in the second portion of the FSB's new international collection of data from G-SIBs. Phase 1 of the collection started in 2013 and focused on companies' counterparty exposures and other major risk dimensions. Phase 2 in 2014 added information about institution-to-institution liabilities, large bank and nonbank funding providers, and their sources of funding. Phase 3 will include more detailed balance-sheet data (see FSB, 2014b).

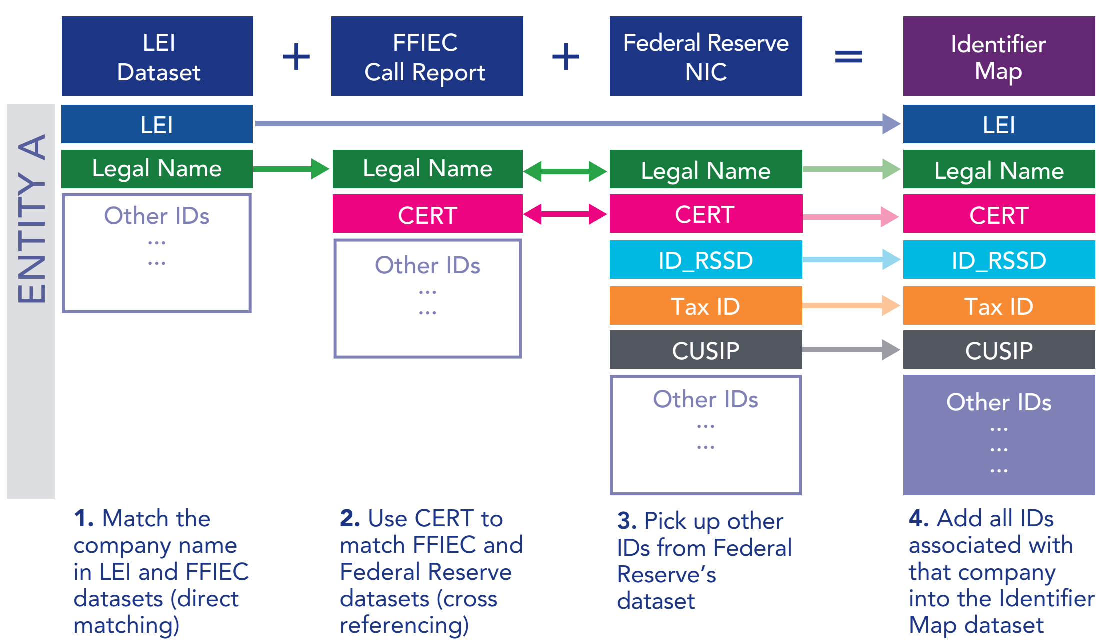
We began our analysis by reviewing the Interagency Data Inventory to identify reports that might have areas of overlap with the FSB Phase 2 data collection template. An overlap occurs if some companies have been asked to report the same type of data in multiple forms. We compared the purposes, scope, organizational frameworks, data definitions, line items, and data fields of the Phase 2 template and existing reports. We also considered whether a filer could have fulfilled a data request in Phase 2 with an existing report, either an exact match or through a small modification of an existing data field. Such modifications could include adding subfields for more detail or minor alterations in data definitions.

This FSB data collection on G-SIBs will form an unprecedented set of detailed and comparable data about some of the largest and most complex financial institutions in the world — an invaluable resource for financial stability analysis. For this and most new collections, exploring for and understanding potential overlaps in regulatory datasets and addressing reporting burden are complex tasks. We continue to work through our findings, but have identified the following general issues:

- **Variations in Data Definitions and Concepts.** Even a simple concept can have complex dimensions. For example, the Federal Reserve's Form Y-9 collects information on deposits broken down into two categories: interest-bearing and noninterest-bearing. The FSB project's Phase 2 template requests data on nonmaturity deposits. These categories are different.
- **Challenges of Disaggregation and Reaggregation.** Reporting forms may rely on the same definitions, but differ in their requests for detail. For example, Phase 2 requests data on bond holdings. But there is no such item on the Y-9, which instead includes bond holdings in more than one line item, including "Line 2. Securities" and "Line 5. Trading Assets" on Schedule HC, on the Consolidated Balance Sheet. To compare the two forms, an analyst would have to disaggregate, or separate, these and other line items to identify the bond subcomponents (not currently possible with Y-9 data), and then reaggregate them to calculate a total comparable to the Phase 2 data entry.
- **Variations in Collection Frequency.** Collection schedules can be expensive to change for regulators and companies because of the cost of systems and processes. The Y-9 is reported quarterly, but the Phase 2 data are to be reported monthly, with a lag of five working days. The goal is to report Phase 2 data weekly with a lag of three working days.

Standardization of data definitions and formats can address many of these differences (see **Chapter 5**). Another way to promote reporting efficiency is to collect

Figure 6-9. Matching a Firm Across Datasets



Source: OFR analysis

data, not forms — or in other words, to transmit data using existing standard transmission protocols such as SDMX, XBRL, and ISO 2022, which provide definitions for the transmission and meaning of the data.

Working together, regulators should be able to collect the information they need and minimize the burden for reporting firms. Regulators that identify a need for a new collection could determine first whether the needed information already lies in existing collections that can be accessed through regulatory collaboration and data sharing, or modest reworking of the standards or definitions in existing collections.

Identifier Mapping

Analysts need connected sets of information about companies, industries, and markets to conduct financial stability analysis and monitoring.

Datasets from regulatory and commercial sources frequently use proprietary unique identifiers to identify firms, so matching firms to compare or link information about them across datasets can be difficult or even impossible. The Legal Entity Identifier (LEI), a unique identifier for firms in financial transactions, offers a solution to this problem, but companies and regulators need time to adopt and implement it fully (see **Section 5.3**). Until then, matching firms across datasets is a time- and resource-intensive undertaking.

To address this need, the OFR is creating an "identifier map" to enable research and analysis that may not otherwise be feasible. We intend to make it publicly available once complete. The identifier map will match firms and link their identifiers across regulatory and private vendor datasets, so the same firm in one dataset can be definitively identified in other datasets. It will enable information about a firm to be combined across multiple sources of data, allowing insights not possible by looking at each dataset in isolation.

The map is an example of a project made possible by the Interagency Data Inventory, showing how valuable collaboration among Council member agencies can be.

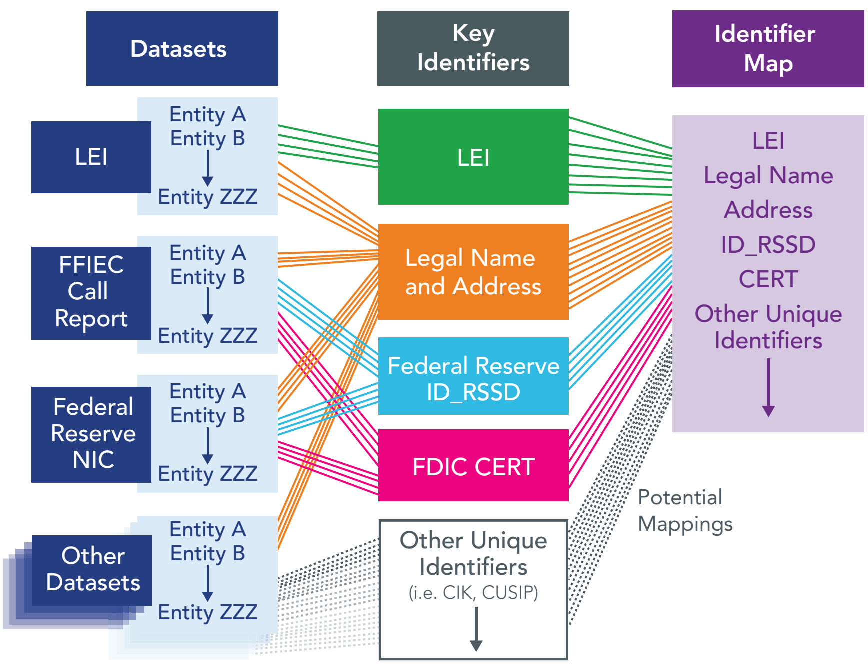
IDENTIFIER MAPPING PILOT

In 2014, the OFR's pilot project mapped the LEI with: 1) the FDIC's entity identifier, the certificate number (CERT), used in the FFIEC Consolidated Reports of Condition and Income (commonly known as the commercial bank Call Report), and 2) the Federal Reserve's entity identifier (ID_RSSD), used in its National Information Center (NIC) database.

The pilot used two techniques:

1. **Direct matching** seeks an exact match of one or more fields between datasets. If any variation exists in the fields to be matched, it is not considered a match. We found matches between the "Legal

Figure 6-10. Complexities of Creating an Identifier Map



Source: OFR analysis

Name" fields of the LEI dataset and the call report. Matches between the "Legal Name" fields allowed for company matches between the two datasets and mapping of their identifiers (LEI and CERT).

2. **Cross-referencing** verifies the results of the direct match and adds commonly shared identifiers to the final merged identifier map. The FDIC's certificate number is in the FFIEC's call report and the NIC database. We used the certificate number for further verification of the firms mapped through the "Legal Name" fields. The cross referencing also allowed us to add identifiers from the NIC database, such as the Federal Reserve's entity identifier (ID_RSSD), the tax ID number (an entity identifier used by the Internal Revenue Service), and the CUSIP (a widely used entity identifier used in financial transactions), making the identifier map a more information-rich resource.

Figure 6-10 shows the connections between the datasets we mapped and the complexity of the process and relationships.

Figure 6-9 shows the process for matching a single company across the LEI, FFIEC call report, and NIC database, and creation of the identifier map. The pilot showed us that, although algorithms exist to aid the mapping process, mapping identifiers is still a heavily manual process.

We believe the identifier mapping project will prove valuable to the OFR, the Council, other researchers, and the public. We intend to expand the scope of the project and release results as they develop.

Once the LEI has been fully adopted and embedded in industry and regulatory datasets, it will allow datasets that contain LEIs to be merged based on the company LEI, minimizing the need for time-intensive, manual entity resolution and identifier mapping.

Securing Data for Collaboration and Sharing

Data on a broad range of activities and markets across the financial system must be available and easily accessible for monitoring and analysis. However, no single regulator has all needed data, and it is critical to not duplicate data collections. Consequently, it is imperative that the OFR and Council member agencies collaborate and share data for financial stability analysis.

The benefits of sharing data are largely understood. Still, there are obstacles to doing so appropriately. Regulatory agencies must maintain the security of confidential data, financial institutions need strong comfort on the appropriate regulatory sharing of their data, and regulatory agencies receiving shared data must provide assurances that the data will be appropriately interpreted. The OFR collaborates with Council member agencies to overcome these obstacles. We also collaborate with researchers and research organizations in analysis and monitoring.

INTERAGENCY FRAMEWORK FOR INFORMATION SECURITY CATEGORIZATION

In 2013, OFR co-chaired a working group of the Council Data Committee that recommended a common information security categorization framework for communicating and ensuring the security of shared data among Council member agencies. The goal is to ease data sharing and ensure the receiver of shared data keeps them at least as secure as the data provider does.

The framework sets out principles for data sharing and responsibilities between agencies. It also establishes procedures that emphasize joint communication and control and required documentation of the data request process. The framework leverages existing information security guidance issued by the National Institute of Standards and Technology (NIST) for federal agencies.

The framework is voluntary and agencies may choose whether or not to adopt it. We believe, if adopted, it will improve secure information sharing. The OFR follows this framework for information sharing.

OFR'S SECURING DATA FOR COLLABORATION

To appropriately protect data that others share and entrust with us, the OFR takes legal and technical steps to secure the data and protect its confidentiality. For example, we and Council member agencies have signed a memorandum of understanding (MOU) governing the treatment of nonpublic data. We continue to enter into other nondisclosure agreements and additional MOUs as necessary to protect and preserve data confidentiality and outline the responsibilities of data users. We also work to ensure the proper handling of data through education and training, written policies, securing files at rest and in transit, encrypting files for transmission, and signed confidentiality agreements.

The OFR purchases data from commercial vendors and is bound by licensing agreements. These licenses provide access to data and restrict some types of data sharing. However, OFR can often use such data to create work products which can subsequently be shared. In other cases, the OFR establishes agreements with noncommercial providers, such as financial market utilities, for use of their data for our research and analysis.

OFR INFORMATION SECURITY PROGRAM

Our information security program employs a variety of technologies to safeguard data security through transmission, storage, access control, and dissemination or publication.

Transmission. Our data sharing agreements set standards for handling highly sensitive data, using the information security categorization framework as a minimum standard. The OFR also enters into interconnection security agreements, which go a step beyond MOUs to outline expected behaviors for incident handling and notification procedures. The agreements are developed in accordance with NIST Special Publication (SP) 800-47, *Security Guide for Interconnecting Information Technology Systems* (see NIST, 2002).

When the OFR requests data, we work closely with the data provider to address any unique security requirements. Once we receive the data, we continuously monitor for any anomalous activities and potential signatures that may indicate a cyberattack or an unauthorized access attempt.

Storage and Access Control. To protect data stored and accessed by OFR employees, we constructed a new analytic environment and adopted a continuous monitoring approach, with proactive security measures to prevent, detect, and respond to potential attacks and attempts to gain unauthorized access. We completed an independent security assessment and authorization of the analytic environment in accordance with standards from NIST SP 800-53 Revision 4, *Security and Privacy Controls for Federal Information Systems and Organizations* (see NIST, 2013). We also completed an external penetration test conducted by an independent third party. The analytic environment achieved full accreditation, which verifies that an information technology system has passed a host of rigorous security checks based on NIST guidelines.

To guard against potential access by unauthorized individuals, we conduct routine access reviews and security posture assessments, and require multiple levels of approval before granting staff members access to data. We developed an access control and management application and employ a role-based access control model that incorporates physical access controls, technical controls over network connections, and frequent internal audits. The access control model also allows security groups and policies to be applied at a detailed level, ensuring a high degree of oversight and control.

Dissemination and Publication. The OFR is also evaluating technologies to promote collaboration and dissemination of data, while ensuring that data remain secure. One technology uses virtual computing platforms that allow users (such as researchers working outside our offices) to work collaboratively without affecting the overall security of the environment.

Another collaboration mechanism uses secure peer-to-peer technologies that meet the security requirements of FIPS 140-2, *Security Requirements for Cryptographic Modules* (see NIST, 2001) and allows secure file sharing among federal agencies.

OFR RESEARCH ON SHARING AND SECURITY

In 2014, our researchers continued to explore a cryptographic method called "noise addition," which is related to common data anonymization and masking techniques. Noise addition adds statistical noise to a dataset, so no information is initially available. Over time, the variance of the added noise is reduced, gradually revealing more information. This technique might allow us to secure data to collaborate with other regulators and appropriately share data with agencies, researchers, and potentially the public while protecting confidentiality.

OFR researchers also continue to explore other cryptographic methods that could help with safe and effective sharing of data, as described in a 2013 OFR working paper (see Flood and others, 2013). The purpose of this work is to improve access to data that would otherwise be confidential, closing data gaps for market participants and the public. Tension exists between making data available and protecting those data, and this research focuses on easing that tension.

OUTREACH, COLLABORATION, AND INFRASTRUCTURE

7

Collaboration is central to the mission of the OFR and includes outreach to Congress, Council member agencies, international financial regulators, academic researchers, industry groups, and the public. Since 2010, we have assembled a virtual research community of global financial stability experts and, at the same time, built a highly skilled OFR workforce and cost-effective operational systems.

7.1 Collaboration and Outreach Drive the OFR's Work

In FY 2014, the OFR partnered with the CFTC to help improve how swap data repositories collect and standardize data about derivatives trades. The OFR also collaborated with other regulators and industry internationally and in the United States as the Office played a key role in developing, launching, and rolling out the global Legal Entity Identifier (LEI) system to help map connections in the financial system that will cut industry costs for cleaning, combining (aggregating), and reporting data.

The OFR regularly reaches out to academic and financial industry groups for input about emerging issues in financial stability and financial data standards. In FY 2014, we cosponsored two conferences that featured leading experts on monitoring and measuring risks to the financial system.

- In January 2014, the OFR and the Council cosponsored their third joint conference. The event, entitled "Mapping and Monitoring the Financial System: Liquidity, Funding, and Plumbing," explored the interconnectedness among firms and markets as well as other vulnerabilities in the financial system.
- In June 2014, we joined the Consortium for Systemic Risk Analytics and the Massachusetts Institute of Technology's Laboratory for Financial Engineering in sponsoring the "Conference on Systemic Risk" in Cambridge, Massachusetts. The event explored four broad aspects of the measurement of financial stability: risk data, stress testing, market-based measures, and measurement of financial networks.

We collaborate with others to maximize our resources, support financial stability research, and promote standards that will help produce reliable, high-quality data about the financial system.

We also chaired the interagency planning committee of the annual Regulatory Data Workshop in August 2014. More than 300 employees of Council member agencies and regional Federal Reserve banks attended to share potential solutions to common financial data-related problems. The government-only event discussed ways to improve financial data standards and governance, strategies to visually represent data for analysis, techniques to securely collect and store data, and protocols to safely share data with other regulators.

OFR Responsibilities Under the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 established the OFR and its Data Center and Research and Analysis Center. The law requires the OFR to support the Financial Stability Oversight Council and to carry out the following responsibilities:

DATA CENTER

- Collect data on behalf of the Council and the public;
- Assist Council member agencies in determining the types and formats of data authorized by the Act to be collected;
- Standardize the types and formats of data reported and collected;
- Prepare and publish a financial company reference database and a financial instrument reference database; and,
- Perform other related services.

RESEARCH AND ANALYSIS CENTER

- Develop and maintain metrics and reporting systems for risks to U.S. financial stability;
- Monitor, investigate, and report on changes in systemwide risk to the Council and to Congress;
- Conduct, coordinate, and sponsor research to improve regulation of financial entities and markets;
- Evaluate and report on stress tests or other stability-related evaluations of financial entities overseen by Council member agencies;
- Maintain the expertise necessary to support specific requests for assistance from financial regulators;
- Investigate disruptions and failures in the financial markets, report findings, and make recommendations to the Council;
- Conduct studies and provide advice on the impact of policies related to systemic risk; and
- Promote best practices for financial risk management.

Our director and senior managers also speak frequently at industry and academic events to explain the OFR's projects and discuss potential threats to financial stability. The following speeches during the 2014 fiscal year are published on our website:

- Director Richard Berner, at the Money Marketeers of New York University, "Financial Stability: Progress and Challenges," October 16, 2014;
- Director Berner at the Joint Conference of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland and The Clearing House, "The Financial Industry in a Post-Crisis World Symposium," July 10, 2014;
- Chief Data Officer Linda Powell at the Object Management Group Technical Meeting, March 26, 2014;
- Chief Data Officer Powell at the GS1 Global Forum 2014, February 18, 2014; and,
- Director Berner at the Exchequer Club of Washington, October 16, 2013.

We welcome groups or companies that want to share information with the OFR on issues related to financial stability or data standards. Because of the international nature of financial markets, we are building relationships with authorities in other countries to discuss research and analysis and promote information sharing and the use of data standards around the world.

Financial Research Advisory Committee

Our work is enhanced by the insights and expertise of the OFR's Financial Research Advisory Committee, a group of 31 distinguished professionals in economics, data management, risk management, information technology, and other fields. The committee, established in November 2012, meets approximately twice each year. It has three subcommittees that meet more frequently and are focused on research; data and technology; and financial services and risk management.

In 2014, the committee welcomed 11 new members to replace members whose terms expired. Current members include a former vice chairman of the Board of Governors of the Federal Reserve, a former chief economist of the Securities and Exchange Commission, and senior data and risk management executives at major financial services companies.

At the committee's most recent meeting in July 2014, members addressed two discussion topics suggested by the OFR: 1) the impact of reduced liquidity on financial markets during stress events, and 2) the metrics regulators need to analyze and aggregate data about the swap market. The committee also adopted and presented to the OFR a recommendation for the Office to begin a project to evaluate how standardized definitions (known collectively as ontologies) could help the CFTC and OFR improve data quality in swap data repositories.

Working Papers, Grants, and Seminars

The OFR Working Paper Series is an important tool for disseminating OFR research and informing the process of assessing, measuring, monitoring, and mitigating threats to financial stability. The series is also a significant collaboration tool because papers are frequently coauthored by OFR staff researchers with outside experts from academia, industry, and other federal agencies. At the end of November 2014, the OFR had published a total of 21 working papers on subjects ranging from risk management to stress tests to shadow banking.

The OFR launched a new research product in FY 2014, the OFR Staff Discussion Paper Series, for our staff researchers to share more of their work with the academic community and the public. Three discussion papers were published as part of the new series that contributes to our understanding of financial markets, financial data, and financial institution risks. In the coming year, the OFR will continue fine-tuning and improving our Financial Stability Monitor to keep the public informed about vulnerabilities. The monitor, initially released in our 2013 annual report and updated in this report, tracks financial distress based on a mix of economic indicators, market indexes, and measurements calculated by the OFR.

To supplement the work of our staff members in the OFR's Research and Analysis Center, we brought outside experts on board for fellowships and other temporary employment. We also awarded three grants in FY 2014 to promote financial stability research. A University of Maryland researcher received a grant of approximately $300,000 over two years to research whether information in companies' 10-K annual filings with the SEC can be extracted, aggregated, and interpreted to help identify emerging risks to financial stability. Another grant of the same size went to a University of South Florida researcher to explore whether detailed information collected from financial contracts can be used to determine economic risk exposures. A third grant of $250,000 over two years went to a University of Michigan researcher to study the stability of dynamic credit networks by applying recent developments in economics and computer science to risk analysis.

Throughout the year, we invited experts from financial regulatory agencies, universities, and industry who are exploring new financial stability theories to discuss their work with our staff in a collaborative forum where ideas can be tested and expanded. This series of in-house research seminars is just one of the ways the OFR leverages the expertise of staff members and promotes the continuing exploration of issues related to financial stability.

Public Transparency

The OFR is committed to sharing nonconfidential financial stability information with the public on our website.

In FY 2014, we posted the public portion of the Interagency Data Inventory, which catalogs the data that Council member agencies buy from vendors, collect from industry, or derive from other data. This portion of the inventory included more than 300 items that U.S. regulators collect from industry, typically on a monthly, quarterly, or annual basis.

OFR's financial stability conferences and advisory committee meetings are also accessible to the public through webcasts. Although much of the OFR's work products cannot be made public because of confidential and market-sensitive data, we strive to be transparent whenever possible. Traffic has steadily increased on the OFR's website and total visitors rose more than 35 percent in FY 2014 from the previous year. When we post significant content on our website, we send an alert to website subscribers. At the end of FY 2014, we had nearly 6,000 subscribers signed up to receive e-mail alerts, more than double from the end of the previous year.

OFR speeches, Congressional testimony, press releases, and information about public conferences and events are posted online at www.treasury.gov/ofr.

Congressional Affairs

We meet frequently with Members of Congress and their staffs to keep lawmakers informed of our work and to discuss financial stability issues. OFR Director Berner testified in January 2014 before the Senate Banking Subcommittee on Economic Policy and in February 2014 before the House Financial Services Subcommittee on Oversight and Investigations.

At both hearings, the Director described the Office's accomplishments, priorities, and efforts to enhance transparency and accountability. In addition, the Director gave a presentation on Capitol Hill for Congressional staff members in April 2014 for the Capital Markets 101 Distinguished Speakers Series. During the presentation, the Director discussed the OFR's mission and highlighted some of the Office's significant work.

OFR's Vision, Mission, and Goals for FY 2015-19

Vision: A transparent, efficient, and stable financial system.

The OFR's mission is to promote financial stability by delivering high-quality financial data, standards, and analysis for the Council and the public.

Goal: The OFR is an essential source of data and analysis for monitoring threats to financial stability.

- The OFR's monitoring tools and analyses are widely used and critical to assessing financial stability.
- Data used to monitor financial stability are comprehensive, reliable, and accessible to policy makers and the public through the OFR.
- Data providers and the public recognize that OFR data are protected and secure.

Goal: Standards that improve the quality and utility of financial data are identified and adopted.

- Industry and policy makers recognize the need for standards.
- The OFR is the source of expert knowledge needed to develop and implement types and formats of data reported and collected.
- Financial data standards that create efficiencies and facilitate analysis are widely used.

Goal: Leading edge research improves financial stability monitoring and the scope and quality of financial data, and informs policy and risk management.

- The OFR is the recognized center for objective, innovative research on financial stability.
- OFR research is widely cited and used to improve policy making, risk management, financial stability, and the scope and quality of financial data collections.

7.2 OFR Vision, Mission, and Operations

The OFR's mission is to promote financial stability by delivering high-quality financial data, standards, and analysis for the Council and the public. Our strategic plan will guide our goals and objectives in fiscal years 2015-19. Through our work, we aim to move toward the vision of a "transparent, efficient, and stable financial system."

Strategic Plan for FY 2015-19

The statutory mandates in the Dodd-Frank Act and the OFR's strategic plan are the foundation for our mission, vision, goals, objectives, and strategies. The FY 2015-19 plan builds upon the strategic framework covering FY 2012-14, and guides our next stage of development. The new plan sets three strategic goals, each with specific objectives and strategies, to fulfill our Congressional mandate and produce value for stakeholders (see **OFR's Vision, Mission, and Goals for FY 2015-19**). The strategic plan, which will be released shortly, also serves as a guide for us in setting priorities and allocating resources over the next five years.

The financial system will continue to change over the life of this strategic plan and will require the OFR to continually review its strategies for effectiveness in achieving the organization's goals and objectives to deliver on its mission. As a result, strategies and tactics may change related to data management, financial data standards, research that the organization pursues, and initiatives aimed at building institutional capabilities. All these efforts will focus on delivering ever-increasing value for our stakeholders.

Performance

The OFR established initial performance measures in 2012 tied to its then-current strategic goals. The measures were designed to track our performance in achieving the OFR's goals and objectives. The measures are continually reviewed for effectiveness in assessing the performance of the organization, and changes are implemented as appropriate. These measures are shared annually with the public in the President's Budget.

Tracking performance measures is only one way to manage performance. We will also use qualitative information to assess our performance, and we will continue to use comprehensive performance reviews to check progress and make appropriate course adjustments.

Budget

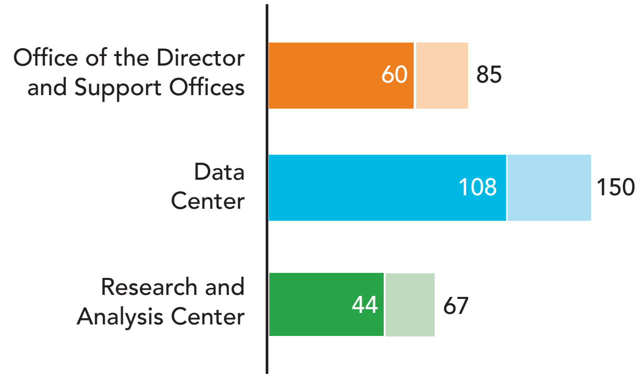
The Dodd-Frank Act directed the Department of the Treasury to establish a schedule to collect assessments to pay the expenses of the Office, the Council, and certain expenses for the implementation of the FDIC's orderly liquidation authority.

Treasury finalized a rule in 2012 that enabled the Office to collect semiannual assessments from bank holding companies with total consolidated assets of $50 billion or greater and nonbank financial companies supervised by the Board of Governors of the Federal Reserve. The initial assessment on July 20, 2012, was based on a fee rate of about $7,700 per $1 billion of assets held by the assessed companies. The semiannual fee rate has since declined to about $3,000 per $1 billion of assets held by the assessed companies.

In FY 2014, the OFR spent about $82.7 million. Our estimated budget for FY 2015 is $99.5 million. Details are provided annually in the President's Budget.

Our budgets are developed following the Office of Management and Budget's Budget Circular A-11 guidance. The OFR's financial management process follows Treasury policies, and our financial activities and controls are reviewed as part of the Department's consolidated audit. To strengthen our stewardship of the funds entrusted with us, we have also developed additional rigorous internal controls, project review mechanisms, and decision-making protocols to monitor spending effectively. Treasury's Office of the Inspector General and the Government Accountability Office periodically audit OFR governance, processes, procedures, and activities.

Figure 7-1. Current and Target Workforce



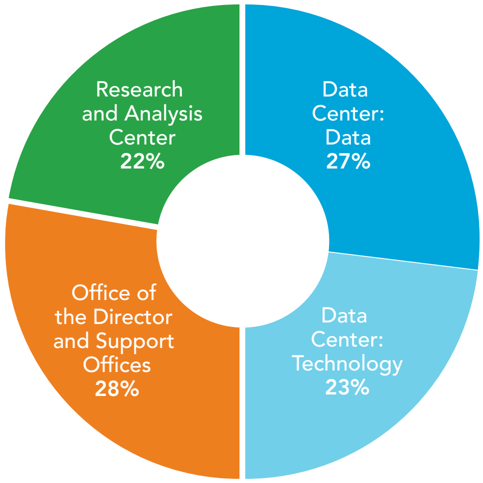
Source: OFR analysis

Because of the international nature of financial markets, we are building relationships with authorities in other countries to discuss research and analysis and promote information sharing and the use of data standards around the world.

Information Technology

The Dodd-Frank Act requires the OFR to maintain adequate information technology systems for data acquisition, management, analysis, and dissemination, applying strict rules for security and data sharing. In FY 2014, we completed the installation of a robust, long-term analytical environment for storing and handling large amounts of data to support complex financial models, computations, and analysis. The Office has continued to install a wide range of security tools and components to strengthen its already high security protections.

Figure 7-2. Planned Workforce Distribution



Source: OFR analysis

> Through our work, we aim to move toward the vision of a "transparent, efficient, and stable financial system."

7.3 OFR Organization and Workforce

The OFR continues to hire specialized and highly qualified employees for our Research and Analysis Center, Data Center, and other operations.

The Dodd-Frank Act requires that a Director lead the OFR and oversee its two major components: the Data Center and the Research and Analysis Center. One of our priorities is to recruit and hire specialized and highly trained employees to fulfill our mission. We continue to build an organization and culture of trust, accountability, and urgency to attract and retain talented individuals.

The OFR staff has increased from 30 in FY 2011 to 224 at the end of FY 2014. Our target for FY 2015 is to reach a total workforce of approximately 300, including permanent, reimbursable, and detailed staff members (see **Figure 7-1**).

When fully staffed, the OFR will have about 50 percent of its workforce in the Data Center. The Research and Analysis Center will constitute about 22 percent of the OFR's staff, complemented by a broad network of resources through work arrangements with outside researchers and collaboration with other Council members. The Director's office and support functions (Counsel, External Affairs, and Operations) will constitute the remaining 28 percent of the OFR workforce (see **Figure 7-2**).

Most of our staff members are located at the OFR's Washington, D.C., headquarters. We maintain a small office in New York City to support our research and data initiatives and to facilitate regular contact with regulators, data providers, academics, and financial market participants. The OFR also has a small number of work arrangements with contributors outside Washington, D.C., and New York to support research collaboration with academics.

During FY 2014, the OFR focused on developing a high-caliber workforce and producing research and data products. We recruited to fill vacant positions, aligned functions and resources within the Office to meet stakeholder and staff needs, and developed current staff members to address critical skills gaps.

In FY 2015, we will continue to review, refine, and expand our human capital strategies, while ensuring alignment with the OFR's FY 2015-19 strategic plan.

AGENDA AHEAD 8

We will soon publish a detailed, five-year strategic plan about our strategic goals and their implications for our direction in coming years. The three goals in the plan will also drive the OFR's research and data agenda for 2015, as follows:

- We will provide critical data and analysis for monitoring threats to financial stability. A top priority is our joint project with the Federal Reserve to collect repo data from firms on a voluntary basis. We will also improve our Financial Stability Monitor, publish a Financial Markets Monitor, and expand the suite of dashboards, monitors, metrics, and other tools that we offer the Council.
- We will help develop and promote standards that improve the quality and utility of financial data. We will work to further integrate the Legal Entity Identifier (LEI) in regulatory reporting and business practices, collaborate with the CFTC to promote standards in derivatives markets, and create prototype entity and instrument reference databases to promote market transparency.
- We will conduct and publish leading edge research to improve financial stability monitoring and inform policy and risk management. Key projects will focus on macroprudential policy, stress tests, agent-based models, and innovative tools that can promote financial stability analysis. We will also conduct and publish research related to short-term wholesale funding, credit default swaps, hedge funds, and other important financial activities.

Research Priorities

Our research activities encompass financial stability monitoring, macroprudential policy evaluation and analysis, and basic research to contribute to our understanding of vulnerabilities in the financial system.

We will broaden our monitoring framework tools in 2015. When possible, we will make our analysis available to the public, using appropriate techniques to ensure the security and confidentiality of non-public data. In the near term, we plan to share with the public a version of our monthly Financial Markets Monitor, which we currently present to the Council. We will develop additional monitoring products focused on money market funds, hedge funds, and credit default swap markets. We will also publish working papers describing in greater detail how we produce our Financial Stability Monitor and our Financial Stress Index, as well as a series of shorter, less technical papers on emerging threats to financial stability.

We will expand our contribution to the analysis and debate about the macroprudential policy toolkit in the coming year. The Office has an important mandate under the Dodd-Frank Act to conduct studies and research on regulation, conduct studies and provide advice on the impact of financial stability policy, and evaluate and report on stress tests and best practices in risk management. We are in a position to objectively evaluate and study such policies because we do not make policy. Our contribution may include research on what tools are available, how they work, and how they complement or conflict with other policy goals. We continue to build our policy analysis team to broaden our expertise across financial institutions and markets, with a focus on banking, insurance, and asset management. A key debate for 2015 will revolve around the current cyclical excesses in some markets and the effectiveness of the tools that policymakers now have to address them (see **Chapter 3**).

The OFR's basic research supports our monitoring and policy analysis work. We will publish several papers in 2015 resulting from the three research streams described in Chapter 4 — visualization, agent-based modeling, and the analysis of credit derivatives markets. Our research program on agent-based modeling has resulted in two working papers so far. In this annual report, we described a preliminary use of the tool to analyze the risk of contagion in a specific market segment (see **Assessing the Vulnerability of Agency mREITs** in **Chapter 2**). More research on agent-based models will come in 2015. We will also publish several papers on short-term wholesale funding markets, including a reference guide on repurchase agreement (repo) and securities lending markets.

Data Priorities

In the coming year, we will advance two key aspects of our data agenda:

1. to develop and promote financial data standards, and
2. to identify and fill gaps in the data that analysts need to monitor and evaluate threats to financial stability.

The Legal Entity Identifier (LEI) system is now up and running and growing quickly. To realize its full benefits, it is essential that the LEI become widespread in business practices. The OFR and the Council have called on regulators to require use of the LEI in regulatory reporting, beginning with large, complex financial companies and market participants. We note in Section 5.3 several examples of regulatory reports in which agencies have already adopted or proposed the use of the LEI. The LEI system generates efficiencies for financial companies in internal reporting, risk management, and in collecting, cleaning, and aggregating data. We believe it will decrease overlap and duplication in regulatory reporting, reducing the reporting burden for companies.

Another priority is our work with the CFTC and other regulators to promote the use of data standards in trade repository reporting. Our joint project with the CFTC seeks to enhance the quality, types, and formats of data collected from registered swap data repositories. In 2015, OFR and the CFTC will make progress in establishing standards and data harmonization.

The Dodd-Frank Act mandate for the OFR to prepare and publish reference databases for financial entities and financial instruments is a top priority. The global LEI system will meet the requirement for an entity reference database. In 2015, we will build a prototype reference database for financial instruments.

The repo data collection pilot is a signature project for the OFR (see **Section 6.2**). The pilot marks the first time we are going directly to financial companies to collect data. Participation is voluntary. Companies that participate will be asked for input on what data should be collected. We expect to begin collecting data early next year. We intend to publish aggregated data from the survey to provide greater transparency into the bilateral repo market for participants and policymakers. We expect the project will be a template for future data collection efforts.

The OFR will continue to collaborate broadly to share data and to design and implement financial data standards that give U.S. supervisors and their foreign counterparts a more accurate and global picture of the financial risks assumed by the entities they oversee.

Institutional Priorities

In 2015, we plan to further align our efforts to meet the three strategic goals in our new strategic plan (see **Chapter 7**). The strategic plan will help guide our long-term investment in people, processes, and technologies, while effective strategy management will ensure we remain responsive to changes in technology, stakeholder needs, and the financial system.

In 2014, the OFR completed the installation of the secure analytic environment needed to collect, process, store, manage, administer, and analyze large and complex datasets.

In 2015, we plan to deploy the initial release of the new OFR public website. We will also build an improved intranet for the OFR staff, expand the capabilities of our virtual research community offerings, and continue automating business processes.

We will continue in 2015 to identify and fill critical staffing gaps, based on the capabilities and competencies needed to achieve OFR strategic goals and objectives through 2019 and consistent with our forthcoming FY 2015-19 strategic plan. Recruiting and training are also essential to build the capabilities needed to analyze risks to financial stability, fill data gaps, and promote financial data standards, and we will continue to allocate resources toward these essential activities.

We will continue to build strong relationships with our stakeholders. We will work closely with the Council and its member agencies and we will engage with Congress to ensure that Congress is apprised of our activites. We will accelerate our outreach and collaboration through our network of outside researchers, academics, industry experts, and others. We continue to receive valuable recommendations from our external Financial Research Advisory Committee. We will expand the grants program, in collaboration with the National Science Foundation, and will continue to sponsor conferences and research on financial stability and related topics.

GLOSSARY A

Accommodation
Expansionary monetary policy in which a central bank seeks to lower borrowing costs for businesses and households to make credit more easily available.

Agency Mortgage-Backed Securities
A mortgage-backed security issued or guaranteed by federal agencies or government-sponsored enterprises.

Advanced Approaches
Under Basel III, the standard that U.S. banks with $250 billion or more in consolidated assets, or $10 billion or more in foreign exposures, must use to calculate risk-weighted assets. The advanced approaches require models based upon a bank's experience with its internal rating grades. Smaller banks use a standardized approach that sets risk weights for asset classes.

Bank for International Settlements (BIS)
An international financial organization that serves central banks in their pursuit of monetary and financial stability, helps to foster international cooperation, and acts as a bank for central banks.

Bank Holding Company (BHC)
Any company that has direct or indirect control of one or more banks and is regulated and supervised by the Federal Reserve under the Bank Holding Company Act of 1956. BHCs may also own nonbanking subsidiaries such as broker-dealers and asset managers.

Basel Committee on Banking Supervision (BCBS)
An international forum for bank supervisors that aims to improve banking supervision worldwide. The BCBS develops guidelines and supervisory standards such as standards on capital adequacy, the core principles for effective banking supervision, and recommendations for cross-border banking supervision.

Basel III
A comprehensive set of global regulatory standards for bank capital adequacy and liquidity. The reform measures, published in 2010 by the Basel Committee on Banking Supervision, introduced a leverage ratio along with two liquidity standards: the liquidity coverage ratio and the net stable funding ratio.

Call Report
A quarterly report of a bank's financial condition and income that all federally insured U.S. depository institutions must file.

Capital Requirement
The amount of capital a bank must hold to act as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause a bank to fail. U.S. banking regulators require banks to hold more high-quality, or Tier 1, capital against total risk-weighted assets under the Basel III international accord. Banks are classified as well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized based on regulators' capital and leverage calculations.

Captive Reinsurance Company
A subsidiary entity that provides insurance for its parent company.

Carry Trade
An investment strategy involving borrowing at low interest rates to purchase assets that yield higher returns.

Central Clearing
A settlement system in which securities or derivatives of a specific type are cleared by one entity, a clearinghouse or central counterparty, which guarantees the trades. It is an alternative to bilateral or over-the-counter trading (see Over-the-Counter Derivatives).

Central Counterparty (CCP)	An entity that interposes itself between counterparties to contracts traded in one or more financial markets. A CCP becomes the buyer to every seller and the seller to every buyer to help ensure the performance of open contracts.
Clearing Bank	A commercial bank that facilitates payment and settlement of financial transactions, such as check clearing or matching trades between the sellers and buyers of securities and other financial instruments or contracts.
Clearing Member	A member of, or a direct participant in, a central counterparty (CCP) that is entitled to enter into a transaction with the CCP.
Clearing	A system that facilitates the transfer of ownership of securities after they are traded.
Clearinghouse	See Central Counterparty.
Collateral	Any asset pledged by a borrower to guarantee payment of a debt.
Collateralized Loan Obligation (CLO)	Securities that hold pools of corporate loans and are sold to investors in tranches with varying levels of risk.
Commercial Paper (CP)	Short-term (maturity of up to 270 days), unsecured corporate debt.
Comprehensive Capital Analysis and Review (CCAR)	The Federal Reserve's annual exercise to ensure that the largest U.S. bank holding companies have robust, forward-looking capital planning processes that account for their unique risks and sufficient capital for times of financial and economic stress. The exercise also evaluates the banks' individual plans to make capital distributions such as dividend payments or stock repurchases.
Concentration Risk	Any single exposure or group of exposures with the potential to produce losses large enough to threaten a financial institution's ability to maintain its core operations.
Conditional Value at Risk (CoVaR)	A measure of the value at risk of the financial system conditional on distress at a single financial institution, from Adrian and Brunnermeier (2011).
Correlation Risk	The risk that the value of two or more assets will move in tandem, increasing a portfolio's volatility and potentially leading to large, simultaneous losses. Correlation risk is typically mitigated through hedging.
Countercyclical	The movement of a financial or macroeconomic variable in the opposite direction of the business or credit cycle (see Procyclical).
Countercyclical Capital Buffer	A policy requiring banks to build capital buffers during favorable economic periods that can be used to absorb losses in unfavorable periods.
Counterparty Risk	The risk that the party on the other side of a contract, trade, or investment will default.
Covenant-lite Loans	Loans that do not include typical covenants to protect lenders, such as requiring the borrower to deliver annual reports or restricting loan-to-value ratios.
Credit Default Swap (CDS)	A bilateral contract protecting against the risk of default by a borrower. The buyer of CDS protection makes periodic payments to the seller and in return receives a payoff if the borrower defaults, similar to an insurance contract. The protection buyer does not need to own the loan covered by the swap.
Credit Risk	The risk that a borrower may default on its obligations.
Credit Spread	The difference in yield between a security and an otherwise similar security of higher quality.

Cyclical Risk	Any financial or economic risk that is closely tied to the business cycle.
Dark Pools	Private electronic trading venues, also referred to as alternative trading systems, that allow institutional investors to anonymously buy and sell securities, primarily stocks. Unlike stock exchanges, dark pools do not publish pretrade prices for offers to buy and sell, and report transactions to regulators after a trade is executed.
Derivative	A financial contract whose value is derived from the performance of underlying assets or market factors such as interest rates, currency exchange rates, and commodity, credit, and equity prices. Derivative transactions include structured debt obligations, swaps, futures, options, caps, floors, collars and forwards.
Distressed Insurance Premium (DIP)	An indicator of a firm's vulnerability to systemic instability. DIP uses information from credit default swap spreads and equity prices to measure the implied cost of insuring a given firm against broader financial distress.
Dodd-Frank Act	Short name for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the most comprehensive financial reform legislation in the United States since the Great Depression. The Dodd-Frank Act seeks to promote financial stability by improving accountability in the financial system, adding transparency about over-the-counter (OTC) derivative markets, and protecting consumers from abusive financial services practices.
Duration Risk	The risk associated with the sensitivity of the prices of bonds and other fixed-income securities to changes in the level of interest rates.
Emerging Markets (EM)	Developing countries where investments are often associated with both higher returns and higher risk. EM countries fall between developed markets such as the United States and frontier markets that are more speculative.
Eurozone	A group of 18 European Union countries that have adopted the euro as their currency.
Exchanged-Traded Fund	An investment fund whose shares are traded on an exchange. Because ETFs are exchange-traded products, their shares are continuously priced unlike mutual funds which offer only end-of-day pricing. ETFs are often designed to track an index or a portfolio of assets.
Fair Value Models	Models for determining the value of an asset based on the price at which the asset could be bought or sold between two willing parties.
Federal Financial Institutions Examination Council (FFIEC)	An interagency body that prescribes uniform principles, standards, and report forms for the federal examination of financial institutions. The FFIEC makes recommendations to promote uniformity in banking supervision. Members include the Federal Reserve, the FDIC, the NCUA, the OCC, the CFPB, and a representative of state financial supervisors.
Financial Contagion	A scenario in which financial or economic shocks initially affect only a few financial market participants then spread to other financial sectors and countries in a manner similar to the transmission of a medical disease. Financial contagion can happen at both the international level and the domestic level.
Financial Intermediation	Any financial service in which a third party or intermediary matches lenders and investors with entrepreneurs and other borrowers in need of capital. Often investors and borrowers do not have precisely matching needs, and the intermediary's capital is put at risk to transform the credit risk and maturity of the liabilities to meet the needs of investors.

Financial Stability	The condition in which the financial system is sufficiently functioning to provide its basic tasks for the economy, even under stress.
Financial Stability Board (FSB)	An international coordinating body that monitors financial system developments on behalf of the G-20 nations. The FSB was established in 2009 and is the successor to the earlier Financial Stability Forum.
Fire Sale	The disorderly liquidation of assets to meet margin requirements or other urgent cash needs. Such a sudden selloff can drive prices below their fair value. The quantities sold are large relative to the typical volume of transactions.
Fiscal Risk	Risk stemming from deviations in fiscal policy from expectations.
Form N-MFP	A monthly disclosure of portfolio holdings submitted by money market funds to the SEC, which makes the information publicly available. SEC Rule 30b1-7 established the technical and legal details of N-MFP filings.
Form PF	A periodic report of portfolio holdings, leverage, and risk management submitted by hedge funds, private equity funds, and related entities. The report is filed with the SEC and CFTC, which keep the information confidential. The Dodd-Frank Act mandated the reporting to help the Council monitor financial stability risks.
Funding Liquidity	The availability of credit to finance the purchase of financial assets.
General Collateral Finance (GCF)	An interdealer repurchase agreement (repo) market in which the Fixed Income Clearing Corporation plays the role of intraday central counterparty. Trades are netted at the end of each day and settled at the triparty clearing banks (see Triparty Repo).
Global Systemically Important Banks (G-SIBs)	Banks annually designated by the Basel Committee on Banking Supervision for having the potential to disrupt international financial markets. The designations are based on banks' size, interconnectedness, complexity, dominance in certain businesses, and global scope.
Haircut	The discount at which an asset is pledged as collateral. For example, a $1 million bond with a 5 percent haircut would collateralize a $950,000 loan.
Hedge Fund	A pooled investment vehicle available to accredited investors such as wealthy individuals, banks, insurance companies, and trusts. Hedge funds can charge a performance fee on unrealized gains, borrow more than one half of their net asset value, short sell assets they expect to fall in value, and trade complex derivative instruments that cannot be traded by mutual funds.
Hedging	An investment strategy to offset the risk of a potential change in the value of assets, liabilities, or services. An example of hedging is buying an offsetting futures position in a stock, interest rate, or foreign currency.
High-Quality Liquid Assets (HQLA)	Assets such as central bank reserves, government bonds, and corporate debt that can be quickly and easily converted to cash during a stress period. U.S. banking regulators require large banks to hold HQLA to comply with the Liquidity Coverage Ratio.
High-Yield Bonds	Instruments rated below investment grade that pay a higher interest rate than investment-grade securities because of the perceived credit risk.
Implied Volatility	The market's estimate of the volatility of the price of an underlying asset. The current market price of an option contract can be used in a mathematical pricing model to calculate the level of volatility that market participants expect.

Initial Margin	A percentage of the total market value of securities that an investor must pay to purchase securities with borrowed funds.
Interest Rate Swap	A swap in which two parties swap interest rate cash flows, typically between a fixed rate and a floating rate (see Swap).
International Monetary Fund (IMF)	An international organization created at the end of World War II to stabilize exchange rates and support international payment systems. The IMF provides credit to developing nations and those in economic distress, typically conditional on economic and financial reforms.
International Organization for Standardization (ISO)	The world's largest developer of voluntary international standards in products, services, and practices.
International Swaps and Derivatives Association (ISDA)	An industry association of over-the-counter derivative market participants. The ISDA Master Agreement standardized derivative terms for counterparties to simplify netting and reduce legal risks.
Investment-Grade Bonds	Securities that credit rating agencies determine carry less credit risk. Non-investment grade securities have lower ratings and a greater risk of default.
Legal Entity Identifier (LEI)	A unique 20-digit alphanumeric code to identify each legal entity within a company that participates in global financial markets.
Leverage	The use of borrowed money to finance investments or conduct financial activities.
Leverage Ratio	The Tier 1 (highest quality) capital of a bank divided by its total exposure to derivatives, securities financing transactions, and on- and off-balance-sheet exposures. The Basel III bank capital standards set a minimum leverage ratio of 3 percent, but the Federal Reserve said it will require the largest U.S. banks to maintain a leverage ratio above 5 percent beginning in 2018.
Liquidity	See Funding Liquidity and Market Liquidity.
Liquidity Coverage Ratio (LCR)	A Basel III standard to ensure that a bank maintains enough high-quality liquid assets to meet its anticipated liquidity needs for a 30-day stress period. The ratio applies to banks with $250 billion or more in total consolidated assets, or $10 billion or more in on-balance-sheet foreign exposure. A less-strict ratio is required of banks with $50 billion or more in total assets (see High-Quality Liquid Assets).
Liquidity Risk	The risk that a firm will not be able to meet its current and future cash flow and collateral needs, both expected and unexpected, without materially affecting its daily operations or overall financial condition.
Living Wills	Annual resolution plans required of U.S. banks with $50 billion or more in total consolidated assets and nonbank financial companies designated by the Council for supervision by the Federal Reserve. Each living will must describe how the company could be dismantled in a rapid, orderly way in the event of failure.
Loan-to-Value (LTV) Ratio	The ratio of the amount of a loan to the value of an asset, typically expressed as a percentage. This is a key metric in the financing of a mortgage.
Local Operating Unit (LOU)	Private- or public-sector group authorized by the Global Legal Entity Identifier Foundation to register and issue LEIs. LOUs also validate and maintain reference data, and protect information that must be stored locally. Some jurisdictions may have multiple LOUs.
Macroeconomic Risk	Risk from changes in the economy or macroeconomic policy.

Macroprudential Supervision	Supervision to promote the stability of the financial system as a whole (see Microprudential Supervision).
Margin Call	A requirement by a broker that a borrower increase the collateral pledged against a loan in response to changes in the collateral's value.
Margin Requirement	Rules governing the necessary collateral for a derivative, loan, or related security required to cover, in whole or in part, the credit risk one party poses to another.
Market Depth	The ability of a market to absorb excess demand to buy or sell a security without affecting the price quoted for subsequent trades. In a deep market, a large number of shares or other financial instruments can be purchased with little impact on prices.
Market Liquidity	The ability of market participants to sell large positions with limited price impact and low transaction costs.
Market Microstructure	In economics, the study of the process and outcomes of exchanging assets under explicit trading rules. Microstructure theory focuses on how specific trading mechanisms affect the price formation process.
Market Risk	The risk that an asset's value will change due to unanticipated movements in market prices.
Market-Making	The process in which an individual or firm stands ready to buy and sell a particular stock, security, or other asset on a regular and continuous basis at a publicly quoted price. Market-makers usually hold inventories of the securities in which they make markets. Market-making helps to keep financial markets efficient.
Maturity Mismatch	The difference between the maturities of an investor's assets and liabilities. A mismatch affects the investor's ability to survive a period of stress that may limit its access to funding and to withstand shocks in the yield curve. For example, if a company relies on short-term funding to finance longer-term positions, it will be subject to significant refunding risk that may force it to sell assets at low market prices or potentially suffer through significant margin pressure.
Maturity Transformation	Funding long-term assets with short-term liabilities. This creates a maturity mismatch that can pose risks when short-term funding markets are constrained.
Metadata	Data that provide information about the structure, format, or organization of other data.
Microprudential Supervision	Supervision of the activities of a bank, financial firm, or other components of a financial system (see Macroprudential Supervision).
Money Market Fund (MMF)	A fund that typically invests in government securities, certificates of deposit, commercial paper, or other highly liquid and low-risk securities. Some MMFs are governed by the SEC's Rule 2a-7.
Mortgage Call Report	A quarterly report of mortgage activity and company information created by state regulators and administered electronically through the Nationwide Mortgage Licensing System & Registry (NMLS).
Mortgage Servicing Rights (MSRs)	The right to service and collect loan payments and fees on a mortgage.
mREITS	Real estate investment trusts that borrow short-term funds in repo markets and invest in real estate, mortgages, and mortgage-backed securities.
Mutual Fund	A pooled investment vehicle, regulated by the SEC, that can invest in stocks, bonds, money market instruments, other securities, or cash.

Net Asset Value	The value of an entity's assets minus its liabilities. For example, a mutual fund calculates its NAV daily by dividing the fund's net value by the number of outstanding shares.
Net Stable Funding Ratio (NSFR)	A Basel III standard to ensure that a bank holds sufficient available stable funding to limit its funding risk from maturity mismatches between assets and liabilities. Available stable funding is the portion of a bank's capital and liabilities expected to be reliable for at least one year.
Network	A model consisting of a set of nodes, or financial institutions, and a set of payment obligations linking them, to show how financial interconnections can amplify market movements.
Operational Risk	Risks occurring during the normal operation of a business, including, for example, failed internal processes, legal risk, and environmental risk.
Option	A financial contract granting the holder the right, but not the obligation, to engage in a future transaction on an underlying security or real asset. For example, an equity call option provides the right, but not the obligation, for a fixed period to buy a block of shares at a fixed price.
Order Book	A list of bids and offers a trading venue uses to match buyers and sellers. A limit order book is a record of unexecuted limit orders (an order to buy a stock at or below a specified price, or to sell a stock at or above a specified price) that are treated equally with other orders in terms of priority of execution. A central limit order book is a centralized database for all limit orders received by specialists and market-makers for different types of securities.
Originate	To extend credit after processing a loan application. Banks, for example, originate mortgage loans and either hold them until maturity or distribute them to other financial market participants. The distribution can include a direct sale or a securitization of a portion of the credit at the time of origination or later.
Over-the-Counter (OTC) Derivatives	Deals negotiated privately between two parties rather than traded on a formal securities exchange. Unlike standard exchange-traded products, OTC derivatives can be tailored to fit specific needs, such as the effect of a foreign exchange rate or commodity price over a given period.
Parallel-Coordinates Plot	A figure used to visualize and analyze multiple financial, economic, and other variables simultaneously.
Price Discovery	The process of determining the prices of assets in the market place through the interactions of buyers and sellers.
Primary Dealer	Banks and securities broker-dealers designated by the Federal Reserve Bank of New York to serve as trading counterparties when the FRBNY is carrying out U.S. monetary policy. Among other things, primary dealers are required to participate in all auctions of U.S. government debt and to make markets for the FRBNY when it transacts on behalf of its foreign official accountholders. A primary dealer buys government securities directly and can sell them to other market participants.
Procyclical	Financial or economic indicators that tend to move in the same direction as the overall economy (see Countercyclical).
Qualified Mortgage (QM)	Under the Dodd-Frank Act, a mortgage loan that meets certain underwriting criteria set by the CFPB. The originator of a QM has certain protections from borrower lawsuits alleging the originator failed to make a good faith and reasonable determination of the borrower's ability to repay the loan.

Qualified Residential Mortgage (QRM)	Under the Dodd-Frank Act, a mortgage loan exempt from the requirement that sponsors of asset-backed securities must retain at least 5 percent of the credit risk of the assets collateralizing the securities.
Quantitative Easing (QE)	An unconventional monetary policy to stimulate growth when policy rates are close to zero by purchasing government or other securities from private institutions.
Refinancing Risk	The risk that a borrower will face liquidity problems if unable to roll over existing debt.
Reinsurance	The risk management practice of insurers to transfer some of their policy risk to other insurers. A second insurer, for example, could assume the portion of liability in return for a proportional amount of the premium income.
Repo Run	A situation in which repurchase agreement (repo) investors lose confidence in the market due to concerns about counterparties, collateral, or both, and respond by pulling back their funding or demanding larger haircuts.
Repurchase Agreement (Repo)	A transaction in which one party sells a security to another party and agrees to repurchase it at a certain date in the future at an agreed price. Banks often do this on an overnight basis as a form of liquidity that is similar to a collateralized loan.
Resolution Plans	See Living Wills.
Risk Management	The business and regulatory practice of identifying and measuring risks and developing strategies and procedures to limit them. Categories of risk include credit, market, liquidity, operations, model, and regulatory.
Risk Retention	Under the Dodd-Frank Act, a requirement that issuers of asset-backed securities must retain at least 5 percent of the credit risk of the assets collateralizing the securities. The regulation also prohibits a securitizer from directly or indirectly hedging the credit risk (see Qualified Residential Mortgage).
Run Risk	The risk that investors lose confidence in a market participant due to concerns about counterparties, collateral, solvency, or related issues and respond by pulling back their funding or demanding more margin or collateral.
Search for Yield (Reach for Yield)	The practice of accepting greater risks in hopes of earning higher than average returns.
Securities Financing	The transfer or lending of securities from one party to another. A borrower of securities puts up collateral in the form of shares, bonds, or cash, and is obliged to return the securities on demand. These transactions provide liquidity in the market.
Securities Lending/Borrowing	The temporary transfer of securities from one party to another for a specified fee and time period in exchange for collateral in the form of cash or securities.
Settlement	The process by which securities are transferred and settled by book entry according to a set of exchange rules. Some settlement systems can include institutional arrangements for confirmation, clearance, and settlement of securities trades and safekeeping of securities.
Shadow Banking System	Credit intermediation outside the insured depository system, involving leverage, maturity transformation, and the creation of money-like liabilities.
Short-Term Wholesale Funding	Funding instruments typically issued to institutional investors to raise large amounts of funding for short periods. Examples include large time deposits, commercial paper, and repurchase agreements.

Single-Family Rental Securitizations (SFR)	A structured security backed by mortgage loans on pools of single-family rental properties.
Spread	The difference in yields between various private debt instruments and government securities of comparable maturity. The spread can be used as one of many indicators of financial stability.
Stress Test	An exercise that shocks asset prices by a pre-specified amount, sometimes along with other financial and economic variables, to observe the effect on financial institutions or markets. Under the Dodd-Frank Act, banking regulators run annual stress tests of the biggest U.S. bank holding companies.
Supplemental Leverage Ratio	Under Basel III, the ratio of a bank's Tier 1 (high quality) capital to its total leverage exposure, which includes all on-balance-sheet assets and many off-balance-sheet exposures. U.S. regulators require a 3 percent ratio for most banks with $250 billion or more in consolidated assets or $10 billion or more in foreign exposures. The eight large U.S. banks designated as global systemically important banks by the Financial Stability Board must maintain a ratio of 5 percent.
Swap	An exchange of cash flows agreed by two parties with defined terms over a fixed period.
Swap Data Repository (SDR)	A central recordkeeping facility that collects and maintains a database of swap transaction terms, conditions, and other information. In some countries, SDRs are referred to as trade repositories.
Swap Execution Facility	Under the Dodd-Frank Act, a trading platform market participants use to execute and trade swaps by accepting bids and offers made by other participants.
Systemic Expected Shortfall (SES)	A systemic risk indicator that estimates the extent to which the market value equity of a financial firm would be depleted by a decline in equity prices.
Tail Risk	The low-probability risk of an extreme event moving an asset price.
Tier 1 Capital Ratio and Tier 1 Common Capital Ratio	Two measurements comparing a bank's capital to its risk-weighted assets to show its ability to absorb unexpected losses. Tier 1 capital includes common stock, preferred stock, and retained earnings. Tier 1 common capital excludes preferred stock.
Triparty Repo	A repurchase agreement in which a third party, such as a clearing bank, acts as an intermediary for the exchange of cash and collateral between two counterparties. In addition to providing operational services to participants, agents in the U.S. triparty repo market extend intraday credit to facilitate settlement of triparty repos.
Volatility Risk	The risk in the value of a portfolio from unpredictable changes in the volatility of a risk factor or underlying asset.
Volcker Rule	A provision of the Dodd-Frank Act that generally prohibits a bank from certain investment activities that are not directly related to trading for customers or for market-making. The provision also limits insured depository institutions from owning or sponsoring hedge funds or private equity funds.
XBRL (eXtensible Business Reporting Language)	A common computer language for the electronic communication of business and financial data. Regulators can use XBRL as an efficient way to obtain information from companies.
XML (eXtensible Markup Language)	A common computer language that defines a set of rules for the semantic markup of documents.

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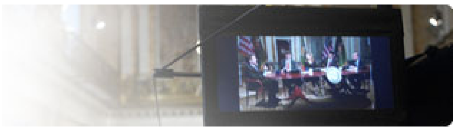

Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman Before the Goldman Sachs Third Annual Housing Finance Conference

3/5/2015

As prepared for delivery

Good morning, and thank you, Carsten, for that kind introduction. It's a pleasure to be with you today to engage on a very important issue for our country and our economy.

This morning, I want to discuss the state of housing finance reform and the path we see to a more sustainable mortgage finance system that meets President Obama's principles and creates a housing finance system that will promote stability in the housing market and the broader economy, and therefore, benefits the American people. First, I'd like to briefly explain why Treasury is devoting significant resources to helping market participants create a robust and responsible non-government-guaranteed securitization market and then discuss our thinking about how to move forward on GSE reform.

Private Label Securities Initiative

The Administration believes that private capital should be at the center of the housing finance system. To that end, Treasury has been working with the industry to develop the structural reforms necessary to help bring the private label securities, or PLS, market back, and get investors off the sidelines. A key component of this effort is rebuilding trust among market participants, and to this end, Treasury published the results of an exercise last month that would provide greater transparency around credit rating agency loss expectations for newly originated mortgage collateral. The goal of this exercise and the broader PLS initiative is to improve confidence in post-crisis practices and encourage investors to return to a reformed PLS market.

Treasury views a diverse housing finance system that features multiple execution channels as essential to promoting competition, market efficiency, and consumer choice. We see the development of a healthy and responsible PLS market as an important component of a sustainable housing finance system and a complement to a reformed government-supported channel, an objective I will discuss in the remainder of my speech.

GSE Reform

With that in mind, let me turn my attention to the GSEs. We are now well into the seventh year of Fannie Mae and Freddie Mac's conservatorship. We cannot forget that the actions taken in the wake of the financial crisis to backstop the GSEs stabilized the housing market, protected the capital markets, and supported the broader economy. But as I have said many times, the status quo is unsustainable. Taxpayers remain at risk, market participants are uncertain about the government's longer-term footprint in the mortgage market, and mortgage access and pricing decisions are not in the hands of market participants. The American people deserve better.

They deserve an efficient, sustainable, housing finance system that serves borrowers effectively and efficiently without leaving taxpayers on the hook for potential future bailouts. The critical flaws in the legacy system that allowed private shareholders and senior employees of the GSEs to reap substantial profits while leaving taxpayers to shoulder enormous losses cannot be fixed by a regulator or conservator because they are intrinsic to the GSEs' congressional charters. And these charters can only be changed by law. That is why we continue to believe that comprehensive housing finance reform is the only effective way forward, not narrowly crafted ad-hoc fixes.

We cannot forget about the important progress made in the Senate during the last Congress and hope that the new Congress will afford the opportunity to again advance bipartisan legislation meeting our principles, even if it is too soon to tell what the ultimate prospects will be. The Administration remains ready, willing, and able to work in good faith with members of both parties to complete this important but unfinished piece of financial reform. As memories of the financial crisis fade, we cannot become complacent. The best time to act is when the housing market is well along the path to recovery and credit markets are normalizing, not on the precipice of a new economic shock when there is little time to be thoughtful.

We do recognize the myriad of challenges to achieving a bipartisan legislative consensus. But as I will explain shortly, we believe that significant progress can be, and is being made, prior to legislation, to help move the housing finance system towards a more sustainable future. While this progress is not a substitute for legislative reform, it can, over time, reduce the challenges to achieving a desired legislative outcome that puts in place a durable and fair housing finance system by advancing us down the path of transition.

Progress under Conservatorship

To that end, I'd like to highlight the steps forward that have been made under the conservatorship – progress that needs to be built upon. Important gains have been and continue to be made in de-risking and preparing the Enterprises for transition. The GSEs' critical housing finance infrastructure and technology – which was allowed to obsolesce in the years preceding the financial crisis – is being renewed and enhanced.

Furthermore, their business practices are being reformed. Between 1995 and 2008, management grew the GSEs' retained investment portfolios, which are financed at government-subsidized borrowing costs, fourfold to a combined total of $1.6 trillion. Since entering conservatorship, those portfolios have been nearly halved, and they are required to shrink further to less than $500 billion in total by year-end 2018.

In addition to being a major source of GSE earnings, these portfolios remain a significant source of financial volatility and potential taxpayer risk. These portfolios, the pursuit of maximum earnings, and the drive to recapture market share through greater risk-taking left taxpayers holding the bag when the bets went wrong. In conservatorship, these practices have been replaced with a recommitment to more effective risk management, prudent underwriting, more appropriate pricing, and a greater emphasis on sustainable mortgage finance.

The Federal Housing Finance Agency (FHFA), as the independent regulator and conservator of the GSEs, is laying the groundwork for a future housing finance system based upon private capital taking the majority of credit risk in front of a government guarantee with greater taxpayer protections, broader access to credit for responsible borrowers, and improved transparency and efficiency. These measures include, among others, expanding and diversifying risk-taking among private actors, further focusing GSE businesses on meeting the mortgage finance needs of middle class households and those aspiring to join the middle class, and developing a securitization infrastructure that can serve as the backbone for the broader mortgage market over time. All of these initiatives are consistent with the long-term vision of providing secure homeownership opportunities for responsible middle-class families.

After the failure of both GSEs, FHFA's ability to stand in the shoes of their respective boards and senior management as conservator in order to set appropriate, statutorily-guided priorities and ensure follow-through has been good for the Enterprises and good for the American people. Preserving FHFA's role in the future housing finance system merits serious consideration.

Administrative Vision

With that history in mind, I want to expand upon our vision for reforms that would transition the GSEs further along a path toward a future housing finance system while they still benefit from Treasury's capital support. In turn, the progress we make today could serve both as a framework for, and reduce certain challenges associated with, achieving bipartisan legislative reform. Within the context of a continuing backstop, further de-risking the Enterprises is common-sense, prudent policy. Other actions that improve market efficiency and liquidity and develop infrastructure that would promote competition are consistent with the Administration's interest in a durable and fair housing finance system.

The first of these areas is in the shedding of GSE legacy risk, both in their retained portfolios and their guarantee book. Given the strengthened underwriting practices and high credit quality of their new guarantee book, this legacy risk represents the overwhelming majority of taxpayer risk exposure to the GSEs today. Despite asset sales and natural run-off, their retained portfolios remain substantial at over $400 billion each and still constitute a significant line of business. The size and complexity of the retained portfolios also necessitate active hedging, introducing considerable basis risk and earnings volatility and making the GSEs susceptible to potentially relying on a future draw of PSPA capital support.

In light of the strong demand for mortgage credit risk in the market today and the market success of Freddie Mac's first nonperforming loan (NPL) sale in July of last year, it would be both feasible and beneficial to taxpayers to responsibly accelerate the reduction of the most illiquid assets in the GSE portfolios. In particular, Treasury sees value in cultivating programmatic NPL sales at both Enterprises with a focus on market transparency, improving borrower outcomes, and community stabilization.

Similarly, in light of the GSEs' expertise in transferring credit risk on their new books of business and recognizing that the bulk of credit risk exposure on their guarantee books is tied to their pre-2009 legacy commitments, the potential for transferring credit risk on their legacy guarantee books also merits consideration despite the unique challenges it may entail.

Continuing with the theme of reducing taxpayer exposure to mortgage credit risk, the second area where we see room for progress is in transferring credit risk on new originations. As I said before, the Administration believes that a sustainable housing finance system must have private capital at its core, and in conservatorship, the GSEs have started down a path of transferring greater mortgage credit risk to private market participants.

As you are aware, beginning in 2013, the GSEs have cultivated their respective credit risk transfer programs. These programs and their effectiveness in transferring credit risk have grown substantially in under two years. The GSEs have also engaged in other innovative forms of risk transfers including reinsurance contracts and recourse agreements.

Although the GSEs are directionally on the right path, there is more to be done on this front. Despite issuing 16 credit risk transfer transactions since 2013 referencing $530 billion notional balance, this amounts to approximately 20 percent of the GSEs' combined guarantees over this time period and roughly 12 percent of the GSEs' combined books of business. And while recent transactions have made progress by selling first-loss exposure for the first time, these transactions still rely on a defined credit event and fixed severity schedule.

The closer the GSEs can come to transferring the majority of risk to private market participants, the better. Such credit risk transfer activities serve to field-test the role of government as a guarantor of catastrophic risk while private capital bears the risk of the majority of potential losses. We are also sensitive to existing constraints to rapidly expanding credit risk transfer activities today and are supportive of additional, measured efforts to foster this market sustainably over time.

This is why we support the conservator's efforts to responsibly expand credit risk transfer efforts through continued structural innovation and counterparty strengthening in order to broaden and diversify the investor base and optimize pricing efficiency and stability. Credit risk transfer activities should not be concentrated in any one mechanism or entity. Rather, they should seek to develop a variety of mechanisms and entities in order to improve pricing efficiency and transparency, provide the lowest cost to borrowers, and ultimately, inform the framework of the future housing finance system. We see great value in leveraging the unique investment needs and competencies of the broad spectrum of market participants in shaping a sustainable model for putting first loss mortgage credit risk in private hands.

Finally, under the direction of FHFA, the GSEs have embarked upon a cutting-edge project to develop a Common Securitization Platform (CSP) and a fungible To-Be-Announced, or TBA, contract. We are broadly supportive of these efforts, which in the immediate future will modernize the GSEs' collective securitization infrastructure and improve the liquidity and efficiency of the market.

However, given the CSP's joint ownership by the GSEs and scope narrowly focused on their businesses, the near-term CSP initiative would not succeed at separating the industry's critical securitization infrastructure from the GSEs' credit risk-taking activities. This separation is necessary to enhance the stability of the housing finance system. Nor will it use its full potential to reshape the broader housing finance landscape by facilitating standardization, transparency, and competition, and serving as a market gateway for both guaranteed and non-guaranteed securities.

This is why we would support opening up the CSP as early as it can be responsibly done to accommodate non-GSE users, which should be reflected not just in the Platform's functionality but also in its governance structure. Greater transparency, more concrete timelines, broader engagement with private stakeholders, and ultimately, expanded governance of the CSP joint venture to include non-GSE stakeholders are all in the interests of moving towards a more sustainable future housing finance system.

The nation's housing finance system is too critical to remain in a state of limbo without a clear, legislated vision for the future. However, the activities I outlined today are representative of the progress that can be made without legislation. By pursuing these and other activities that de-risk the Enterprises, we can put the housing finance system on a course aligned with the Administration's priorities that would promote greater stability for the housing market and broader economy.

Capital

With the recent release of the GSEs' 2014 fourth quarter earnings, there seems to be increased interest in the subject of GSE capital. But before we discuss this, it is worth taking a step back to review the purpose of the Senior Preferred Stock Purchase Agreements, commonly referred to as the PSPAs. The PSPAs were put in place as both companies were placed into conservatorship. These agreements were established to protect the solvency of the two companies and to allow them to continue to operate. This was necessary to protect financial stability and to ensure the continued flow of mortgage credit. The PSPAs gave market participants confidence in the GSEs' debt and MBS obligations through which they fund the majority of the mortgage credit in this country. Without this capital support, it is clear that both GSEs would have been insolvent and that mortgage credit would have dried up as a result.

With this as a backdrop, I want to frame for this group how we think about capital at the GSEs while they are in conservatorship and continue to rely on the PSPAs to support their activities.

Currently, the GSEs operate with a minimal amount of capital at each Enterprise. These capital reserve amounts were established in order to provide protection against unexpected losses related to their retained investment portfolios. This capital amount will amortize to zero by 2018 when we would expect the GSEs to have wound down their legacy investment business. And, from Treasury's standpoint, we would like to see these retained portfolios wound down even faster to further reduce risk.

Despite having only minimal retained capital levels at the GSEs, investors continue to have confidence in their securities due to the ongoing backstop the PSPAs provide each company. The substantial remaining capital support left under the PSPAs gives market participants the confidence to buy 30-year GSE securities on a day-in and day-out basis. This is despite the fact that the companies remain in conservatorship and have minimal capital levels.

However, as a result of the ongoing capital support through the PSPAs, taxpayers remain exposed to potential future losses at the GSEs. Let me remind you, both recapitalization of the GSEs and draws against the existing Treasury backstop due to potential future losses would come at taxpayers' expense.

Allowing the GSEs to exit conservatorship within the existing framework that includes their flawed charters, conflicting missions, and virtual monopolistic access to a government support through the PSPAs exposes taxpayers to great risk and is irresponsible. As we have said repeatedly, the only way to responsibly end the conservatorship of the GSEs is through legislation that puts in place a sustainable housing finance system with private capital at risk ahead of taxpayers, while preserving access to mortgage credit during severe downturns.

One final point for those who advocate a recapitalization of Fannie Mae and Freddie Mac while in conservatorship and subsequent privatization. If in the future the GSEs were to operate as they did prior to conservatorship, the GSEs' size and significance would certainly attract broad regulatory attention due to the financial stability implications of their possible failure. Given this and the associated economic and regulatory ramifications, simply returning these entities to the way they were before is not practical nor is it a realistic consideration.

Conclusion

In closing, I want to return to the issue of timing and the urgency of enacting housing finance reform legislation. We know from experience that mortgage credit will be broadly accessible until it's not; that capital markets will be liquid until they're not. When the next crisis hits, it is unlikely that we will have the benefit of advance warning, and at that point, it will be too late for thoughtful reform. Our options will be limited, our hands will be tied, and we will be destined to relive the mistakes of the past.

Reforming a system as complex and as far-reaching as housing finance in a sensible and sustainable way takes time to get things right and to ensure a smooth transition from the existing system to the new, safer, fairer system. The point I want to make today is that there is an enormous amount of very good work underway to de-risk the enterprises, enhance liquidity, and protect taxpayers in a direction aligned with the Administration's principles for long-term reform.

Nevertheless, institutionalizing these and other critical reforms in bipartisan legislation is by far the better course. Let's be prudent; let's have foresight; let's find a bipartisan pathway to preventing another GSE bailout, which continuation of the status quo guarantees. We can do this, and we must do this.

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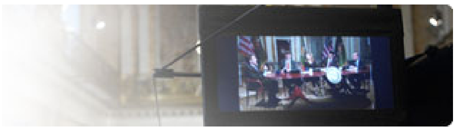

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Financial Stability Oversight Council Announces Changes to Nonbank Designations Process

2/4/2015

New and Formalized Practices Increase Transparency and Strengthen Process

Council Also Votes to Extend Asset Management Comment Period

WASHINGTON – The Financial Stability Oversight Council (Council) today announced that it voted to adopt certain changes and formalize certain practices relating to its process for reviewing nonbank financial companies for potential designation. The Council's designation authority under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act enables the Council to identify and respond to risks that individual nonbank financial companies could pose to U.S. financial stability. Nonbank financial companies that are designated by the Council are subject to consolidated supervision by the Board of Governors of the Federal Reserve System and enhanced prudential standards.

"The changes adopted today represent an important step for the Council that will increase the transparency of our designations process and strengthen the Council overall," said **Treasury Secretary Jacob J. Lew, Chairperson of the Council**. "The Council has the unique and critical mission of identifying and responding to risks to U.S. financial stability. It is a young organization that, as it grows and matures, must continue to be flexible and adjust its processes as needed to fulfill its mandate."

The changes adopted today fall into three categories:

1) **Engagement with companies under consideration by the Council:** The Council will inform companies earlier when they come under review, and provide additional opportunities for companies and their regulators to engage with the Council and staff, without compromising the Council's ability to conduct its work.

2) **Transparency to the broader public regarding the designations process:** The Council will make available to the public more information about its designations work, while continuing to protect sensitive, nonpublic information.

3) **Engagement during the Council's annual reevaluations of designations:** These changes create a clearer and more robust process for the Council's annual reviews of its designations. This process will enable more engagement between designated companies and the Council and staff, with ample opportunity for companies to present information and to understand the Council's analysis.

The vote today follows a presentation and discussion of each of the specific proposals at the Council's public meeting in January. Staff of Council member agencies engaged in extensive outreach to stakeholders throughout the fall of 2014 regarding the Council's designations process. Based on that outreach, staff identified changes to the designations process that would enable earlier engagement with companies under review and increase transparency to the public, without compromising the Council's ability to conduct its work and protect confidential company information. These changes will increase the strength of the Council and its designations process.

The Council's new supplemental guidance is effective immediately. In the future, the Council may consider other proposals for changes to the designations process that strengthen the Council's ability to identify and address potential risks to financial stability. For additional information on these changes, see the following documents:

Supplemental Procedures Relating to Nonbank Financial Company Determinations [LINK]

Frequently Asked Questions on Nonbank Designations (updated February 4, 2015) [LINK]

In addition to adopting the supplemental procedures described above, the Council voted to extend the deadline on its notice seeking public comment regarding potential risks to U.S. financial stability from asset management products and activities. Members of the public are encouraged to submit comments, and all comments provided to the Council will be available on www.regulations.gov. The deadline, which was extended by 30 days, is now March 25, 2015.

Further information regarding the Council is available at www.fsoc.gov.

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Treasury Notes

Treasury Brings Greater Clarity to the Credit Rating Process

By: Michael Stegman 2/5/2015

One of President Obama's key housing principles is to put private capital at the center of the housing finance system. To help advance that goal, Secretary Lew announced that Treasury would launch a Private Label Securities (PLS) initiative in June 2014 to help restart a responsible, sustainable, non-government guaranteed mortgage market.

Treasury sought public comments from investors, securitizers, market participants and stakeholders about the development of a responsible PLS market. Treasury also held a roundtable with institutional investors, and met with issuers, trustees, and due diligence firms to evaluate the most effective methods for ensuring investor protections, implementing necessary market reforms, and enforcing standards.

However, Treasury also recognized that the PLS market has been dormant since the financial crisis partly because of a "chicken-and-egg" phenomenon between rating agencies and originator-aggregators. Rating agencies will not rate mortgage pools without loan-level data, yet originator-aggregators will not originate pools of mortgage bonds without an idea of what it would take for the bond to receive a AAA rating.

Using our convening authority, Treasury invited six credit rating agencies to participate in an exercise over the last several months intended to provide market participants with greater transparency into their credit rating methodologies for residential mortgage loans.

By increasing clarity around loss expectations and required subordination levels for more diverse pools of collateral, the credit rating agencies can stimulate a constructive market dialogue around post-crisis underwriting and securitization practices and foster greater confidence in the credit rating process for private label mortgage-backed securities (MBS). The information obtained through this exercise may also give mortgage originators and aggregators greater insight into the potential economics of financing mortgage loans in the private label channel and the consequent implications for borrowing costs.

The development of a healthy and responsible PLS market is an important component of a reformed, safe, and sustainable housing finance system that will complement the enactment of comprehensive housing finance reform legislation consistent with the President's core principles released last August.

To view the exercise, click here.

Posted in: Housing

SOCIAL HUB

Treasury Notes Blog

Secretary Lew Sends Debt Limit Letter to Congress
Friday March 13, 2015

Today, Secretary Lew sent the following letter to Congress regarding the debt limit...

Working Together to Improve Cybersecurity
Wednesday March 11, 2015

- Social media privacy
- All social feeds

TREASURY FACTS

- The Treasury is the oldest departmental building in Washington and at the time of its completion, it was one of the largest office buildings in the world.

FEATURED VIDEO

Secretary Lew conversation on the economy

A discussion on the economy with Secretary Lew at the World Affairs Council of Northern California on February 19, 2014.

- Social media privacy

FEATURED PHOTO

April 14, 2014 - Secretary Lew and Ukrainian Finance Minister Oleksandr Shlapak met at Treasury and later participated in a signing ceremony for a...

- See more photos
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URBAN INSTITUTE

The Federal Housing Finance Agency's Federal Home Loan Bank Members Proposal Overshoots the Mark

Laurie Goodman[1], *Jim Parrott*[2] , *Karan Kaul*[3]

January 2015

On September 12, 2014, the Federal Housing Finance Agency (HFHA), primary regulator of the 12 Federal Home Loan Banks (FHLBs) and the 2 government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae, published a Notice of Proposed Rulemaking (NPR) that would significantly revise the requirements by which financial institutions can become and maintain their membership in the FHLB System ("System"). The NPR would alter several regulatory practices in the System, with substantial changes to membership eligibility requirements, and the manner in which financial institutions are approved for FHLB membership. Three key revisions to existing regulation would

1. require each FHLB member to hold at least 1 percent of total assets in first-lien home mortgage loans or securities backed by such loans ("1 percent rule");
2. require ongoing compliance with the 1 percent rule, as well as with the existing statutory requirement that depository institutions, except for community financial institutions (CFIs) with less than $1 billion in assets, hold at least 10 percent of total assets in residential mortgage loans or securities backed by such loans ("10 percent rule"); and
3. define "insurance company" to mean "a company whose primary business is the underwriting of insurance for non-affiliated persons or entities."

The third provision above would effectively prohibit captive insurance companies—whose primary business is to insure their parent companies—from becoming FHLB members. A few REITs—which are currently ineligible for FHLB membership—have recently established captive insurance subsidiaries for the purpose of obtaining access to FHLB advances. The FHFA has expressed concerns about this

[1] Laurie Goodman currently sits on the board of MFA Financial, Inc., a self-advised REIT
[2] Jim Parrott serves as a policy advisor to a REIT
[3] The authors submitted a comment letter with these same points to the FHFA on January 9, 2015.

practice, citing captive insurers' "safety and soundness" and other statutory provisions in the Federal Home Loan Bank Act as key drivers for promulgating this prohibition on captive insurers.

The proposed rule has received over one thousand comments, the vast majority from community banks, credit unions, and trade associations concerned about the effects of ongoing compliance with the 1 percent and 10 percent rules. In contrast, only a small number of comments have addressed the prohibition on captive insurers. Given the lack of attention this provision has received and because we believe a prohibition on captive insurers could significantly affect the mortgage market, we focus our comments exclusively on this aspect of the NPR. Our analysis is based primarily on economic and practical considerations of the rule; we do not analyze the legal issues.

To date, only a few REITs have accessed FHLB advances through captives, and current volumes are low. Without this proposed rule change, however, we believe that REITs' use of this funding source would gradually increase, which would in turn diversify and deepen liquidity in the secondary market. Ultimately, captives' access to FHLB advances would lower costs to borrowers and strengthen the housing finance system. Moreover, prohibiting captives from becoming FHLB members would not necessarily mitigate FHFA's safety and soundness concerns. To the extent such risks exist, they are low, and can be more effectively mitigated through existing regulatory and FHLB risk management practices.

Analysis

Prohibiting captive insurers from becoming FHLB members for safety and soundness reasons raises two basic questions:

1. Does the availability of FHLB advances for REIT captives benefit the FHLBs, their members, or the mortgage market more generally?
2. Can the FHFA's safety and soundness concerns about captives be adequately addressed without banning them from membership?

REIT Captives Support the Mission of FHLBs and Benefit the Larger Mortgage Market

REITS have deep mortgage market focus. According to Federal Reserve Flow of Funds data, mortgage REITs held approximately $545 billion in total assets as of Q3 2014.[4] Approximately $295 billion, or roughly 55 percent, of these assets was in the form of residential mortgages or securities backed by residential mortgages. Total mortgage assets—residential and commercial—composed over 85 percent of mortgage REITs' total assets as of the same period. These numbers are not surprising, given that REITs are required, by statute, to hold at least 75 percent of their assets in, and derive 75% of their

[4] Flow tables, *Financial Accounts of the United States, Third Quarter 2014,* Federal Reserve.

gross income from real estate related investments.[5] This almost-singular focus on the mortgage market ensures that REITs' and their captives' business practices and interests remain strongly aligned with the mission[6] of FHLBs—perhaps more so than those of many depository institution and insurance company members.

REITS support the underserved non-QM market. According to recent media reports and other public information,[7] some REITs are building capabilities to provide funding for loans that might not otherwise qualify for traditional financing, including loans that do not meet the qualified mortgage (QM) test. Origination of non-QM loans remains especially tight as lenders tread cautiously in the new "post-QM" lending environment, primarily worried about legal risks of lending outside of QM. This concern is greater for large banks, which face especially high scrutiny from shareholders, investors, regulators, policymakers, and the media, and which therefore may be less willing to originate such loans. The lack of liquidity for non-QM lending has essentially stranded a segment of borrowers who are not necessarily excessively risky. Many borrowers whose debt-to-income ratio exceeds the maximum allowed under QM have a considerable amount of existing equity and other assets, for example. Such people could include relatively low-risk borrowers who are self-employed, business owners or the recently retired, and wealthy borrowers with irregular income streams or temporarily high debt.

Many small lenders—most of which are FHLB members—would be willing to extend loans to these borrow-ers, where they present low to moderate risk, despite their falling outside of QM, because these lenders have closer relationships with their customers, are better equipped to perform manual underwriting, or for other reasons. What they lack is the financial backing to originate such loans at any scale without outside funding. Enter the REITs, which are looking for opportunities to boost their portfolio returns in the face of low returns on agency mortgage-backed securities (due to historically low interest rates) and a dwindling supply of non-agency mortgage-backed securities (MBS). To that end, REITs have established captives to become FHLB members and are building the capability and the operational infrastructure[8] to buy whole loans from originators—especially loans that don't qualify for traditional financing. This creates an entirely new source of funding, particularly useful for the underfunded non-QM segment of the market. While REITs are only starting to build the capability to buy and hold whole mortgage loans, their continued ability to access FHLB advances via captives could be critical to the long-term success of this platform.

[5] Pub. L. 86-779.

[6] According to the FHFA's "Strategic Plan: Fiscal Years 2015–2019," FHLBs' core mission is "to serve as a reliable source of liquidity for their member institutions in support of housing finance and community lending."

[7] Jody Shenn, "Pine River's Two Harbors Now Targets Non-Prime Mortgages," Bloomberg.com, November 5, 2014; and Jody Shenn, "Mortgage REIT Redwood Joins Home Lome Bank in Chicago," Bloomberg.com, June 12, 2014.

[8] See the "Mortgage Market Opportunity" section on page 2 of Two Harbors Investment's (a mortgage REIT) Third Quarter 2014 Fact Sheet.

Banning Captives from the FHLB System Will Adversely Affect the Mortgage Market and the FHLBs

Access to FHLB advances diversifies REIT funding sources, provides reliable longer-term financing, and benefits the mortgage market. The recent move by several REITs to set up captives in order to access FHLB advances is not surprising given the funding limitations they face in the market. REITs depend heavily on repurchase agreements (repos)—a form of collateralized short-term borrowing, facilitated primarily by Wall Street broker-dealers, which must be rolled over (refinanced) frequently. This allows REITs to leverage agency MBS assets to seven-to-eight times their capital. But it also exposes them to the risk that repo lenders, when concerned about the value of collateral (which happens frequently during market turmoil), will demand a higher interest rate, apply a larger haircut to their valuation of the collateral, or curtail lending altogether. The resulting "pinch" can significantly and sometimes dramatically increase repo funding costs, or decrease the availability of credit lines, making it difficult for repo-reliant borrowers—such as REITs—to obtain new financing or roll over existing repos. While it appears unlikely that the idiosyncratic failure of a single REIT will pose systemic risks, implications for mortgage market liquidity certainly exist if there was a considerable amount of forced selling of MBS as a result of repo market tightening. Therefore concerns about the stability of repo financing,[9] further compounded by increased bank capital requirements,[10] have naturally, and in our view usefully, pushed many REITs to try to diversify their financing sources and access longer-term financing by setting up captives to access FHLB advances. Eventually, this also improves systemic financial stability by reducing the role of repos in transmitting financial shocks.

REITs provide liquidity and funding to the mortgage market. REITs also play a major role in absorbing the supply of MBS and in containing mortgage rates for borrowers (see figure 1)—a role that will only become more important as the Fed and Treasury begin to ease out of the market.[11] Since part of FHLBs' mission is to provide liquidity to their member institutions in support of housing finance, providing a more stable funding channel for captives of REITs is entirely in keeping with that mission. While obtaining FHLB advances via captives is still a new trend and accounts for only a small share of REIT funding, it is nevertheless a valuable funding conduit that should be preserved and expanded as a reliable source of funding for nontraditional mortgages. While all funding sources will undoubtedly shrink during downturns, we believe FHLB advances, because they are longer term in nature, should be less volatile than the broker-dealer facilitated repo market.

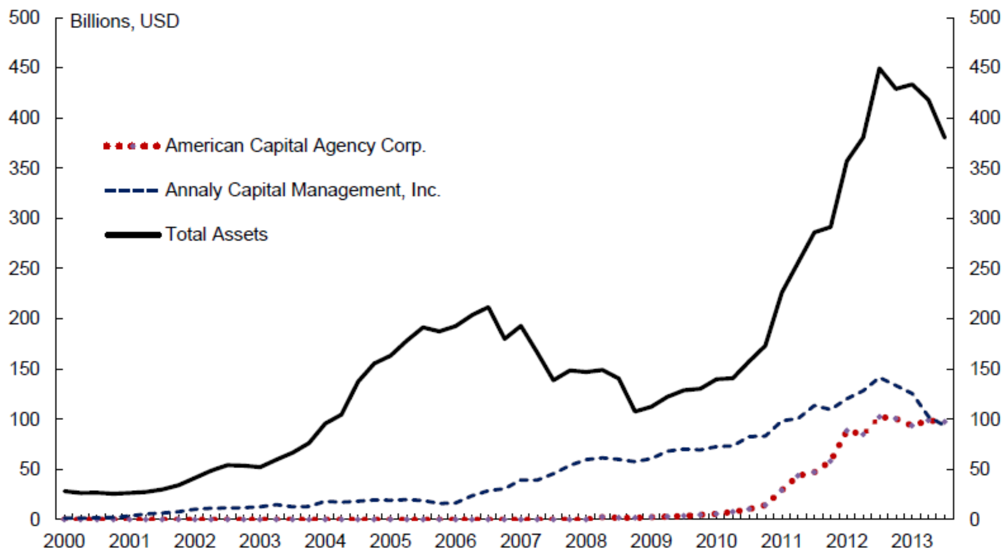
[9] See Zoltan Pozsar, "Shadow Banking: The Money View," Working Paper 2014-04 (Washington, DC: US Treasury, Office of Financial Research, 2014).

[10] Liz Capo McCormick, "Repo Market Contracts as Dealers Face More Capital Requirements," Bloomberg.com, July 25, 2013.

[11] See Michael Fratantoni, "Who Will Own Mortgage Assets?" (Washington, DC: Mortgage Bankers Association, 2014).

FIGURE 1

Total Assets for All Mortgage REITs and the Largest Two, 2000–13



Source: Sabrina R. Pellerin, Steven Sabol, and John R. Walter, "REITs and Their Risks," working paper 13-19R (Richmond, VA: Federal Reserve Bank of Richmond, revised December 2013).

REIT captives' access to FHLB advances creates positive externalities for FHLBs and their members.

Membership diversification. REIT captives allow FHLBs to grow and diversify their membership base beyond traditional channels. A more diversified member base should result in a more stable capital position for FHLBs, which should in turn improve their resilience to economic and market shocks. For example, when depository institutions experience an influx of deposits that reduces their demand for advances, REIT-affiliated captive members could be experiencing different market conditions, and could thus act as a complimentary source of demand for advances. Therefore, when assessing the risks posed by REIT captives to FHLBs, the FHFA should not only consider the individual riskiness of REITs' or their captives' businesses, but also evaluate how those risks might correlate with risks posed by other member types. A more diversified risk base should reduce the overall risk profile of FHLBs.

Support for small lenders. REITs have proven expertise in managing real estate investment risks, and, as discussed in the previous section, they could serve as an investor "take-out" for certain mortgages originated by smaller lenders, who often lack a direct line to capital markets. A steady source of REIT funding could also incentivize small lenders to originate more loans or grow volumes, which should in turn increase their profits.

High quality collateral. The vast majority of mortgage REITs' residential mortgage assets are in the form of MBS that are either implicitly or explicitly guaranteed by the US government and are therefore free from credit risk. To the extent REIT captives predominantly pledge these risk-free securities as collateral for FHLB advances, that should further reduce credit risks of the FHLBs.

Unintended consequences possible with overbroad prohibition on captives. Some captive insurers—including non-REIT captives—have been FHLB members in good standing for many years, and have built reliable mortgage origination and servicing capabilities that cater to specific needs of borrowers in small towns and rural areas. Because this NPR would ban all captives, not just captives of REITs, the rule could have unintended consequences for borrowers and businesses in these communities. While we would share a concern about non-mission related captives accessing advances in the future, we also believe those can be addressed more narrowly, without banning all captives.

Current Risks Posed by Captives Are Low; Future Risks Can Be Managed without a Ban

The FHFA's stated safety and soundness concerns pertaining to captives largely stem from (1) limited availability of captives' financial information, (2) potential deterioration of captives' financial condition because of parents' actions, and (3) relatively non-diversified underwriting risk on captives' balance sheets. These are legitimate concerns for any regulator and must not be overlooked. However, as discussed below, risks posed by captives to FHLBs are currently low. The FHFA's concerns about risks rising over time—especially if captives increase their reliance on advances— can be managed through existing FHLB regulatory and supervisory practices with some minor adjustments.

FHLBs' overall exposure to captive insurers is small. Of the total $540 billion[12] in FHLB advances as of September 30, 2014, only $67 billion, or 12 percent, was outstanding to insurance companies (including captives). Additionally, only 129 of the roughly 4,400 FHLB member borrowers, or just 3 percent, were insurance companies as of the same date. While specific data for captive insurer members are not available publicly, anecdotal evidence suggests that captives are a fraction of FHLBs' total insurer members, currently fewer than 20 members systemwide. This suggests that FHLBs' risk exposure to captive insurers is very small. Even if this exposure (and the resulting risk) were to grow over time, we believe FHLBs are well equipped to mitigate those risks effectively.

FHLBs can manage current and future risks using existing tools. FHLBs have wide latitude in determining the appropriate level of overcollateralization and credit limit for each member borrower based on several criteria. These criteria include member financial condition, credit ratings, quality of collateral pledged, method of pledging collateral, and a FHLB's existing exposure to a member.[13] As an example FHLBs are more likely to take physical possession of collateral when lending to insurance companies (as opposed to a written agreement without any collateral transfer when lending to financially strong banks). Likewise, FHLBs may require insurance companies to pledge more collateral

[12] *Federal Home Loan Banks Combined Financial Report for Quarter Ended September 30, 2014* (Washington, DC: FHLB Office of Finance, 2014).
[13] "Federal Home Loan Banks Lending and Collateral Q&A" (Washington, DC: FHLB Office of Finance, 2014).

for advances than they might require from banks, primarily because of state-level legal uncertainty surrounding claim priority in the event of insurer insolvency. The key point here is that FHLBs have multiple tools in their existing toolkit to manage the kinds of risks described by the FHFA. We believe these existing mechanisms, with minor adjustments, can mitigate these risks effectively.

Strengthening membership approval process for insurers will address many concerns. Concerns about the availability of captive (or parent) financial information appear to be largely rooted in the current regulatory requirement of approving insurers as long as they meet certain minimum capital standards, verified primarily through regulatory filings.[14] In contrast, depository institution applicants undergo a much more rigorous approval process that includes reviews of multiple information sources, such as current and prior regulatory financial reports, audited GAAP financial statements, regulatory exam reports, and outstanding enforcement actions.[15] Consequently, we agree with the FHFA's proposal to strengthen the approval process for insurers (including captives) by requiring FHLBs to review insurer applicants' audited financial statements. To allay further concerns about any adverse impact of parents' financial condition on captives, FHLBs could also require captives to furnish parents' detailed financial and related information. Or, to reduce regulatory burdens, FHLBs could rely on examination and enforcement reports published by State Insurance Commissioners.

Conclusion: FHFA should consider other less invasive alternatives to mitigate its concerns

Whatever legal, regulatory, and supervisory justifications the FHFA might have for prohibiting captive insurers, we urge the Agency to take a more integrated view of the purpose REITs serve within the broader mortgage market, and how captive insurers facilitate that purpose. Financial regulation must strike the right balance between ensuring safety and soundness, and promoting market efficiency. We believe the NPR goes too far by constricting an important development that meets the needs of a changing market, in a way that does not necessarily improve safety and soundness. Therefore, we recommend that FHFA consider the following alternatives to address its concerns:

1. FHLBs have the flexibility to apply higher haircuts to collateral from captives that might pose a greater risk, or to charge a higher interest rate on advances. The FHLBs have not done so yet, but these tools are available. FHLBs' current limits on aggregate borrowing at the member level should also mitigate concerns about risk.

2. FHFA could require FHLBs to review captives' regulatory exam reports and any outstanding enforcement actions brought by State Insurance Commissioners, as well as parents' audited financial information (GAAP or statutory), and any legal actions related to the parents.

[14] §12 CFR 1263.16 - Financial condition requirement for insurance company and certain CDFI applicants.
[15] §12 CFR 1263.11 - Financial condition requirement for depository institutions and CDFI credit unions.

3. Where the FHFA is concerned about future captive members abusing the system (such as using FHLB advances for purposes that are not mission related), the Agency could address such issues more narrowly. As one option, the FHFA could work with FHLBs to create "common eligibility criteria" for approving captive insurer member applications, limiting approval to captives whose business is mission related. This will ensure that captives that are deservedly ineligible for membership in one FHLB district are unable to apply for membership in other districts that might seem more welcoming.

4. Recognizing the ongoing role REITs play in the mortgage market, the FHFA may want to work with Congress to amend the statute and allow REITs to become FHLB members directly, without the need for captives.

About the Authors

Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analysis of housing finance policy issues that they can depend on for relevance, accuracy, and independence.

Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, a boutique broker/dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of Global Fixed Income Research and Manager of US Securitized Products Research at UBS and predecessor firms, which was ranked first by *Institutional Investor* for 11 straight years. She has also held positions as a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York.

Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. She serves on the board of directors of MFA Financial and is a member of the Bipartisan Policy Center's Housing Commission, the Federal Reserve Bank of New York's Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. She has published more than 200 articles in professional and academic journals, and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and a MA and PhD in economics from Stanford University.

Jim Parrott is a senior fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. Jim spent several years in the White House as a Senior Advisor at the National Economic Council (NEC), where he led the team of advisors charged with counseling the cabinet and President on housing issues. He was on point for developing the Administration's major housing policy positions, articulating and defending those positions with Congress, the press and public, and counseling White House leadership on related communications and legislative strategy. Prior to his time with the NEC, Jim was a senior advisor to Secretary Donovan at the Department of Housing and Urban Development. He has a J.D. from Columbia University School of Law, an M.A. from the University of Washington and a B.A. from the University of North Carolina.

Karan Kaul is a Research Associate at the Housing Finance Policy Center, focused on researching topical housing finance issues to highlight the market impact of ongoing regulatory, industry and related developments. He is also responsible for monitoring and reporting on mortgage market trends and current events on a weekly basis. Prior to the Urban Institute, Karan was with Freddie Mac for five years, where he worked on a variety of housing policy issues primarily related to the future of housing finance and GSE Reform. He brings a deep understanding of key reform issues, political landscape surrounding reform, and pros and cons of different approaches concerning their impact on mortgage rates, credit availability, private capital etc. Prior to Freddie Mac, Kaul worked as a research analyst covering financial institutions. He holds a Bachelors degree in Electrical Engineering and an MBA from the University of Maryland College Park.

ABOUT THE URBAN INSTITUTE

The nonprofit Urban Institute is dedicated to elevating the debate on social and economic policy. For nearly five decades, Urban scholars have conducted research and offered evidence-based solutions that improve lives and strengthen communities across a rapidly urbanizing world. Their objective research helps expand opportunities for all, reduce hardship among the most vulnerable, and strengthen the effectiveness of the public sector.

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Office/Mixed Use REITs Roundtable Meeting

Wednesday, April 1st
11:15am – 12:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Tyler Rose, EVP & CFO, Kilroy Realty Corporation
Pamela Roper, SVP-General Counsel & Corporate Secretary

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REITs: BUILDING DIVIDENDS AND DIVERSIFICATION®

AGENDA

REITWISE

REITWISE OFFICE/MIXED USE ROUNDTABLE

April 1, 2015
11:15 am – 12:30 pm
Phoenix, Arizona

Discussion Leaders:

Pamela Roper, SVP, General Counsel & Corporate Secretary, Cousins Properties
Tyler Rose, EVP & CFO, Kilroy Realty Corporation

I. Evolution of Tenant Space Needs

A. Are different markets experiencing different trends
B. What is being said vs. what is being done
C. Teleconferencing/hoteling/densification

II. Impact of Technology

A. Is new technology driving space needs
B. Internal developments: platforms like Yardi/J.D. Edwards/MRI

III. ATM Disclosures and Capital Trends

A. When to disclose; note Citi pushing for more disclosure
B. Trends in secured and unsecured financing

IV. Supply/Demand Equation

A. How are the different markets impacted by the recovery
B. Which tenants are growing/which disappearing

V. Sustainability Issues

A. How are different product types dealing with sustainability issues
B. How important are high GRESB rankings

VI. Social Media

A. How important is it in this sector
B. Use for customers
C. Any concerns

VII. Compensation Issues

♦ ♦ ♦

Public Non-Listed REITs Roundtable Meeting

Wednesday, April 1st
9:45am – 11am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Peter Fass, Partner, Proskauer Rose LLP
Sharon Kroupa, Partner, Venable LLP
Kevin Shields, Chairman & CEO, Griffin Capital Essential Asset REIT, Inc.

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AGENDA

REITWISE ROUNDTABLE: PUBLIC NON-LISTED REITS

Wednesday, April 1, 2015
9:45 am – 11:00 am

Discussion Leaders:

Peter Fass, Partner, Proskauer Rose LLP
Sharon Kroupa, Partner, Venable LLP
Kevin Shields, Chairman & CEO, Griffin Capital Corporation

I. FINRA RN §15-02

A. How will industry comply?
B. What will industry do about share class design?
C. What is likely impact on capital flows into PNLRs?

II. Liquidity Events

A. What have we learned?
   1. stand-alone listing with and without tender offer
   2. sale
   3. merger
B. Process and director duties; is a special committee necessary?

III. Department of Labor Re-proposal to Expand Fiduciary Obligations of Advisors under ERISA

A. What is industry saying about potential impact?
B. What is the impact of the recent White House statements?
C. What are the industry's best arguments against this proposal?

IV. Becoming a PNLR

A. Is the cost of entry too high?

V. Moving From PNLR to Publicly Traded Space

A. How and when should the company's charter be amended? What is an acceptable governance structure if listing?

VI. North American Securities Administrators Association Proposed Revisions to Guidelines for REIT Offerings

A. Effect of a 10% of net worth concentration limit

♦ ♦ ♦

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.reit.com

April 14, 2014

Hon. Mary Jo White, Chair
Hon. Luis A. Aguilar, Commissioner
Hon. Daniel M. Gallagher, Commissioner
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Section 913 Fiduciary Rulemaking – Evidence of Investor Harm

Dear Chair White and Commissioners:

We were encouraged to hear that Chair White expects the Securities and Exchange Commission (SEC or Commission) to make a threshold decision regarding whether the Commission will move forward with a rulemaking, pursuant to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), by the end of the year. As you know, Section 913 authorized the SEC to adopt a rule to require all professionals who provide personalized investment advice to retail customers to do so under a fiduciary standard of care that is no less stringent than the existing standard under the Investment Advisers Act of 1940 (Advisers Act). The undersigned organizations continue to advocate for such a rulemaking and to urge the SEC to move forward expeditiously with a rulemaking consistent with Section 913.

When the SEC issued a Request for Information (RFI) last year seeking data related to the cost and benefits of extending a fiduciary rule to broker-dealers, each signatory of this letter submitted a response. Through those responses, the undersigned organizations provided data and stated support for extending the fiduciary standard of care as the necessary step to better protect investors. Though we will not repeat all of those arguments here, we strongly believe that in order to be meaningful and consistent with Section 913, a uniform fiduciary rule must include more than the current suitability standard supplemented by additional disclosure requirements.

Despite the broad support for rulemaking, some have questioned whether there is evidence of harm to investors that would justify the adoption of a uniform fiduciary standard. After all, they assert, the suitability standard that applies to broker-dealer recommendations affords investors significant protections. For example, it requires brokers to make recommendations that are generally appropriate for their customer based on knowledge of their customer's financial situation. Designed with a sales relationship in mind, however, the suitability standard *does not* impose the same clear obligation that exists under a fiduciary standard, which requires the adviser to put the customer's interest first. Moreover, the suitability standard does not impose an obligation on brokers to appropriately manage conflicts of interest in order to ensure that they do not influence recommendations. These are among the standards that distinguish a suitability relationship from a fiduciary relationship.

While the harm to investors of this two-tiered regulatory scheme may be difficult to quantify, it is nonetheless real and, we believe, pervasive. It directly affects the ability of many middle-income Americans to accumulate funds adequate for their retirement needs and other long-term financial goals. Evidence of the harm to investors from the lack of a uniform fiduciary standard comes in a variety of forms, including observations of industry practices, academic studies, and basic market analysis. First and foremost, however, evidence of this harm is found in the difference between recommendations that satisfy a suitability standard and those that are designed to serve the best interests of the investor. Second, evidence of investor harm is found in the adverse effect that unchecked conflicts of interest have on recommendations. And finally, evidence of harm is found in the effects of a market where investment products compete to be sold rather than bought.

By aggregating a number of examples that appear in the public record, this letter details the harm to investors under a suitability standard that a fiduciary standard consistent with Section 913 of the Dodd-Frank Act would help to ameliorate. Such a rulemaking should ensure that all those who provide personalized investment advice to retail clients have an affirmative fiduciary obligation to act in their clients' best interest and to minimize and appropriately manage conflicts of interest that could impede their ability to do so. In addition, we further explain why disclosure alone or disclosure combined with investor education does not offer an adequate solution. Finally, we provide additional evidence to counter assertions that imposition of a fiduciary standard would itself harm investors by limiting their access to affordable investment services.

Investor Harm as a Result of Investment Recommendations That Are Suitable But Not in the Investor's Best Interest

When examining the range of investment options that brokers and investment advisers might recommend to retail investors – i.e., a particular class of mutual funds or variable annuities – the vast differences in the features of these investment products becomes readily apparent. For example, otherwise similar products may impose different fees on the investor, or achieve comparable investment results with significant differences in volatility, or provide different guarantees, or, in the case of variable annuities, offer the investor a greater or lesser degree of choice among underlying investment options that are of varying quality.

Although all of the options within a particular category may be deemed suitable for a particular investor, these differences in features can profoundly impact costs, risks and overall performance. Investors are harmed when they are encouraged to pay excessive fees, receive substandard performance, or are exposed to unnecessary risks because a broker recommended an investment that, while suitable, was inferior to other available options. This harm could be remedied, or at least ameliorated, by requiring brokers to provide services under a fiduciary standard.

The suitability standard allows for the sale of high-cost investments that erode investors' long-term gains

The most readily observable impact of investor harm resulting from the lack of a uniform fiduciary standard arises out of the significantly different costs imposed by otherwise similar investments. Consumer Federation of America (CFA) addressed this issue in a comment letter responding to the Commission's RFI.[1] CFA examined Morningstar data for S&P 500 index funds to determine the impact of costs on otherwise similar investments. CFA chose this type of fund to analyze because it offers a clear example that any increase in investor fees comes directly out of investment performance without offering any added benefits to compensate for those increased costs. Based on its examination of the Morningstar data, CFA found evidence of thriving cost competition among direct-marketed funds, with investor assets heavily concentrated in a handful of very low-cost options. In contrast, administrative costs for broker-sold S&P 500 index funds held outside of retirement plans were often significantly higher than those of direct-sold funds, even after the cost of compensating the broker was excluded. Moreover, in several cases cited by CFA, customers of major brokerage firms paid sales loads of as much as 5.25 percent in order to purchase an S&P 500 index fund that has an expense ratio roughly ten times or even twenty times as high as the expense ratio of the lowest-cost direct-marketed fund. Far from adding value, the recommendation of a broker, in this case at least, merely added to the already excessive cost.

There is nothing inherently more expensive about operating a broker-sold S&P 500 index fund than a direct-marketed fund (other than the cost of compensating the broker, which CFA subtracted from the administrative fee for the purposes of its analysis). The logical conclusion, therefore, is that the higher fees in broker-sold funds reflect a market where competition is based primarily on factors other than cost. Given the singular role that reducing costs plays in determining performance in index funds, there is every reason to believe that this lack of cost competition has the same impact on the sale of other types of investment products that can be sold on the basis of features other than cost alone. As noted by Dr. Michael Finke in the Investment Management Consultants Association (IMCA) comment letter,[2] this lack of cost competition among broker-sold funds, as is permitted under the suitability standard, may help to explain why broker-recommended mutual funds significantly underperform direct-sold funds more commonly recommended by investment advisers operating under a fiduciary standard.

Excess fees paid by investors who invest based on the recommendation of a broker can have a significant impact on the long-term savings of investors. As the Commission warned in a

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[1] See letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to the SEC in response to the request for comments on the "Duties of Brokers, Dealers, and Investment Advisers," July 5, 2013, pp 25-25, *available at* http://www.sec.gov/comments/4-606/4606-3119.pdf.
[2] Dr. Michael Finke, "Fiduciary Standard: Findings from Academic Literature," attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," *available at* http://www.sec.gov/comments/4-606/4606-3121.pdf (hereinafter "Finke Study").

recent bulletin for investors, "[o]ver time, even ongoing fees that are small can have a big impact on your investment portfolio," reducing returns, shrinking a nest egg, and preventing investors from achieving financial goals.[3] This impact was illustrated in an October 2013 Bloomberg Markets Magazine report on data filed with the SEC which showed that "89 percent of the $11.51 billion of gains in 63 managed-futures funds went to fees, commissions, and expenses during the decade from Jan. 1, 2003 to Dec. 31, 2012."[4] Brokers have an incentive to keep clients in managed-futures funds because they receive annual commissions of up to 4 percent of assets invested and investors pay as much as 9 percent in total fees each year.[5]

The Department of Labor (DOL) illustrates the harm associated with fees that accompany non-fiduciary, suitability-based advice this way: "Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent."[6] If anything, the SEC and DOL examples understate the harmful impact on investors of excessive fees, since they feature only one of the several cost differences among investments commonly sold to retail investors.

<u>The suitability standard allows brokers to sell products with other substandard features</u>

While they may be the most easily quantifiable, excessive costs are not the only concern associated with advice delivered under a suitability standard. In its comment letter, CFA used ratings of variable annuities by Weiss Ratings[7] to help illustrate how factors beyond costs could be affected by a best interest standard, such as the availability of choice and performance. In rating variable annuities, Weiss assesses a number of factors in addition to cost, including both the availability of a wide selection of mutual fund subaccounts with good performance and the financial strength of the insurance company issuing the annuity. In describing the basis for arriving at its recently issued 10-best list, Weiss explained that "mutual fund subaccount performance played an important role in the selection process. After all, a variable annuity can have low costs and a strong Financial Strength Rating, while at the same time offering only mediocre fund performance."[8]

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[3] U.S. Securities and Exchange Commission Investor Bulletin: "How Fees and Expenses Affect Your Investment Portfolio," February 19, 2014, *available at* http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-how-fees-expenses-affect-your-investment-portfolio#.UxpflfldVKg

[4] David Evans, "How Investors Lose 89 Percent of Gains from Futures Funds," Bloomberg Markets Magazine, Oct. 7, 2013, *available at* http://www.bloomberg.com/news/print/2013-10-07/how-investors-lose-89-percent-of-gains-from-futures-funds.html.

[5] *Id.*

[6] U.S. Department of Labor, "A Look at 401(k) Plan Fees," August 2013, *available at* http://www.dol.gov/ebsa/publications/401k_employee.html.

[7] See Weiss Ratings Best and Worst Variable Annuities, *available at* http://weissratings.com/ratings/best-and-worst variable-annuities.aspx.

[8] *Id*.

Lack of fund choice and high surrender fees were also significant factors in determining which annuities ended up on Weiss's 10-worst list. In its comment letter, CFA questioned how some of the funds on the 10-worst list could even exist in a truly competitive market. For example, the list includes two annuities that offer a single fund option (described by Weiss as "weak"), impose high surrender fees, and have high total expenses, including a mortality and expense risk charge (M&E fee) many times higher than other available funds. While these annuities may be deemed to be suitable for an investor, a financial professional subject to a fiduciary duty would find it difficult to defend a recommendation of one of these funds as being in the best interest of the investor.

<u>Financial advisers are more likely to target less sophisticated and less affluent investors with products that are higher-cost or otherwise substandard</u>

IMCA commissioned Dr. Michael Finke, a professor at Texas Tech University, to conduct an in-depth literature review that provides data and other information addressing specific questions related to the benefits and costs resulting from the application of a fiduciary standard of care to the conduct of brokers, dealers and investment advisers.[9] Dr. Finke reviewed a number of academic studies related to the potential benefits to consumers of a fiduciary standard, including studies showing that less sophisticated and less wealthy investors are most likely to suffer the harmful consequences of recommendations that are not based on the best interest of the investor:

- A 2012 study found that commission-compensated insurance agents "will consistently recommend higher commission products to less sophisticated consumers, leading to welfare losses that are greatest among those who can least afford to sustain them."[10]

- An earlier study similarly examined financial firms' "incentive to shroud attributes."[11] The researchers described how producers "will rationally segment the market by level of investor sophistication," with less efficient, more opaque products created to "maximize economic rents from less sophisticated consumers" while more competitive products are simultaneously offered to sophisticated consumers. "Examples of product differentiation through opaque characteristics are evident in the mutual fund market."

- Another study cited by Dr. Finke describes how fund companies use different tactics to attract "less sophisticated investors, who fund families attract through marketing, and more sophisticated, direct-channel investors who are targeted through higher performance."[12]

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[9] See Finke Study.
[10] Finke Study at 6 (citing S. Anagol, S. and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," American Economic Review, 102(1): 576-593).
[11] Finke Study at 7 (citing X. Gabaix and D. Laibson, 2006, "Shrouded attributes, consumer myopia, and information suppression in competitive markets," Quarterly Journal of Economics, 121(2), 505-540).
[12] Finke Study at 7 (citing N.M. Stoughton, Y. Wu and J. Zechner, 2011, "Intermediated investment management," The Journal of Finance, 66(3), 947-980).

- This is consistent, Dr. Finke suggests, with evidence from a separate academic study "that successful mutual funds appear either to gain market share through lower expenses or by increasing opaque fees which are then used to incent advisor recommendations."[13]

- Finally, Dr. Finke cites research suggesting that the "latitude of recommendation quality allowed in a suitability model is particularly troubling when clients are older and have experienced cognitive decline that may reduce their ability to perceive self-serving recommendations."[14]

In other words, while opposition to fiduciary rulemaking is often presented as being motivated by concern over the well-being of middle-income investors, the academic literature strongly suggests that it is precisely these less wealthy, often less sophisticated investors who are most at risk from harmful practices permitted under a suitability standard.

<u>A fiduciary standard affords investors legal protections not available under a suitability standard with regard to an adviser's ongoing duty of care</u>

Under a suitability standard, investors are harmed because a broker has no duty to monitor or revise a recommendation, even when the client's circumstances have changed. In its response to the SEC's RFI, the Public Investors Arbitration Bar Association (PIABA), whose members represent individual investors in resolving complaints with brokers, highlighted several examples of the how the fiduciary standard protects investors seeking recourse in ways that a simple suitability standard does not.[15]

Using specific examples, PIABA illustrates how investors can be better protected with a fiduciary standard that requires advisers to: (i) update investment recommendations when a client's personal circumstances change, (ii) review existing investments when a customer changes advisers and provide advice regarding the appropriateness of the investments, and (iii) inform investors of new information that comes to the adviser's attention that impacts that investment's risk profile.

Among the most significant differences in the legal accountability for brokers and advisers is that investment advisers are held to an ongoing fiduciary duty to act in the best interests of their clients. By contrast, most brokers contend, and courts generally agree, that their duties begin and end with the securities transaction.[16] Imposing a fiduciary duty on broker-dealers would better protect investors by limiting the circumstances in which brokers' can argue that, among other things, the investor was negligent or was sophisticated enough to understand

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[13] Finke Study at 7 (citing A. Khorana and H. Servaes, 2012, "What drives market share in the mutual fund industry?" Review of Finance, 16, 81-113).
[14] Finke Study at 6 (citing M.S. Finke and T. Langdon, 2012, "The impact of a broker-dealer fiduciary standard on financial advice," Journal of Financial Planning, 25(7), 28-37).
[15] See letter from Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, July 3, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," *available at* http://www.sec.gov/comments/4-606/4606-3107.pdf.
[16] *See In de Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1303 (2d Cir. 2002). Whether imposition of a fiduciary duty on broker-dealers would address this difference will turn on how the Commission applies the ongoing duty of care in instances where the broker is providing ongoing advice.

the transaction(s) or had ratified the transaction(s) or was estopped from bringing claims or had failed to mitigate his or her damages.

Financial Incentives Often Cause Brokers to Make Recommendations That Are Not in the Customer's Best Interest

Under the suitability standard, a broker-dealer is free to recommend the security that pays the broker-dealer the highest compensation, so long as it is otherwise appropriate for the investor. As the Financial Industry Regulatory Authority (FINRA) noted in its October 2013 Report on Conflicts of Interest, such conflicts "are widespread across the financial services industry."[17] The report goes on to state, "[w]hile the existence of a conflict does not, per se, imply that harm to one party's interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly."[18] In a comment letter to the Commission, Massachusetts Secretary of the Commonwealth William Galvin, the state securities regulator, suggested he was stating the obvious when he pointed out that a broker's recommendations can be influenced by how they are compensated:

> "It is a truism that many of the riskiest investments pay the highest selling compensation. Too often, brokers, who are subject to sharp conflicts of interest, recommend high-commission alternative products that carry inappropriate levels of investment risk, detrimentally high costs, and/or expose investors to factors such as illiquidity or price volatility."[19]

It is significant that those who are on the front line of enforcing the securities laws see a direct connection between conflict-inducing broker-dealer compensation and practices that result in harm to investors. This occurs because broker-dealers are not required to place their client's interest above their own.

Recent media accounts also provide evidence of the significant pressure brokers may be under from their employers to sell proprietary products regardless of the investor's best interests. This is illustrated, for example, by a recent *New York Times* article on J.P. Morgan's aggressive tactics aimed at pushing the sale of in-house products.[20] According to the article, several advisers who resisted the pressure to sell the firm's proprietary products said "they were told to change their tactics or be pushed out." As the article notes, while the promotion of in-house products is not illegal, the concern is that, "driven by fees, banks will push their own products over lower-cost options with stronger returns." Moreover, at least one former J.P. Morgan broker

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[17] FINRA, "Report on Conflicts of Interest," October 2013, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf
[18] *Id.*
[19] See letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, Boston, Massachusetts, June 27, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," available at http://www.sec.gov/comments/4-606/4606-3088.pdf.
[20] Susanne Craig and Jessica Silver-Greenberg, "Selling the Home Brand: A Look Inside an Elite JPMorgan Unit," The New York Times, March 2, 2013, accessed at http://dealbook.nytimes.com/2013/03/02/selling-the-home-brand-a-look-inside-an-elite-jpmorgan-unit-

left the firm because he did not feel that the firm's policy on selling in-house products allowed him to do what was best for his customers.

Similarly, a recent *Investment News* article noted that MetLife had increased both its minimum production limits for its sales force (by 50 percent) and the percentage of that minimum that must come from the sale of proprietary products (two-thirds).[21] Although the sale of proprietary products or a limited range of products may not, in and of itself, violate a fiduciary duty, it can create a clear conflict of interest with the potential to inflict considerable harm on investors.

This potential harm to investors is evidenced in a Government Accountability Office (GAO) analysis of 401(k) roll-over recommendations by the major call centers. GAO found considerable evidence of questionable practices that appear to be the result, at least in part, of conflicts of interest.[22] Among other things, GAO found that call centers (i) provided questionable information to investors about the benefits of various options available to them and (ii) directly undercut their own 401(k) plans in order to move individuals into Individual Retirement Accounts (IRA). The financial incentives for firms to undercut their own 401(k) plans are significant since roll-overs provide the primary source of money flowing into IRAs. Among its more specific findings, the GAO study noted:

- Financial advisors "encouraged rolling 401(k) plan savings into an IRA even with only minimal knowledge of a caller's financial situation."

- Representatives claimed that 401(k) plans had extra fees and that IRAs "had no fees," or argued that IRAs were always less expensive, notwithstanding the fact that opposite is generally true. IRAs are more expensive for investors, on average, than 401(k) plans.

- Misleading statements made it difficult for investors to understand IRA fees. For example, a GAO investigator called a number of 401(k) plan service providers, most of which offer IRA products, and found that 7 of 30 call center representatives (representing firms administering at least 34 percent of IRA assets at the end of the 1st quarter of 2011) said that their IRAs were 'free or had no fees with a minimum balance,' without clearly explaining that investment, transaction, and other fees could still apply, depending on investment decisions. In the GAO's review of 10 IRA websites, investigators found 5 providers that made similar claims, often with certain conditions such as a $50,000 minimum balance or consent to receive electronic statements explained separately in footnotes.

Numerous additional examples exist in academic research illustrating the pernicious effect that conflicts of interest can and do have on the recommendations of transaction-

[21] Darla Mercado," Under new structure, fewer MetLife advisers pushed to produce more," October 25, 2013, accessed at http://www.investmentnews.com/article/20131025/FREE/131029914?utm_source=issuealert-20131027&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text#
[22] Labor and IRS Could Improve the Rollover Process for Participants, Government Accountability Office, GAO-13-30 (March 2013) ("GAO Report") available at http://www.gao.gov/assets/660/653506.txt.

compensated salespeople. For example, in 2009, Professors Michael Finke and Sandra Huston[23] designed a study to measure the adequacy of life insurance coverage for consumers who used a financial planner versus those who used a broker.[24] The study found that "[c]onsistent with agency theory, the use of financial intermediaries who have the strongest fiduciary duty toward a household is associated with holding life insurance at or above the adequacy threshold. Even though households who employ brokers are demographically similar to those who rely on financial planners, the lack of contracting incentive among brokers … may reduce their willingness to recommend financial products that are substitutes for those that provide direct compensation. In other words, households that obtain life insurance using intermediaries who operate under a fiduciary duty (i.e., financial planners) tend to have a more adequate level of insurance than households that use non-fiduciary intermediaries (i.e., broker-dealers).

A 2012 study by the National Bureau of Economic Research sent mock investors with one of four different portfolios (all cash, index funds, a large position in company stock, and a large position in sector funds) to get portfolio recommendations from financial advisors compensated through product sales.[25] The study found that, because these financial professionals were compensated through product sales, they favored recommendations that provided greater remuneration over recommendations that "were objectively optimal." When advisers mentioned fees, they did so in a way that downplayed them without lying. For example, they often used arguments such as, "[t]his fund has 2% fee but that is not much above industry average."

Despite the data demonstrating the harm to investors as a result of higher fees in connection with transaction-compensated salespeople, one might expect that investors who rely on financial professionals would be less prone than those investing on their own to engage in self-destructive practices, such as chasing returns. On the contrary, Dr. Finke's analysis of the academic literature suggests that the "lack of a fiduciary standard of care coupled with contracting incentives can also encourage advisers to cater to, and perhaps amplify, welfare-reducing investor biases."[26]

Dr. Finke cites research that shows investors' tendency to chase returns in mutual funds leads them to underperform average market returns by 1.56% per year, since they tend to buy overvalued sectors after prices have risen and to sell following a market decline. Researchers found that "this underperformance was significantly greater in commission funds, perhaps because advisors benefitted from acceding to investor demands to buy and sell funds at a greater frequency."[27] A separate, more recent study finds that "commission-compensated insurance

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[23] Associate Professors with the Division of Personal Financial Planning, Texas Tech University.
[24] Dr. Michael Finke, Dr. Sandra Huston, and William Waller, "Do Contracts Impact Comprehensive Financial Advice,?" Working Paper, July 4, 2009, available at http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1431173_code57590.pdf?abstractid=1429807&mirid=1.
[25] Sendhil Mullainathan, Markus Nöth and Antoinette Schoar, "The Market For Financial Advice: An Audit Study," March 2012, Working Paper 17929, National Bureau of Economic Research, *available at* http://www.nber.org/papers/w17929.
[26] Finke Study at 5.
[27] Finke Study at 5 (citing G.C. Friesen and T.R.A. Sapp, "Mutual fund flows and investor returns: An empirical examination of fund investor timing ability," Journal of Banking & Finance, 31(9), 2796-2816).

agents will play into a client's biases if these biases help them sell a higher commission product."[28]

A Fiduciary Standard Could Help Reduce the Harm to Investors Resulting From Market Conditions

The marketplace for investment products is among the most competitive in the world, offering investors an immense array of options designed to serve every investment need. This fact raises the question of how objectively inferior investment products (e.g., those that combine extremely high costs with poor performance) continue to exist and in some cases attract significant assets, particularly in the broker-sold marketplace. In other words, investors who invest through broker-dealers operating under a suitability standard of care do not appear to benefit from that market competition.

A key reason for this, as discussed in the previous section, is that investment products that cannot compete based on quality and cost succeed instead because those who sell them are rewarded with generous financial incentives. Brokers operating under a suitability standard are free to recommend products that reward them financially, even where better options are available, as long as their recommendation is generally suitable. Indeed, the broker-sold investment marketplace is characterized by "reverse competition," where investment products compete to be sold, not bought, and do so on terms that may actively induce brokers to ignore the best interests of their customers.

Imposition of a fiduciary standard has the potential to fundamentally change the basis on which investment products compete in the broker-sold market. As Dr. Finke concluded based on his review of the academic literature, "the majority of retail investor welfare loss from suitability standards arises from self-serving recommendations of products that are more expensive than the ideal, and reduced incentives to both create more efficient financial products and to invest in the knowledge required to make high quality recommendations. To the extent that fiduciary standards help align the interests of the agent and retail investor, it is possible that a combination of improved price disclosure and more effective disincentives to make self-serving recommendations will have little impact on the supply of advice while improving investor outcomes." [29]

Adoption of a fiduciary standard for broker-dealers' retail investment advice would promote market competition on pro-investor terms. This would be done not by eliminating all conflicts of interest, but by applying an over-arching best interest obligation on broker-dealer recommendations and by requiring brokers to appropriately manage their conflicts of interest. If brokers were required to have and document a reasonable basis for believing their recommendations are in the best interest of the investor, investment products would face increased pressure to compete based on features that promote client interests. That one change has the potential to deliver dramatic benefits to investors in the form of reduced costs, reduced exposure to unnecessary risks, and improved long-term performance.

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[28] Finke Study at 5 (citing S. Anagol and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," American Economic Review, 102(1): 576-593).
[29] Finke Study at 17.

There is No Evidence to Support the Contention That a Fiduciary Standard of Care Will Harm Investors

Some opponents of fiduciary rulemaking have argued that investors, particularly middle-income investors, could be harmed if brokers stop serving this market, thereby leaving middle-income investors without access to affordable financial advice. In advancing this argument, critics make an inaccurate comparison between brokers and investment advisers. These critics draw a false conclusion that, because investment advisers tend to serve higher income clients than brokers that, therefore, brokers practicing under a fiduciary standard would be compelled to serve higher income clients as well.

In addition, the argument that investors could lose access to affordable advice is based on the false assumption that adoption of a fiduciary standard for broker-dealers' investment advice would force brokers to abandon transaction-based compensation arrangements. And, it assumes that broker-dealers would face significantly higher liability risks under a fiduciary standard than they currently face under the suitability standard. Several studies have been conducted in recent years that explore the real-world impact that a fiduciary duty has on the cost of service, the availability of services to middle-income customers, and the liability risks that financial professionals face. These studies strongly refute the claim that adopting a fiduciary standard for all financial professionals who provide personalized investment advice will increase costs or cause-middle income investors to lose access to products or services.

Aité Group study

The Financial Planning Coalition's submission to the SEC included a study conducted by the Aité Group that supports the conclusion that a uniform fiduciary standard will benefit retail customers and their financial advisers, and will not impose significant costs.[30] The study concludes that financial advisers and broker-dealers at investment advisory firms who deliver services to their customers under a fiduciary standard experience stronger asset growth, stronger revenue growth, and obtain a greater share of client assets than their counterparts who provide services primarily under a non-fiduciary model. Notwithstanding opposition arguments that a fiduciary standard would increase compliance burdens on brokers, the study found that fiduciary financial advisers do not spend any more of their time on compliance or other back-office tasks.

Specifically, both the financial advisers associated with investment advisory firms and the fiduciary registered representatives surveyed for the study report that, since 2007, they have achieved higher customer asset and stronger revenue growth than the financial advisers at broker-dealers who primarily work on a non-fiduciary commission basis. These findings suggest that transitioning to a fiduciary model is not likely to have a negative effect on broker-dealer financial advisers. To the contrary, operating under a fiduciary standard is likely to improve both their relationships with customers, the quality of advice they provide to those customers, and their bottom-line profits.

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[30] See Attachment A, "Aité Fiduciary Study Findings," in the letter from the Financial Planning Coalition, July 5, 2013 to the SEC in in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," available at http://www.sec.gov/comments/4-606/4606-3126.pdf.

Finke/Langdon Study

Dr. Michael Finke and Thomas Langdon, professors at Texas Tech University and Roger Williams University, respectively, conducted an illuminating study that includes an analysis of the availability of financial services to investors in states that treat broker-dealers as fiduciaries as compared to states that apply a lesser standard of conduct to broker-dealers.[31] The authors identified four states that impose an unambiguous fiduciary standard on broker-dealers (the “fiduciary states”), 14 states that do not impose a fiduciary standard on broker-dealers (the “non-fiduciary states”), and 32 states that impose a limited fiduciary standard (“limited fiduciary states”). They then compared the “saturation rate” (the number of registered representatives of broker-dealers that are not dually-registered compared to the number of households) among the three types of states.

The Finke and Langdon study finds no statistically significant difference in the ratio of registered representatives to total households in states in which broker-dealers have a full fiduciary duty, a limited fiduciary duty, or no fiduciary duty to customers. This study suggests that applying a uniform fiduciary duty standard on broker-dealers will have little if any effect on the availability of investment advice to customers, including customers with moderate levels of income or assets.

The authors also surveyed registered representatives located in fiduciary and non-fiduciary states regarding the conduct of their business. The survey covered such items as: the brokers’ ability to serve moderate wealth customers; the ability to offer a variety of products; the ability to provide product recommendations that are in their customers’ best interest; and whether representatives experience a greater compliance burden. The difference in responses from representatives in fiduciary states and those in non-fiduciary states was not statistically significant. The authors found (i) that the percentage of clients with an income of less than $75,000 is statistically equal between both groups, and (ii) that there is no statistically significant difference in either the percentage of brokers who believe they serve the needs of high-wealth clients or in the percentage of brokers who believe they serve the needs of low and moderate-wealth clients. Nearly all respondents believe they are able to provide products and advice that meet the needs of customers.

In contrast to the speculation and conjecture that characterizes the argument that a fiduciary standard would reduce investor access to affordable services, the Finke-Langdon study provides real-world empirical evidence that the imposition of a uniform fiduciary standard would neither reduce the availability of retail advice to investors nor unduly constrain the ability of financial advisors to provide a broad range of products or tailored advice to retail investors.

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[31] The Finke and Langdon study is available in the Journal of Financial Planning (July 2012) at http://www.fpanet.org/journal/TheImpactoftheBrokerDealerFiduciaryStandard/.

Cerulli Associates Data

Finally, the Cerulli Associates data[32] referenced in the Financial Planning Coalition's letter concerning the conversion of fee-based (non-fiduciary) brokerage accounts to fiduciary, non-discretionary (fiduciary) advisory accounts suggests that a fiduciary standard will impose little if any additional cost or burden on brokers. In fact, the Cerulli data show the opposite; that there is already a strong brokerage industry trend toward providing investment advice on a fiduciary basis and that the costs of such a transition will not be significant.

The industry data indicate that the number of these accounts, and their amount of assets in the accounts, have grown dramatically since the conversion. Cerulli Associates found that, even after the broad market declines of 2008, the client assets in non-discretionary advisory accounts rose by almost 75% from approximately $329.6 billion at the end of the conversion process in 2007 to $574 billion in the third quarter of 2012. Meanwhile, the level of fees charged to customers for this service model at the major national firms has stayed flat or decreased since 2007. In sum, the experience of converting fee-based (non-fiduciary) brokerage accounts to non-discretionary advisory (fiduciary) accounts demonstrates that the expense of operating under a fiduciary model has not prevented the number of accounts and level of assets in those accounts from continuing to grow substantially.

Better Disclosure and Investor Education Alone Will Not Solve the Problem

Despite the clear benefits to investors of adopting a uniform fiduciary standard, some continue to suggest that the Commission can cure the significant investor harm that currently exists by simply improving disclosures, better educating investors about the differences between brokers and advisers, and relying on investors to choose the business model that is best for them. It is in this context that the well-documented problem of investor confusion becomes relevant. Numerous studies over the years have demonstrated that investors do not understand the differences between brokers and advisers, including the differences in the legal obligations to clients. Indeed, a 2008 RAND Study found that most investors cannot identify whether their own financial adviser is a broker or investment adviser even after the differences have been explained to them.[33] Earlier Commission efforts to design effective disclosure regarding the different legal obligations of brokers and advisers proved futile, even after extensive redesign based on investor testing.[34]

We are not aware of any new research that would suggest that disclosure and education can offer an effective solution to this problem. To the contrary, the Commission's comprehensive study of financial literacy provides convincing evidence of the extreme

[32] As referenced in the Financial Planning Coalition letter to the SEC, Cerulli Associates, Cerulli Quantitative Update: Advisor Metrics, Exhibit 1.02 (2012).
[33] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, Rand Institute for Civil Justice, "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," released January 2008 by the SEC and available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.
[34] See Siegel & Gale, LLC and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, March 10, 2005.

limitations of disclosure as an effective investor protection tool.[35] Despite decades of increased attention to improving investor knowledge, the SEC staff study found that investors typically do not understand basic financial concepts, such as compound interest and inflation.

A review of studies and surveys on investor knowledge, prepared by the Library of Congress for the SEC, found that many investors do not understand key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. Moreover, investors lack critical knowledge about investment fraud. In addition, surveys demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average person in the general population.

Academic research confirms that disclosure is not enough to protect consumers. For example, in 2007, employees with low saving rates were randomly assigned to a study in which they were paid $50 each to read a short survey explaining their 401(k) plan, including a calculation of how much money they would personally gain by taking full advantage of the employer match. Relative to a control group, this group did not significantly increase its average 401(k) saving rate.[36] In a March 2009 study, researchers found that the adoption of an easy-to-read summary prospectus by the SEC, which simplifies mutual fund disclosure, seemed to have no effect on investor choices.[37]

Moreover, academic research has shown that conflicts of interest disclosures can actually have the opposite of the intended effect because investors tend to place more trust in the financial adviser's recommendations and financial advisers tend to be less concerned about acting in the customer's best interest when conflicts are disclosed. A 2005 study found that in certain situations, disclosure can sometimes lead advisers to give more biased advice by providing individuals with "moral license" to engage in self-interested behavior.[38] The results of this study were confirmed by a more sophisticated study in 2011, which found that disclosure alone lessens moral reluctance to provide biased advice.[39]

Investors who cannot distinguish between brokers and advisers, who do not understand the different legal standards that apply to their recommendations, and who do not understand the

[35] Staff of the Securities and Exchange Commission, Study Regarding Financial Literacy Among Investors (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act), August 2012.
[36] *See* Choi, *et al*, "Are Empowerment and Education Enough? Underdiversification in 401(k) Plans," Brookings Papers on Economic Activity 2: 151–98 (2005), *available at* http://scholar.harvard.edu/files/laibson/files/are_empowerment_and_education_enough_under-diversification_in_401k_plans.pdf.
[37] *See* John Beshear, *et al*, "How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?" Kennedy School of Government Harvard University, Working Paper No. RWP09_16 (March 2009), *available at* http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/MRCBG_FWP_2009_02-2009_Madrian_Mutual_Fund.pdf.
[38] Daylian M. Cain, *et al*, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. Legal Stud. 1 (2005).
[39] Daylian M. Cain, *et al*, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836 (2011).

ramifications of disclosed conflicts of interest cannot be expected to make an informed decision about which business model would best serve their interests.[40] Certainly, there is no reasonable basis for believing that a disclosure and education-based approach would promote informed decisions by investors unless brokers were also prohibited from using titles and marketing their services in ways that are designed to portray them as trusted and expert financial advisers.

Conclusion

The bifurcated approach to regulating investment advice offered by broker-dealers and investment advisers reflects the failure of regulatory policy to keep pace with changes in market practices. There is no justification for applying different standards of care to financial professionals who are offering the same services to investors. Over the years, broker-dealers have not only identified themselves as financial advisers, but they have offered virtually identical services to investors in order to compete. The Commission has permitted, at least tacitly, this evolution by failing to apply the appropriate regulatory standard.

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[40] Dr. Sunita Sah, *et al*, "The Burden of Disclosure: Increased Compliance with Distrusted Advice," Working Paper, Dec. 2011, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615025&download=yes (The study reflected that eliminating conflicts of interest is also key to enhancing the benefits of disclosure. The study found that the choosers were aware that their advisers had not put their interests first, but due to the pressure of the situation, the chooser was more likely to comply with the advice, even though they were less satisfied with their choice.).

Investors suffer concrete harm – in the form of higher costs and poorer performance – as a result. The Commission has an opportunity to reduce this harm to investors without imposing undue costs or regulatory burdens by applying a fiduciary standard to both broker-dealers and investment advisers when they offer personalized investment advice to retail customers. We urge the Commission to move forward expeditiously with a rulemaking, consistent with Section 913 of the Dodd-Frank Act, to achieve this goal.

Sincerely,

Joyce A. Rogers
Senior Vice President
Government Affairs
AARP

Barbara Roper
Director of Investor Protection
CFA

Kevin R. Keller, CAE
Chief Executive Officer
CFP Board

Lauren Schadle, CAE
Executive Director/ CEO
FPA®

Mercer Bullard
President and Founder
Fund Democracy, Inc.

Geof Brown, CAE
Chief Executive Officer
NAPFA

Cc: Hon. Tim Johnson
Hon. Mike Crapo
Hon. Jeb Hensarling
Hon. Maxine Waters

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–73339; File No. SR–FINRA–2014–006]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities

October 10, 2014.

I. Introduction

On January 31, 2014, Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act") [1] and Rule 19b–4 thereunder,[2] a proposed rule change to amend provisions in the NASD and FINRA rulebooks addressing per share estimated valuations for unlisted direct participation program ("DPP") and real estate investment trust ("REIT") securities. In particular, FINRA proposes revising NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of a per share estimated value for unlisted DPP and REIT securities on a customer account statement and FINRA Rule 2310 (Direct Participation Programs) to modify the requirements applicable to members' participation in a public offering of DPP or REIT securities.

The proposed rule change was published for comment in the **Federal Register** on February 19, 2014.[3] The Commission received eighteen (18) comment letters in response to the Notice of Filing.[4] On March 14, 2014, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to May 20, 2014. On May 20, 2014, the Commission issued an order instituting proceedings pursuant to Section 19(b)(2)(B) of the Act [5] to determine whether to approve or disapprove the proposed rule change. The order was published for comment in the **Federal Register** on May 27, 2014.[6] The Commission received six (6) comment letters in response to the Proceedings Order.[7]

On July 11, 2014, FINRA filed a letter responding to comments and Amendment No. 1 to the proposed rule change.[8] A notice of the amendment was published for comment in the **Federal Register** on July 22, 2014.[9] The Commission received six (6) comment letters in response to the Notice of Amendment.[10] On September 16, 2014, FINRA filed a letter responding to these comments.[11]

This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal, as Modified by Amendment No. 1

A. Proposed Revisions to NASD Rule 2340 (Customer Account Statements)

FINRA proposes to amend NASD Rule 2340 to require general securities members to include in customer account statements a per share estimated value for an unlisted DPP or REIT security, developed in a manner reasonably designed to ensure that the per share estimated value is reliable, as well as to make related disclosures.[12] FINRA also proposes two methodologies for calculating the per share estimated value for a DPP or REIT security that would be deemed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) The net investment methodology; and (2) the appraised value methodology.[13] Each methodology is described in greater detail below, along with other proposed revisions.

1. Net Investment Methodology

Under the proposal, the net investment methodology would reflect the "net investment" disclosed in the issuer's most recent periodic or current

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Exchange Act Release No. 71545 (Feb. 12, 2014), 79 FR 9535 (Feb. 19, 2014) (Notice of Filing of Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) ("Notice of Filing"). The comment period closed on March 12, 2014.

[4] Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated February 5, 2014; David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated February 5, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated February 11, 2014; Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts, dated February 14, 2014; Jeff Johnson, Chief Executive Officer, Dividend Capital Diversified Property Fund Inc., dated February 28, 2014; Michael Crimmins, Chief Executive Officer and Managing Director, KBS Capital Markets Group, dated February 28, 2014; Scott Ilgerfritz, Immediate Past-President, Public Investors Arbitration Bar Association, dated March 11, 2014; Thomas Price, Managing Director, Securities Industry and Financial Markets Association, dated March 12, 2014; Steve Morrison, Senior Vice President and Associate Counsel, LPL Financial, dated March 12, 2014; Jacob Frydman, Chairman and Chief Executive Officer, United Realty Trust Incorporated, dated March 12, 2014; Dechert LLP, dated March 12, 2014; David Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated March 12, 2014; Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts, dated March 12, 2014; Kirk Montgomery, Head of Regulatory Affairs, CNL Financial Group, LLC, dated March 12, 2014; Mark Goldberg, Chairman, Investment Program Association, dated March 12, 2014; David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated March 12, 2014; Martel Day, Principal, NLR Advisory Services, LLC, dated March 12, 2014; and Mark Kosanke, President, Real Estate Investment Securities Association, dated March 12, 2014. Comment letters are available at *www.sec.gov*.

The Commission discussed these comments in the Proceedings Order. *See infra* note 6.

[5] 15 U.S.C. 78s(b)(2)(B).

[6] Exchange Act Release No. 72193 (May 20, 2014), 79 FR 30217 (May 27, 2014) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) ("Proceedings Order"). The comment period closed on June 26, 2014.

[7] Letters to Elizabeth Murphy, Secretary, SEC, from Kenneth Mills, dated June 24, 2014; Jason Doss, President, Public Investors Arbitration Bar Association, dated June 25, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated June 26, 2014; Thomas F. Price, Managing Director, Operations, Technology and BCP, Securities Industry and Financial Markets Association, dated June 26, 2014; David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated June 26, 2014; and Peter Peters, dated July 15, 2014. Comment letters are available at *www.sec.gov*.

[8] Letter to Kevin O'Neill, Deputy Secretary, SEC, from Matthew E. Vitek, Associate General Counsel, FINRA, dated July 11, 2014 ("FINRA's First Response Letter"). FINRA's First Response Letter is available at *www.sec.gov*.

[9] Exchange Act Release No. 72626 (July 16, 2014); 79 FR 42590 (July 22, 2014) (Notice of Filing of Amendment No. 1 to Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) ("Notice of Amendment"). The comment period closed on August 12, 2014.

[10] Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated July 28, 2014 ("IPA Letter"); Steven A. Wechsler, President and Chief Executive Office, National Association of Real Estate Investment Trusts, dated August 12, 2014 ("NAREIT Letter"); Frederick P. Baerenz, President and Chief Executive Officer, AOG Wealth Management, dated August 12, 2014 ("AOG Letter"); Daniel R. Gilbert, Chief Investment and Operating Officer, NorthStar Asset Management Group, Inc., dated August 12, 2014 ("NorthStar Letter"); David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated August 12, 2014 ("FSI Letter"); and Andrea Seidt, President, North American Securities Administrators Association, Inc., and Commissioner, Ohio Division of Securities, dated August 22, 2014 ("NASAA Letter"). Comment letters are available at *www.sec.gov*.

[11] Letter to Brent J. Fields, Secretary, SEC, from Matthew E. Vitek, Associate General Counsel, FINRA, dated September 16, 2014 ("FINRA's Second Response Letter"). FINRA's Second Response Letter is available at *www.sec.gov*.

[12] *See* Proposed NASD Rule 2340(c).

[13] *See* Proposed NASD Rule 2340(c)(1).

report. More specifically, the proposal would require "net investment" to be based on the "amount available for investment" percentage in the "Estimated Use of Proceeds" section of the offering prospectus; [14] alternatively, where "amount available for investment" is not provided, the proposal would require "net investment" to be based on another equivalent disclosure that reflects the estimated percentage deduction from the aggregate dollar amount of securities registered for sale to the public of sales commissions, dealer manager fees, and estimated issuer offering and organization expenses.[15]

The proposal would not require the calculation of "net investment" to involve the deduction from the per share estimated value of "over-distributions." [16] The proposal would, however, require members that use the net investment methodology to provide a per share estimated value for a DPP or REIT security to disclose in the customer account statement the following statement: "IMPORTANT—Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement." [17] The proposal would require the member to disclose this statement prominently and in proximity to the disclosure of distributions and the per share estimated value.[18]

In addition, the proposal would clarify that when an issuer provides a range of amounts available for investment, the proposal would allow a general securities member to use the maximum offering percentage unless the member has reason to believe that such percentage is unreliable. If the member has reason to believe that it is unreliable, the member must use the minimum offering percentage.[19]

Finally, the proposal would allow a member to use the net investment methodology at any time before 150 days following the second anniversary of the breaking of escrow.[20]

2. Appraised Value Methodology

Under the proposal, the appraised value methodology would consist of the appraised valuation disclosed in the issuer's most recent periodic or current report. More specifically, the proposal would require: (1) That the valuation be based on valuations of the assets and liabilities of the DPP or REIT; and (2) that those valuations: (a) Be performed at least annually; (b) be conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and (c) be derived from a methodology that conforms to standard industry practice. The proposal would allow a member to use the appraised value methodology at any time.[21]

The proposed rule change would, however, provide a different requirement for DPPs subject to the Investment Company Act of 1940 ("1940 Act") (*e.g.*, business development companies). Specifically, FINRA acknowledged that business development companies that fall under the definitions of DPP are subject to the 1940 Act, which already requires the issuer to determine and publish its net asset value on a regular basis.[22] Thus, for these DPPs, the proposed rule would require the appraised value methodology to be consistent with the valuation requirements of the 1940 Act and the rules thereunder.[23]

3. General Disclosures

The proposal would also require members to include specific disclosures on customer account statements that provide a per share estimated value for a DPP or REIT security (calculated using either the net investment methodology or the appraised value methodology). In particular, the proposal would require a member to include disclosures stating that the DPP or REIT security is not listed on a national securities exchange, is generally illiquid, and that, even if a customer is able to sell the security, the price received may be less than the per share estimated value provided in the statement.[24]

B. Proposed Revisions to FINRA Rule 2310 (Direct Participation Programs)

FINRA also proposes to amend FINRA Rule 2310(b)(5) to prohibit a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose:

(1) A per share estimated value of the DPP or REIT security that is: (a) Developed in a manner reasonably designed to ensure it is reliable, and (b) disclosed in the DPP's or REIT's periodic reports filed pursuant to Sections 13(a) or 15(d) of the Act; an explanation of the method by which the value was developed; and the date of the valuation; and

(2) a per share estimated value of the DPP or REIT security that is: (a) Based on valuations of the assets and liabilities of the DPP or REIT performed at least annually by, or with the material assistance or confirmation of, a third-party valuation expert or service; (b) derived from a methodology that conforms to standard industry practice; and (c) disclosed in the DPP's or REIT's periodic reports filed pursuant to Sections 13(a) or 15(d) of the Act within 150 days following the second anniversary of breaking escrow (and in each annual report thereafter); and a concomitant written opinion or report by the issuer, delivered at least annually to the member that explains the scope of the review, the valuation methodology used, and the basis for the reported value.

The proposed rule change would, however, except DPPs subject to the 1940 Act from the requirements of proposed Rule 2310(b)(5). As stated above, FINRA acknowledged that such DPPs are subject to an existing regulatory framework (the 1940 Act) that already requires the issuer of their securities to determine and publish their net asset value on a regular basis.[25]

C. Technical Change

FINRA also proposes making a change to its Rules Manual to conform to the other revisions discussed above by deleting FINRA Rule 5110(f)(2)(L) (Corporate Financing Rule—Underwriting Terms and Arrangements). That paragraph currently provides that it is unfair and unreasonable for a member or person associated with a member to participate in a public offering of a REIT unless the trustee will disclose in each annual report distributed to investors a per share estimated value of the trust securities, the methodology by which it

[14] "This disclosure is typically included in the prospectus for REIT offerings and is described in the SEC's Securities Act Industry Guide 5 (Preparation of registration statements relating to interests in real estate limited partnerships)." Notice of Filing at note 12.

[15] *See* Proposed NASD Rule 2340(c)(1)(A).

[16] *See* Notice of Filing at note 20 (generally describing "over-distributions" as a return of investor capital as a distribution rather than the use of that capital to generate return on investment); *see also* Notice of Amendment (clarifying that "over-distributions" should be excluded from the calculation of "net investment").

[17] *See* Proposed NASD Rule 2340(c)(2)(A).

[18] *Id.*

[19] *See* Proposed NASD Rule 2340(c)(1)(A).

[20] *See Id. See also* Notice of Filing at note 11 (stating that "[g]enerally, offering proceeds are placed in escrow until the minimum conditions of the offering are met, at which time the issuer is permitted to access the offering proceeds").

[21] *See* Proposed NASD Rule 2340(c)(1)(B).

[22] *See* Notice of Amendment.

[23] *See* Proposed NASD Rule 2340(c)(1)(B).

[24] *See* Proposed NASD Rule 2340(c)(2)(B).

[25] *See* Notice of Amendment.

was developed, and the date of the data used to develop the value.

The text of the proposed rule change is available at the principal office of FINRA, on FINRA's Web site at *http://www.finra.org,* and at the Commission's Public Reference Room.

III. Description of Comments on the Proposal, as Amended, and FINRA's Response

A. Comments

As stated above, the Commission received six (6) comment letters in response to the Proceedings Order.[26] Those commenters generally reiterated concerns expressed in response to the Notice of Filing.

In addition, the Commission received six (6) comment letters in response to the Notice of Amendment.[27] Four (4) of these commenters fully supported the proposal.[28] Two (2) other commenters, however, raised concerns (discussed below).[29]

One of the concerned commenters supported aspects of the proposal.[30] This commenter, however, encouraged rejecting the proposal's requirement for members to report initial share prices, stating that substituting "a flawed share pricing system with a different flawed pricing system is apt to lead to confusion rather than clarity." [31] This commenter also suggested that market forces are sufficiently driving improvements in the unlisted DPP and REIT industry, noting changes in fee structures.[32]

The second concerned commenter also supported aspects of the proposal.[33] This commenter, however, opposed the following other aspects of the proposal:

(1) The commenter opposed excluding over-distribution from the valuation calculation under the net investment methodology, stating that excluding it would decrease the accuracy and transparency of the disclosed values of DPP and REIT securities.[34]

(2) The commenter also expressed concern that members could use the net investment methodology's requirements concerning offering and organization expenses to manipulate valuation of DPP and REIT securities.[35]

(3) In addition, the commenter recommended that FINRA require disclosure of the identity of the third-party valuation expert or service used to obtain a valuation under the appraised value methodology and clarify that such third-party must be independent.

(4) Finally, the commenter opposed the extension of the effective date of the proposal, as amended, stating that "industry should not need an additional year-and-a-half to make the necessary changes" and "[investors] should not be forced to wait another year for more transparent price reporting." [36]

B. FINRA's Response

In its response letter, FINRA stated that it has considered the concerns raised by the two concerned commenters.[37] FINRA also stated, however, that it believes that the proposal, as amended, "significantly improves the transparency of the per share estimated value of DPP and REIT securities on customer account statements." [38] Accordingly, FINRA declined making any additional changes in response to commenters' concerns but stated that it would "continue to monitor practices in this area to determine whether additional changes are necessary." [39]

IV. Discussion and Commission Findings

The Commission has carefully considered the proposal, as amended; the comments received; and FINRA's responses to the comments. Based on its review of the record, the Commission finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[40] In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that FINRA's rules be designed to prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; and, in general, protect investors and the public interest.[41]

The proposal, as amended, is designed to address longstanding concerns with the current industry practice of displaying a DPP or REIT security's immutable offering price as its per share estimated value on customer account statements throughout the offering period (which can last several years),[42] despite the fact that the value of the DPP or REIT security fluctuates. FINRA's proposed rule change would require members to include in customer account statements per share estimated values of unlisted DPP and REIT securities that are developed in a manner reasonably designed to ensure they are reliable. The Commission believes that the proposal would, therefore, greatly improve the accuracy and transparency of the value of DPP and REIT securities and, in turn, better protect the investing public.

As discussed above, the Commission received eighteen (18) comment letters in response to the Notice of Filing, six (6) comment letters in response to the Proceedings Order, six (6) comment letters in response to the Notice of Amendment, and two (2) response letters from FINRA. The Commission appreciates the points raised by the commenters, and the Commission believes that FINRA responded appropriately to their concerns.[43] The

[26] *See supra* note 7.

[27] *See supra* note 10.

[28] FSI Letter, IPA Letter, NAREIT Letter, and NorthStar Letter.

[29] AOG Letter and NASAA Letter.

[30] AOG Letter (stating that "providing sponsor companies with a formula and timeline . . . for appraising and reporting the values [other than the initial value] of non-traded REITS is very valuable" and "[providing] broker-dealers assurance that they can rely on those values is also very helpful").

[31] *Id.*

[32] *Id.*

[33] NASAA Letter (stating that "[r]equiring securities to be valued on the customer account statement enhances transparency to the customer").

[34] *See supra* note 16 and surrounding text.

[35] *See supra* note 19 and surrounding text.

[36] NASAA Letter.

[37] FINRA's Second Response Letter. *See, e.g.,* FINRA's First Response Letter (summarizing and responding to commenters' concerns about calculating over-distributions); FINRA's First Response Letter (proposed NASD Rule 2340(c)(1)(A) (stating that if a member has reason to believe that the maximum offering percentage is unreliable, the member must use the minimum offering percentage); FINRA's First Response Letter (extending the effective date to provide industry participants sufficient time to make adjustments to product structures and any necessary operational changes, as well as to limit the impact of the amended proposal on current offerings); and proposed NASD Rule 2340(c)(1)(B) (stating that the valuation expert or service must be a third-party).

[38] FINRA's Second Response Letter.

[39] *Id.*

[40] In approving the proposal, as amended, the Commission has considered the impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

See, e.g., Proceedings Order at 7 (noting commenters' concern about the potential economic impact of the proposal, as originally proposed; *also* FINRA's First Response Letter, which provided a detailed economic impact statement in response to those commenters). The Commission has received no additional public comment on the potential economic impact of the proposed rule change, as amended.

[41] 15 U.S.C. 78o–3(b)(6).

[42] *See* Notice of Filing at note 8 and surrounding text (stating that "Rule 415(a)(5) under the Securities Act of 1933 ('Securities Act') provides that certain types of securities offerings, including continuous offerings of DPPs and REITs, may continue for no more than three years from the initial effective date of the registration statement. Under Rule 415(a)(6), the SEC may declare another registration statement for a DPP or REIT effective such that an offering can continue for another three-year offering period").

[43] FINRA did not directly respond to the commenter's recommendation to require disclosure of the name of the third-party expert or service for purposes of proposed NASD Rule 2340(c)(1)(B). The

Continued

Commission notes that, while one commenter on the amended proposal suggested market forces should be sufficient to drive improvements in the unlisted DPP and REIT industry,[44] given current industry practice with respect to disclosure of DPP and REIT values, the Commission believes that FINRA's amended proposal is warranted.

Also, given commenters' concern regarding the complexity of calculating over-distributions, the Commission supports FINRA's amended approach of requiring enhanced disclosure surrounding them. More specifically, the Commission believes that, at this time, this approach would improve investor awareness and understanding in a practical manner.

In addition, one commenter on the amended proposal expressed concern that members could use the net investment methodology's requirements concerning offering and organization expenses to manipulate DPP and REIT values.[45] Under the amended proposal, however, if a member has reason to believe a calculation of the offering and organization expenses using the maximum offering percentage is unreliable, the member must use the minimum offering percentage.[46]

The same commenter further recommended that FINRA require disclosure of the identity of the service used to obtain a valuation under the appraised value methodology and clarify that such service must be independent.[47] Regarding disclosure of the valuation service's identity, the Commission notes that this information may be available through an issuer's prospectus. Regarding the independence of the service, the amended proposal requires the use of a "third-party valuation expert," which both the Commission and FINRA interpret as being an independent entity.[48]

Finally, the commenter opposed the extension of the effective date under the amended proposal, stating that investors should not have to wait for more transparent price reporting.[49] FINRA extended the effective date, however, to provide industry participants sufficient time to make adjustments to product structures and any necessary operational changes, as well as to limit the impact of the amended proposal on current offerings.[50]

In sum, the Commission believes that the proposal, as amended, represents a significant improvement to current industry practice concerning the disclosure of the value of unlisted DPP and REIT securities. As amended, the proposal would help ensure that investors receive more accurate information regarding the nature and worth of their holdings of DPP and REIT securities. While the Commission believes that this outcome would improve accuracy and transparency and, consequently, investor protection, it will continue to monitor the activity in this market for potential abuses.

For the reasons stated above, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[51] that the proposed rule change (SR–FINRA–2014–006), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[52]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–24681 Filed 10–16–14; 8:45 am]

BILLING CODE 8011–01–P

Commission notes, however, that this information may be available in an issuer's prospectus.

[44] AOG Letter.

[45] NASAA Letter.

[46] *See* FINRA's First Response Letter.

[47] *Id.*

[48] *See, e.g.,* FINRA's First Response Letter (discussing the economic impact of requiring "independent valuations").

[49] NASAA Letter.

[50] FINRA's First Response Letter.

[51] 15 U.S.C. 78s(b)(2).

[52] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–73342; File No. SR–NYSEArca–2014–114]

Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing of Proposed Rule Change To List and Trade Shares of the iShares Interest Rate Hedged 0–5 Year High Yield Bond ETF, iShares Interest Rate Hedged 10+ Year Credit Bond ETF, and the iShares Interest Rate Hedged Emerging Markets Bond ETF Under NYSE Arca Equities Rule 8.600

October 10, 2014.

Pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 (the "Act")[2] and Rule 19b–4 thereunder,[3] notice is hereby given that, on September 29, 2014, NYSE Arca, Inc. (the "Exchange" or "NYSE Arca") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

The Exchange proposes to list and trade the following under NYSE Arca Equities Rule 8.600 ("Managed Fund Shares"): iShares Interest Rate Hedged 0–5 Year High Yield Bond ETF; iShares Interest Rate Hedged 10+ Year Credit Bond ETF; and the iShares Interest Rate Hedged Emerging Markets Bond ETF. The text of the proposed rule change is available on the Exchange's Web site at *www.nyse.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to list and trade shares ("Shares") of the following under NYSE Arca Equities Rule 8.600, which governs the listing and trading of Managed Fund Shares:[4] iShares Interest Rate Hedged 0–5 Year High Yield Bond

[1] 15 U.S.C. 78s(b)(1).

[2] 15 U.S.C. 78s(b)(1).

[3] 17 CFR 240.19b–4.

[4] A Managed Fund Share is a security that represents an interest in an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1) ("1940 Act") organized as an open-end investment company or similar entity that invests in a portfolio of securities selected by its investment adviser consistent with its investment objectives and policies. In contrast, an open-end investment company that issues Investment Company Units, listed and traded on the Exchange under NYSE Arca Equities Rule 5.2(j)(3), seeks to provide investment results that correspond generally to the price and yield performance of a specific foreign or domestic stock index, fixed income securities index or combination thereof.

Regulatory Notice 15-02

January 2015

DPP and Unlisted REIT Securities

SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities

Effective Date: April 11, 2016

Executive Summary

The SEC approved amendments to NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of per share estimated values for direct participation program (DPP) and unlisted real estate investment trust (REIT) securities on account statements, and to FINRA Rule 2310 (Direct Participation Programs) to make corresponding changes to the requirements applicable to members' participation in public offerings of DPP or REIT securities.[1] The amendments become effective on April 11, 2016.

The amended rule text is available at *www.finra.org/notices/15-02*.

Questions concerning this *Notice* should be directed to:

- Joseph E. Price, Senior Vice President & Counsel, Advertising Regulation and Corporate Financing, at (240) 386-4642 or *Joseph.Price@finra.org*;
- Paul M. Mathews, Vice President & Director, Corporate Financing, at (240) 386-4639 or *Paul.Mathews@finra.org*; or
- James S. Wrona, Vice President & Associate General Counsel, Office of General Counsel, at (202) 728-8270 or *Jim.Wrona@finra.org*.

Background & Discussion

NASD Rule 2340 currently requires a general securities member to include on account statements an estimated value of a DPP or REIT security from the annual report, an independent valuation service or any other source, unless the member can demonstrate the estimated value is inaccurate. FINRA Rule 2310 provides that a member may not participate in a DPP or REIT offering unless the general partner or sponsor will disclose a per share estimated value in each annual report.

Notice Type
- Rule Amendment

Suggested Routing
- Compliance
- Legal
- Senior Management

Key Topics
- Customer Account Statements
- Direct Participation Programs
- Unlisted Real Estate Investment Trusts

Referenced Rules & Notices
- FINRA Rule 2310
- NASD Rule 2340

FINRA Financial Industry Regulatory Authority

The general industry practice is to use the offering price (or "par value") of DPP and REIT securities as the per share estimated value during the offering period, which can continue as long as seven and one-half years. The offering price, typically $10 per share, often remains constant on customer account statements during this period even though various costs and fees have reduced investors' principal and underlying assets may have decreased in value.

The SEC recently approved FINRA's proposed amendments to Rule 2340 and Rule 2310 that require general securities members to provide more accurate per share estimated values on customer account statements, shorten the time period before a valuation is determined based on an appraisal and provide various important disclosures. The effective date of the amendments is April 11, 2016.

I. NASD Rule 2340 (Customer Account Statements)

NASD Rule 2340 generally requires that general securities members provide periodic account statements to customers, on at least a quarterly basis, containing a description of any securities positions, money balances or account activity since the last statement. Paragraph (c) addresses the inclusion of per share estimated values for DPP and REIT securities held in customer accounts or included on customer account statements. The rule also provides for several disclosures regarding the illiquidity and resale value of DPP and REIT securities.

The SEC has approved amendments to Rule 2340(c) to require, among other things, general securities members to include in customer account statements a per share estimated value for a DPP or REIT security developed in a manner reasonably designed to ensure that the per share estimated value is reliable. In addition, the amended rule provides two methodologies for calculating the per share estimated value for a DPP or REIT security that is deemed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) the net investment methodology and (2) the appraised value methodology. The amended rule also imposes various enhanced disclosure obligations, as discussed below.

A. Net Investment Methodology

The amendments to Rule 2340(c)(1)(A) require "net investment" to be based on the "amount available for investment" percentage in the "Estimated Use of Proceeds" section of the offering prospectus. Where "amount available for investment" is not provided, the amended rule requires "net investment" to be based on another equivalent disclosure that reflects the estimated percentage deduction from the aggregate dollar amount of securities registered for sale to the public of sales commissions, dealer manager fees and estimated issuer offering and organization expenses. In addition, the amended rule clarifies that when an issuer provides a range of amounts available for investment, a member may use the maximum offering percentage unless the member has reason to believe that such percentage is unreliable. If the member has reason to believe that it is unreliable, the member must use the minimum offering percentage. The rule permits the net investment value to be used until 150 days following the second anniversary of breaking escrow in the public offering.

B. Appraised Value Methodology

The appraised value methodology, which can be used at any time, consists of the appraised valuation disclosed in the issuer's most recent periodic or current report filed with the SEC. As amended, Rule 2340(c)(1)(B) requires that the per share estimated value disclosed in an issuer's most recent periodic or current report be based on valuations of the assets and liabilities of the DPP or REIT, and that those valuations be:

- performed at least annually;
- conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and
- derived from a methodology that conforms to standard industry practice.

Where a DPP is subject to the Investment Company Act of 1940 (1940 Act) (e.g., business development companies), instead of a valuation that meets the appraisal requirements listed immediately above, the rule requires that the appraised value must be consistent with the valuation requirements of the 1940 Act and the rules thereunder.

C. Disclosures

New Rule 2340(c)(2)(A) requires members that use the "net investment" methodology to provide, if applicable, enhanced disclosure relating to the return of investors' capital (often referred to as "over distributions") in order to address potential misunderstanding by customers when their capital is returned to them through a distribution that otherwise could appear to represent earnings on their investment. Rule 2340(c)(2)(A) requires an account statement that provides a "net investment" per share estimated value for a DPP or REIT security to disclose, if applicable, prominently and in proximity to disclosure of distributions and the per share estimated value the following statements: "IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."

The disclosure under new Rule 2340(c)(2)(A) applies only to an account statement that provides a "net investment" per share estimated value where part of the distribution includes a return of capital. Thus, for example, this requirement does not apply to an account statement that provides an "appraised value" for the per share estimated value, which already would reflect returns of capital.

However, the disclosures under new Rule 2340(c)(2)(B) are required for all account statements that provide a per share estimated value for a DPP or REIT security. Pursuant to this new provision, a member must disclose that the DPP or REIT securities are not listed on a securities exchange, are generally illiquid and that, even if a customer is able to sell the securities, the price received may be less than the per share estimated value provided in the account statement.

II. FINRA Rule 2310 (Direct Participation Programs)

FINRA Rule 2310(b)(5) generally provides that a member may not participate in a public offering of DPP or REIT securities unless specified disclosures about the value of such securities will be made by the general partner or sponsor of the DPP or REIT in each annual report distributed to investors pursuant to Section 13(a) of the Exchange Act. FINRA amended the requirements to correspond to the amendments to NASD Rule 2340(c). As amended, Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose:

- a per share estimated value of the DPP or REIT security, developed in a manner reasonably designed to ensure it is reliable, in the DPP or REIT periodic reports filed pursuant to Section 13(a) or 15(d) of the Exchange Act;
- an explanation of the method by which the value was developed; and
- the date of the valuation.

In addition, amended Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose, in a periodic or current report filed pursuant to Section 13(a) or 15(d) of the Exchange Act within 150 days following the second anniversary of breaking escrow and in each annual report thereafter, a per share estimated value:

- based on the valuations of the assets and liabilities of the DPP or REIT performed at least annually by, or with the material assistance or confirmation of, a third-party valuation expert or service;
- derived from a methodology that conforms to standard industry practice; and
- accompanied by a written opinion or report by the issuer, delivered at least annually, that explains the scope of the review, the valuation methodology used and the basis for the reported value.

The amendments to Rule 2310(b)(5) do not apply to DPPs that are subject to the 1940 Act as such DPPs are already required to determine and publish net asset value on a regular basis.

Endnotes

1. *See* Securities Exchange Act Release No. 73339 (October 10, 2014), 79 FR 62489 (October 17, 2014) (Order Approving SR-FINRA-2014-006, as Modified by Amendment No. 1).

Client Account Statement Rule Changes:

Rules 2340 and 2310

What does it all mean?

Griffin Capital Corporation

Kevin Shields | *Chairman & CEO*

Summary of Risk Factors

We are an "emerging growth company" under the federal securities laws and will be subject to reduced public company reporting requirements. Investing in our common stock involves a high degree of risk. You should purchase these securities only if you can afford a complete loss of your investment. See "Risk Factors" beginning on page 19 of our Prospectus for a discussion of certain factors that should be carefully considered by prospective investors before making an investment in the shares offered hereby. These risks include but are not limited to the following:

- No public market currently exists for our shares and we may not list our shares on a national exchange immediately after completion of this offering, if at all. It will be difficult to sell your shares. If you sell your shares, it will likely be at a substantial discount. Our charter does not require us to pursue a liquidity transaction at any time.
- We may pay distributions from sources other than our cash flows from operations, including net proceeds of this offering or from borrowings in anticipation of future cash flows, and it is likely that we will do so to fund a portion of our initial distributions. We are not prohibited from undertaking such activities by our charter, bylaws or investment policies, and we may use an unlimited amount from any source to pay our distributions.
- This is an initial public offering; we have no prior operating history, and the prior performance of real estate programs sponsored by affiliates of our sponsor may not be indicative of our future results.

Summary of Risk Factors

- This is a “best efforts” offering. If we are unable to raise substantial funds in this offering, we may not be able to invest in a diverse portfolio of real estate and real estate-related investments, and the value of your investment may fluctuate more widely with the performance of specific investments.
- We are a “blind pool” because we have not identified any properties to acquire with the net proceeds from this offering. As a result, you will not be able to evaluate the economic merits of our future investments prior to their purchase. We may be unable to invest the net proceeds from this offering on acceptable terms to investors, or at all.
- There are substantial conflicts of interest among us and our sponsor, advisor, property manager and dealer manager.
- Our advisor will face conflicts of interest relating to the purchase of properties, including conflicts with Griffin Capital Essential Asset REIT, Inc., and such conflicts may not be resolved in our favor, which could adversely affect our investment opportunities.
- We have no employees and must depend on our advisor to select investments and conduct our operations, and there is no guarantee that our advisor will devote adequate time or resources to us.
- We will pay substantial fees and expenses to our advisor, its affiliates and participating broker-dealers, which will reduce cash available for investment and distribution.
- We may incur substantial debt, which could hinder our ability to pay distributions to our stockholders or could decrease the value of your investment
- We may fail to qualify as a REIT, which could adversely affect our operations and our ability to make distributions.

FINRA RN 15-02: Proposed Account Statement Rule

Proposed changes to Rules 2340 and 2310

- Rule Relates to Per Share Estimated Valuation for Unlisted DPP and real estate investment trusts
- Progression: 11-44 to 12-14 to 14-06 to 15-02
- IPA submitted detailed response March 21, 2014
- FINRA submitted letter to SEC extending timeline on action to October 17, 2014
- SEC adopted SR-FINRA 2014-006 October 10, 2014
- FINRA RN 15-02: Effective Date Set at April 11, 2016

FINRA RN 15-02: Proposed Account Statement Rule

Existing Rule: FINRA 09-09 for DPP and PNLR

- Must develop initial valuation no later than 18 months after close of offering
- Estimated valuation included on customer statements may be based on data up to 18 months old
- No disclosure required regarding impact of any distributions in excess of earnings
- Disclosures regarding valuation methodology limited in scope
- Account statement must include disclosures that securities are generally illiquid and estimated value may not be realized upon such liquidation

FINRA RN 15-02: Proposed Account Statement Rule

FINRA RN 15-02 proposes:

1. ***Broker-dealers*** provide per share estimated value of security on customer account statements in a manner reasonably designed to provide a reliable value – using one of two methodologies that are presumptively reliable:
    I. Net Investment Methodology (NIM) or
    II. Appraised Value Methodology (AVM)

FINRA RN 15-02: Proposed Account Statement Rule

FINRA RN 15-02 proposes:

- NIM equals Gross Offering Price less sales commissions, dealer-manager fees and organizational and offering expenses (based upon maximum offering amount)
- AVM is based upon an appraisal of the assets and liabilities of the program by or with the *material assistance of a third party valuation expert* in conformance with standard industry practice

FINRA RN 15-02: Proposed Account Statement Rule

FINRA RN 15-02 proposes:

- AVM may be used any time during the offering period
- Disclosures:
  I. Prior to reporting pursuant to AVM, account statement must include disclosure 'part of distribution constitutes return of capital, which reduces estimated per share value shown on account statement'

  II. Regardless of valuation methodology used, must state 'DPP and PNLR are not listed on a national exchange, generally illiquid and price received may be less than per share estimated value'

FINRA RN 15-02: Proposed Account Statement Rule

FINRA RN 15-02 proposes:

2. Timing and Frequency
   - NIM applicable anytime before 150 days following second anniversary of breaking escrow
   - After adopting AVM, appraisals must be performed every year thereafter
3. BDCs: DPPs are exempt – subject to '40 Act regulation
4. Effective Date: no earlier than 18 months following SEC approval – ***April 11, 2016,*** provides sufficient time for:
   I. Industry education about proper interpretation
   II. Re-program IT systems for compliance
   III. Create investor education material and adapt existing

FINRA RN 15-02: Proposed Account Statement Rule

Non-Listed REIT Exemplar

Equity Investment		$1,000,000
Sales Commission	7.0%	70,000
Dealer-Manager Fee	3.0%	30,000
Organizational and Offering Expenses	1.0%	10,000
Total Offering Load	11.0%	110,000
Net Investment (Account Stmt. Price)	89.0%	$890,000
Leverage Ratio	45.0%	728,182
Total Asset Purchase Price		$1,618,182
Fees as a Percentage of Equity		11.0%
Fees as a Percentage of Asset Purchase Price		6.8%

FINRA RN 15-02: Proposed Account Statement Rule

Home Purchase Example

Equity Investment		$1,000,000
Leverage Ratio	45.0%	818,182
Total Asset Purchase Price		$1,818,182
Sales Commissions and Closing Costs	7.0%	127,273
Net Sales Proceeds		$1,690,909
Less Leverage (Mortgage Debt)		818,182
Net Cash Proceeds (Account Stmt. Price)		$872,727
Fees as a Percentage of Equity		12.7%
Fees as a Percentage of Asset Purchase Price		7.0%

FINRA RN 15-02: Proposed Account Statement Rule

Non-Listed REIT Exemplar

Fees as a Percentage of Equity	11.0%
Fees as a Percentage of Asset Purchase Price	6.8%

Home Purchase Example

Fees as a Percentage of Equity	12.7%
Fees as a Percentage of Asset Purchase Price	7.0%

FINRA RN 15-02: Proposed Account Statement Rule

What Does it all Mean?

Incumbent upon industry to educate investors that:

1. Adoption of 15-02 does not represent a change in fee structure, just how such fees are disclosed on the account statement
2. Value on the account statement does not represent market value of the security prior to issuing a net asset value
3. The presentation of the Net Investment Methodology is not materially different than if we reflected the purchase of our home net of fees and expenses
4. Industry will coalesce around a share class design to mitigate impact of 15-02.

Client Account Statement Rule Changes:

Rules 2340 and 2310

What does it all mean?

GRIFFIN CAPITAL
guardians of wealth

Griffin Capital Corporation

Kevin Shields | *Chairman & CEO*

This is an excerpt of a full report comparing the performance of non-traded REITs to publicly-traded REITs. The entire report is available through the link at the bottom of the page.

Heard on the Beach

Devolution

August 27, 2014

Green Street Advisors

Executive Summary

In the presence of a highly credible and successful publicly traded REIT industry, the ten-fold expansion in fund raising that the non-traded REIT (NTR) sector has enjoyed over the last fifteen years comes as a big surprise. Who knew investors needed a higher-cost, more conflict-laden, less-liquid vehicle?

The drawbacks of NTRs relative to their publicly traded cousins have long been obvious, but, until recently, it has been impossible to directly compare their performance. A flurry of liquidity events in the sector now affords the opportunity to gauge the round-trip total returns generated by 34 NTRs. Key findings:

- On average, NTRs lagged their publicly traded peers in the same property sector by 360 bps/year. Three-quarters of the NTRs failed to keep pace.
- NTRs focusing on sectors where listed REITs trade at very large premiums to NAV fared far better than most.

The second point provides a strategic roadmap for success for any NTR or, for that matter, any private real estate market participant. When real estate is priced dearly on Wall Street, it can make sense to instead buy it on Main Street.

Those opportunities are, however, few and far between, and the best advice for anyone trying to access the commercial property asset class is, as always, "Buy publicly traded REITs."

To download the full report, go to:

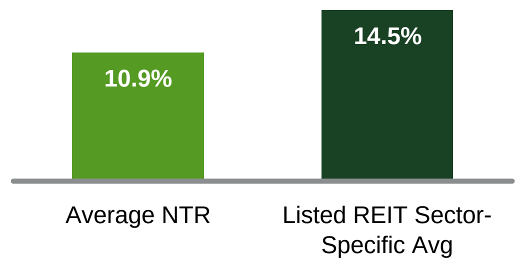
www.GreenStreetAdvisors.com/FeaturedResearch

Important disclosure on page 2

Report Card: Non-traded REITs (NTRs) that have undergone a liquidity event have, in aggregate, failed to deliver total returns on par with their publicly traded peers. The high up-front costs associated with NTRs are difficult to overcome.

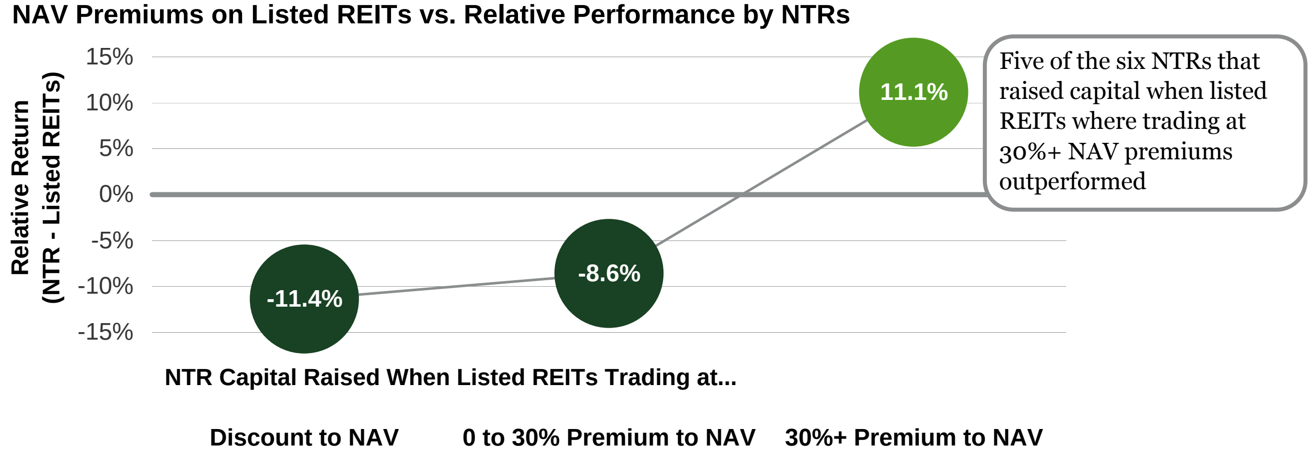
A Comprehensive Study
– 34 NTR's have experienced liquidity events
– Returns are estimated based on public filings
– These 34 NTRs raised $54 billion
– That's roughly half of the total capital raised by all NTRs
– Findings were shared with sponsors
– Comparisons vs Listed REITs are within same property type over same time span

Annualized $-Weighted Returns



Keep an Eye on Public Premiums: 75% (26 of 34) of the NTRs failed to deliver returns commensurate with those delivered by listed REITs in the same property sector. Most of the successful NTRs raised capital when listed REITs in the same property sector were trading at very large premiums.

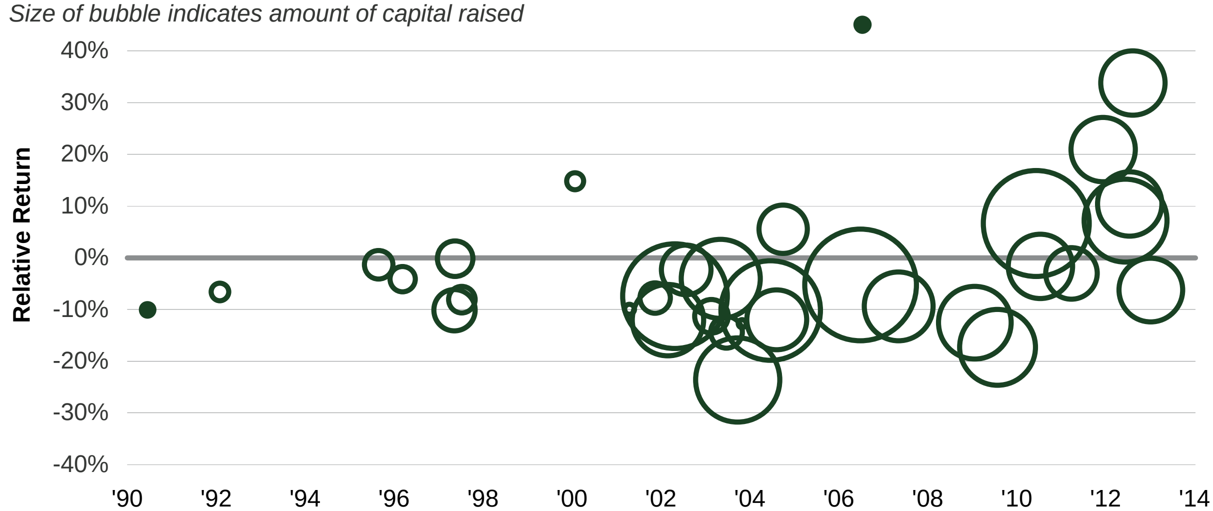
NAV Premiums on Listed REITs vs. Relative Performance by NTRs



Getting Better: Until recently, there had never been a large NTR that outperformed listed REITs. Recent performance by NTRs has been far more impressive, particularly those sponsored by American Realty Capital.

Relative Returns (vs. Listed REITs) by Vintage and Deal Size

Size of bubble indicates amount of capital raised



Access the full report here:

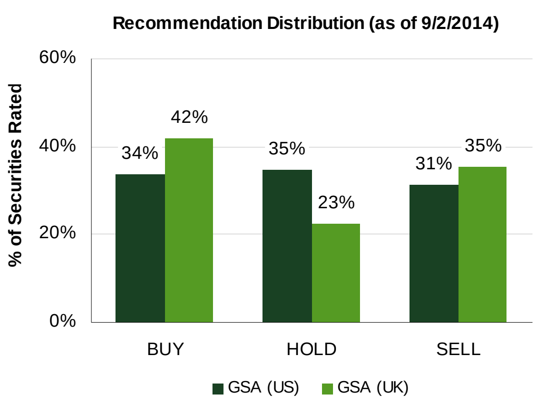
www.GreenStreetAdvisors.com/FeaturedResearch

About Green Street Advisors, Inc.

Founded in 1985, Green Street Advisors is the preeminent independent research, trading, and consulting firm concentrating on Real Estate Investment Trusts (REITs), other publicly traded real estate securities, and the private commercial real estate markets in North America and Europe. Additional information on Green Street Advisors is available online at www.greenstreetadvisors.com

Green Street's Disclosure Information

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".

Total Return of Green Street's Recommendations[1,2]

Year	Buy	Hold	Sell	Universe[3]
2014 YTD	25.4%	21.4%	15.6%	20.8%
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	**11260.1%**	**912.7%**	**6.2%**	**1021.3%**
Annualized	**24.5%**	**11.3%**	**0.3%**	**11.9%**

The results shown above are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from the hypothetical performance shown above 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 returns above 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 September 2, 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

Green Street's Disclosure Information

Analyst Certification – The research analysts listed below hereby certify that all of the views expressed in this research report accurately reflect their personal views about any and all of the subject companies or securities. They also certify that no part of their compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Research Analysts: Mike Kirby, Casey Thormahlen, Peter Rothemund.

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References to "Green Street" in Disclosures in this section and in the Other Important Information section apply to:
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Certified Provider

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- The research recommendation contained in this report was first released for distribution on the date identified on the cover of this report.
- Green Street will furnish upon request available investment information supporting the recommendation(s) contained in this report.

DESCRIPTION OF SECURITIES

We are a corporation formed under the laws of the State of Maryland. Your rights as a stockholder are governed by Maryland law, our charter and our bylaws. The following summarizes the material terms of our common stock as described in our charter and bylaws which you should refer to for a full description. Copies of these documents are filed as exhibits to the registration statement of which this prospectus is a part. You also can obtain copies of these documents if you desire. See “Where You Can Find More Information” below.

General Description of Shares

Our charter authorizes us to issue up to 400,000,000 shares of common stock and 50,000,000 shares of preferred stock, each share having a par value of $0.001. Of the total shares of common stock authorized, 320,000,000 are classified as Class A Shares and 80,000,000 are classified as Class T Shares.

Each share of Class A and Class T common stock is entitled to participate in distributions on its respective class of shares when and as authorized by the board of directors and declared by us and in the distribution of our assets upon liquidation. The per share amount of distributions on Class A and Class T Shares will differ because of different allocations of class-specific expenses. See “— Distribution Policy” below. Each share of common stock will be fully paid and non-assessable by us upon issuance and payment therefor. Shares of common stock are not subject to mandatory redemption. The shares of common stock have no preemptive rights (which are intended to insure that a stockholder has the right to maintain the same ownership interest on a percentage basis before and after the issuance of additional securities) or cumulative voting rights (which are intended to increase the ability of smaller groups of stockholders to elect directors). We have the authority to issue shares of any class or securities convertible into shares of any class or classes, to classify or to reclassify any unissued stock into other classes or series of stock by setting or changing the preferences, conversion or other rights, voting powers, restrictions, limitations as to distributions, qualifications and terms and conditions of redemption of the stock, all as determined by our board of directors. In addition, the board of directors, with the approval of a majority of the entire board and without any action by the stockholders, may amend our charter from time to time to increase or decrease the aggregate number of shares or the number of shares of any class or series that we have authority to issue. The issuance of any preferred stock must be approved by a majority of our independent directors who do not have an interest in the transaction and who have access, at our expense, to our counsel or independent legal counsel.

We will not issue stock certificates unless expressly authorized by our board. Shares will be held in “uncertificated” form, which will eliminate the physical handling and safekeeping responsibilities inherent in owning transferable stock certificates and eliminate the need to return a duly executed stock certificate to the transfer agent to effect a transfer. Transfers can be effected by mailing to DST a duly executed transfer form available upon request from DST or from our website at www.InlandResidentialTrust.com. Upon the issuance of our shares and upon the request of a stockholder, we will send to each such stockholder a written statement which will include all information that is required to be written upon stock certificates under Maryland law.

Class A Shares

We will pay our dealer manager selling commissions equal to 6.0% of the price per Class A Share sold, or $1.50 per Class A Share, with certain exceptions. Our dealer manager anticipates reallowing (paying) the full amount of the selling commissions to participating soliciting dealers as compensation for their services in soliciting and obtaining subscriptions. See “Plan of Distribution — Compensation We Pay For the Sale of Our Shares” for additional information. In addition, we will also pay a dealer manager fee of approximately $0.69 per Class A share, or 2.75% of the price per share sold. Certain purchasers of Class A Shares may be eligible for volume discounts. See “Plan of Distribution — Volume Discounts (Class A Shares Only)” for additional information.

There are no distribution and stockholder servicing fees charged with respect to the Class A Shares.

We may also sell our Class A Shares at a discount to the offering price of $25.00 per share through the following distribution channels in the event that the investor:

(1) purchases shares through fee-based programs, also known as wrap accounts;

(2) purchases shares through certain registered investment advisors;

(3) purchases shares through soliciting dealers and any of their respective directors, officers, employees or affiliates who request and are entitled to alternative fee arrangements with their clients; or

(4) purchases shares as a result of a volume discount.

Investors purchasing shares through one of the above distribution channels in our offering will pay $23.50 per Class A Share (other than shares purchased as a result of a volume discount), reflecting the absence of selling commissions. The net proceeds to us will not be affected by any such reduction in selling commissions.

Inland Securities or any of its or our directors, officers, employees or affiliates or any directors, officers and employees of its affiliates, or any family members of those individuals (including spouses, parents, grandparents, children and siblings), may purchase Class A Shares net of sales commissions and the dealer manager fee for $22.81 per Class A Share.

Class T Shares

We will pay our dealer manager selling commissions equal to 2.0% of the price per Class T Share sold, or approximately $0.48 per Class T Share. In addition, we will also pay a dealer manager fee of approximately $0.66 per share, or 2.75% of the price per share sold.

We will also pay the dealer manager a distribution and stockholder servicing fee of 1.0% per annum of the purchase price per share (or, once reported, the amount of our estimated value per share) for Class T Shares sold in the primary offering. The distribution and stockholder servicing fee will accrue daily and be paid monthly in arrears. The dealer manager may reallow the distribution and stockholder servicing fee to the soliciting dealer who sold the Class T Shares or, if applicable, to a subsequent broker-dealer of record of the Class T Shares so long as the subsequent broker-dealer is party to a soliciting dealer agreement, or servicing agreement, with the dealer manager that provides for such reallowance. The distribution and stockholder servicing fees are ongoing fees that are not paid at the time of purchase. See “Plan of Distribution — Compensation We Pay for the Sale of Our Shares — Distribution and Stockholder Servicing Fee (Class T Shares Only).”

The per share amount of distributions on Class A and Class T Shares will differ because of the distribution and stockholder servicing fee that we pay on the Class T Shares. The distribution and stockholder servicing fee will be paid on each Class T Share that is purchased in the primary offering. We will cease paying the distribution and stockholder servicing fee with respect to any particular Class T Share and that Class T Share will convert into a Class A Share by multiplying each Class T Share to be converted by the “Conversion Rate” described herein on the earlier of (i) a listing of the Class A Shares on a national securities exchange; (ii) a merger or consolidation of the Company with or into another entity, or the sale or other disposition of all or substantially all of the Company’s assets; (iii) the end of the month in which the Dealer Manager determines that total underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid on all Class T Shares sold in the primary offering is equal to 10% of the gross proceeds of the primary offering from the sale of both Class A Shares and Class T Shares; and (iv) the end of the month in which the underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid with respect to that Class T Share equals 10% of the gross offering price of that Class T Share. In the case of a Class T Share purchased in the primary offering at a price equal to $23.95, the maximum distribution and stockholder servicing fee that may be paid on that Class T Share will be equal to approximately $1.26 per share. Although we cannot predict the length of time over which this fee will be paid due to potential changes in the estimated value of our Class T Shares, this fee would be paid over approximately 5.25 years from the date of purchase, assuming a constant estimated value of $23.95 per Class T Share. The Conversion Rate will be equal to the quotient, the numerator of which is the estimated value per Class T Share (including any reduction for distribution and stockholder servicing fees as described herein) and the denominator of which is the estimated value per Class A Share. See “ERISA Considerations — Annual Valuation Requirement.” Persons wishing to purchase Class T Shares at multiple times during the primary offering must open a separate account for each purchase . We will further cease paying the distribution and stockholder servicing fee on any Class T Share that is redeemed or repurchased, as well as upon the Company’s dissolution, liquidation or the winding up of the Company’s affairs, or a merger or other extraordinary transaction in which the Company is a party and in which the Class T Shares as a class are exchanged for cash or other securities. If $1 billion in shares (consisting of $800 million in Class A Shares, at $25.00 per share, and $200 million in Class T Shares, at $23.95 per share) are sold in the primary offering, then the maximum amount of distribution and stockholder servicing fees payable is estimated to be up to $10.5 million, before the 10% limit on Class T Shares is reached. These estimates will change if the actual allocation of Class A and Class T Shares differs from our estimate. The aggregate amount of underwriting compensation for the Class A Shares and Class T Shares, including the distribution and stockholder servicing fee for the Class T Shares, will not exceed FINRA’s 10% cap on underwriting compensation.

Voting Rights. The Class A and Class T Shares will vote together as a single class, and, subject to the restrictions on transfer and ownership of stock set forth in our charter and except as may otherwise be specified in our charter, each share is entitled to one vote on each matter submitted to a vote at a meeting of our stockholders. Generally, all matters to be voted on by stockholders at a meeting of stockholders duly called and at which a quorum is present must be approved by a majority of the votes cast by the holders of all shares of common stock present in person or represented by proxy, voting together as a single class, subject to any voting rights granted to holders of any preferred stock, although the affirmative vote of a majority of shares present in person or by proxy at a meeting at which a quorum is present is necessary to elect each director.

Rights Upon Liquidation

If we liquidate (voluntarily or otherwise), dissolve or wind up, immediately before such liquidation, dissolution or winding up, our Class T Shares will automatically convert to Class A Shares at the Conversion Rate, and our net assets, or the proceeds therefrom, will be distributed to the holders of Class A Shares, which will include all converted Class T Shares, in accordance with their proportionate interests.

Q: Why are you offering two classes of common stock and what are the similarities and differences between the classes?

A: We are offering two classes of our common stock in order to provide investors with more flexibility in making their investment in us. Investors can choose to purchase shares of either class of common stock in the offering. Each share of our common stock, regardless of class, will be entitled to one vote per share on matters presented to the common stockholders for approval. The differences between each class relate to the stockholder fees and selling commissions payable in respect of each class. The following summarizes the differences in fees and selling commissions between the classes of our common stock.

Class A Shares

- Subject to the 10% limit on underwriting compensation, Class A Shares have a higher front-end selling commission, which is a one-time fee charged at the time of purchase of the shares, than charged on the Class T Shares. There are ways to reduce these charges. See "Plan of Distribution — Volume Discounts (Class A Shares Only)" for additional information.

- No annual distribution or stockholder servicing fees.

Class T Shares

- Subject to the 10% limit on underwriting compensation, Class T Shares have a lower front-end selling commission than Class A Shares.

- The Company pays, subject to, among other things, the 10% limit on underwriting compensation, distribution and stockholder servicing fees in an annual amount equal to 1.0% of the purchase price per Class T Share sold in the primary offering (or, once reported, the amount of our estimated value per share), payable on a monthly basis. This fee is not charged on Class A Shares and, all things equal, will result in the per share distributions on the Class T Shares being less than the per share distributions on the Class A Shares. There is no assurance we will pay distributions in any particular amount, if at all.

The distribution and stockholder servicing fee will be paid on each Class T Share that is purchased in the primary offering. We will cease paying the distribution and stockholder servicing fee with respect to any particular Class T Share and that Class T Share will convert into a Class A Share by multiplying each Class T Share to be converted by the "Conversion Rate" described herein on the earlier of (i) a listing of the Class A Shares on a national securities exchange; (ii) a merger or consolidation of the Company with or into another entity, or the sale or other disposition of all or substantially all of the Company's assets; (iii) the end of the month in which the Dealer Manager's determines that total underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid on all Class T Shares sold in the primary offering is equal to 10% of the gross proceeds of the primary offering from the sale of both Class A Shares and Class T Shares; and (iv) the end of the month in which the underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid with respect to that Class T Share equals 10% of the gross offering price of that Class T Share. In the case of a Class T Share purchased in the primary offering at a price equal to $23.95, the maximum distribution and stockholder servicing fee that may be paid on that Class T Share will be equal to approximately $1.26 per share. Although we cannot predict the length of time over which this fee will be paid due to potential changes in the estimated value of our Class T Shares, this fee would be paid over approximately 5.25 years from the date of purchase, assuming a constant estimated value of $23.95 per Class T Share. The Conversion Rate will be equal to the quotient, the numerator of which is the estimated value per Class T Share (including any reduction for distribution and stockholder servicing fees as described herein) and the denominator of which is the estimated value per Class A Share. See "ERISA Considerations — Annual Valuation Requirement." Persons wishing to purchase Class T Shares at multiple times during the primary offering must open a separate account for each purchase. See "Description of Securities — General Description of Shares — Class T Shares" for further details. In addition to the above circumstances, we will further cease paying the distribution and stockholder servicing fee on any Class T Share that is redeemed or repurchased or upon the Company's liquidation, dissolution or winding up.

If we liquidate (voluntarily or otherwise), dissolve or wind up our affairs, then, immediately before such liquidation, dissolution or winding up, our Class T Shares will automatically convert to Class A Shares at the Conversion Rate and our net assets, or the proceeds therefrom, will be distributed to the holders of Class A Shares, which will include all converted Class T Shares, in accordance with their proportionate interests.

The per share amount of distributions on Class A Shares and Class T Shares will differ because of the distribution and stockholder servicing fee. If the distribution and stockholder servicing fee paid by the Company exceeds the amount distributed to holders of Class T Shares in a particular period, the estimated value per Class T Share would be permanently reduced by an amount equal to the Excess Fee for the applicable period divided by the number of Class T Shares outstanding at the end of the applicable period, reducing both the estimated value of the Class T Shares used for conversion purposes and the Conversion Rate described herein.

Inland Securities or any of its or our directors, officers, employees or affiliates or any directors, officers and employees of its affiliates, or any family members of those individuals (including spouses, parents, grandparents, children and siblings), may purchase Class A Shares net of sales commissions and the dealer manager fee for $22.81 per Class A Share.

VENABLE® LLP

750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

October 24, 2013

Maryland Trial Court Upholds Maryland's Narrow Futility Demand Exception and Special Committee's Approval of Acquisition of REIT's External Manager

In an opinion issued yesterday, Judge Althea Handy of the Maryland Business and Technology Case Management Program in the Circuit Court for Baltimore City dismissed, with prejudice, the Amended Complaint in a suit challenging the acquisition by Cole Real Estate Investments, Inc., a Maryland corporation (formerly known as Cole Credit Property Trust III, Inc.) ("CREI"), of its external manager, Cole Holdings Corporation, an Arizona corporation, for stock of CREI and $20 million in cash. The transaction was reviewed and approved by a Special Committee of the Board of Directors of CREI, composed of the three independent directors. The Special Committee also reviewed and rejected two subsequent acquisition proposals by American Realty Capital Properties, Inc., a Maryland corporation ("ARCP"). (ARCP and CREI yesterday announced an acquisition by ARCP of CREI.)

The plaintiff stockholders filed a putative class action, alleging breach of fiduciary duties, aiding and abetting, unjust enrichment, waste and breach of the duty of candor and seeking an injunction of the stockholder vote on certain charter amendments and damages.

Plaintiffs argued that their allegations constituted direct claims for damages to the stockholders arising from (a) the issuance of the new shares in the transaction and (b) insufficient due diligence before rejecting ARCP's offers. Judge Handy disagreed, holding their claims were derivative in nature because there were no allegations of any separate harm to plaintiffs apart from any harm to CREI. The Court then held that plaintiffs were required to make demand on the Board, subject to Maryland's narrow futility exception, set forth in the decision of the Court of Appeals of Maryland (our highest state court) in *Werbowsky v. Collomb* in 2001. This narrow exception applies only where (a) demand or a delay in waiting for a response to a demand would cause "irreparable harm to the corporation" or (b) a majority of the board is "so personally conflicted and committed to" the transaction "that they could not be expected to respond to a demand in good faith and within the ambit of the business judgment rule." To succeed in the conflict exception, according to the Court of Appeals, plaintiffs must identify "clearly" and in "a very particular manner" the disqualifying conflicts of a majority of the board.

Judge Handy recognized the sufficiency of plaintiffs' allegations that the two management directors "were personally and directly conflicted in terms of the Merger" and that a demand made on them "would have been futile." However, with respect to the three members of the Special Committee, the Court held that allegations that they would continue to serve as directors and "earn hundreds of thousands of dollars in [director] fees" were "insufficient" to invoke the futility exception under the *Werbowsky* case. Indeed, the Court of Appeals in *Werbowsky* specifically rejected continued service and compensation as a director as a ground for demand futility. Judge Handy noted that plaintiffs alleged no other conflict as to the three Committee members and thus demand was required.

Having rejected plaintiffs' arguments for the futility exception, Judge Handy nevertheless went on "to address Defendants' alleged breaches of their fiduciary duties in light of the business judgment rule." Starting from the three-part statutory standard of conduct for directors in Section 2-405.1(a) of the Maryland General Corporation Law (which expressly applies to actions of members of a board committee) and quoting from the Supreme Court of Delaware in *Barkan v. Amsted Indus., Inc.*, that "there is no single blueprint that a board must follow to fulfill its duties," the Court noted that plaintiffs had failed to plead the "particularized facts" necessary to overcome the presumption in favor of the actions of the members of the Special Committee.

Judge Handy dismissed the Amended Complaint with prejudice because she had already allowed plaintiffs to amend once and the problems she identified, especially on the demand futility issue, should have been corrected, if plaintiffs had any facts to address those issues, in the Amended Complaint.

Although the Court held that "dismissal of Plaintiffs' entire Consolidated Complaint [was] proper" for the reasons stated above, she specifically included in her dismissal a rejection of plaintiffs' "duty of candor" claim because the duty of candor has been "rigidly" limited by the Court of Appeals to "cash-out mergers" and also because plaintiffs had failed to plead direct claims against defendants for the reasons stated above.

Judge Handy's decision is another recognition by the judges of the Maryland Business and Technology Case Management Program that the actions of directors, particularly independent directors, of Maryland corporations will continue to receive broad judicial deference.

* * * *

As always, please feel free to call any of us or any of our colleagues at any time for any questions concerning Maryland law.

Jim Hanks
Sharon Kroupa
Chris Pate

VENABLE® LLP

750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

April 9, 2014

Board Classification in Maryland: Evaluating Section 3-803 of the MGCL

Since 1999, Section 3-803 of the Maryland General Corporation Law (the "MGCL") has permitted the board of directors of a Maryland corporation or the board of trustees of a Maryland real estate investment trust with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors or trustees to elect to classify itself notwithstanding any contrary provision in the charter, declaration of trust or bylaws and without a stockholder vote. This statute, adopted by the Maryland legislature specifically to address the abuses of hostile takeovers, has recently received negative commentary from governance scorekeepers and activists. Green Street Advisors has urged boards to opt out of Section 3-803, REIT Zone Publications has issued several missives similarly attacking Section 3-803 and a union group, focused on the hotel industry, has sent stockholder proposals seeking an opt-out from this provision of Maryland law.

As is regrettably common with corporate governance scorekeepers and activists, they take an unbending one-size-fits-all position. On this issue, they declare with utter certainty that it is never appropriate for the board of any Maryland corporation or REIT to classify itself without stockholder approval under any circumstance now or in the future. Recently, they have asserted that, as is permitted by the MGCL, the boards of all Maryland companies should opt out of the provisions of Section 3-803 and condition any future opt-in on a stockholder vote. This approach ignores the fact that the directors, who are statutorily required to act in the best interests of the company, have the most information about the company and are, therefore, in the best position to evaluate the governance of the company.

Classified boards have been a common feature of corporate governance for nearly 100 years. At the most, they defer a change of control of the board for a year. We continue to believe that a classified board serves important and legitimate corporate governance objectives, including (a) providing a modest measure of continuity and stability in business strategies, operations and management; (b) enabling the board to focus on long-term value maximization strategies rather than short-term stock price movements; and (c) protecting the company from coercive takeovers by encouraging would-be acquirers to negotiate with the board, as the stockholders' elected representatives. In addition, a board's power under Section 3-803 to classify itself provides a valuable tool to promptly and effectively respond to a hostile attack that is not in the best interests of stockholders, which would likely not be possible if it were necessary to obtain stockholder approval in advance. Let's be clear: A classified board will not stop a fully-financed premium bid for a company, but it will prevent a sudden shift of the board into the hands of people seeking a low-ball sale of the company or other transaction not necessarily in the best interests of the company or all the stockholders.

Unlike the governance scorekeepers and activists, we do not take a hard and fast, arbitrary position with no exceptions or acknowledgement of differing situations. We recognize that a classified board and the board's power to classify itself may not be right for all companies at all times and under all circumstances. We also recognize that there are arguments in favor of a declassified board or opting out of Section 3-803, including that a declassified board enables stockholders to register their views annually on the performance of the entire board and each director and that declassifying or opting out of Section 3-803 would be popular with many institutional investors and corporate governance critics. We think these arguments should be weighed by a board together with the benefits of classification in various circumstances, and we are especially concerned about a board effectively renouncing for all future boards of the company the availability of a protection against hostile takeovers.

We have advised many boards on opting into Section 3-803 and on considering whether to retain the power to classify itself. In addition, we have recently received questions from clients and others on Section 3-803. In general, we recommend that a board:

- Receive legal, financial and other relevant advice (including empirical data) on the advantages and disadvantages, for the company, of a classified board and Section 3-803;

- Analyze the company's existing and desired governance profile, considering its overall takeover risk profile and available defenses;

- Evaluate options in between remaining subject to Section 3-803 and opting out of it entirely (*e.g.*, providing that any opt-in to Section 3-803 be submitted for stockholder approval within twelve months); and

- Discuss the board's position on these issues with and solicit the views of the company's major stockholders.

Electing to opt out of Section 3-803 is a significant and likely permanent loss to a company's defenses against hostile takeovers and we recommend that a board carefully evaluate the facts as they relate to the particular company.

* * * *

As always, please do not hesitate to call any of us if you have any questions or comments about any of the foregoing or any other matter of Maryland law.

Jim Hanks	Sharon Kroupa	Patsy McGowan	Michael Leber
Mike Schiffer	Chris Pate	Carmen Fonda	Jeff Keehn
Brian Field	Hirsh Ament	Michael Sheehan	Nick Collevecchio
Gabe Steele	Dan Mendelsohn	Gueter Aurelien	

This memorandum is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations for which Venable LLP has accepted an engagement as counsel.

NASDAQ Listing and Tender Offer

Closing Checklist

DOCUMENT OR ACTION
NASDAQ Listing
1. HCT Listing Application
a. Reserve ticker symbol
b. Obtain CIK number
c. Obtain CUSIP number
2. Certification re: Corporate Governance Documents
a. Copy of Amended and Restated Audit Committee Charter
b. Copy of Nominating & Corporate Governance Committee Charter
c. Copy of Compensation Committee Charter
d. Copy of Amended and Restated Code of Ethics
e. Copy of Corporate Governance Guidelines
3. Pay Application Fee
4. Pay Registration Fee
5. Listing Agreement
6. Written confirmation from Transfer Agent that the security to be listed is or will be eligible for a Direct Registration Program
7. File Form 8-A
8. Request that NASDAQ file its Form 8-A certification with the SEC
9. Notice of Issuance from NASDAQ
10. Respond to comments from NASDAQ
11. Amended and Restated Bylaws
12. 2014 Outperformance Award Agreement

DOCUMENT OR ACTION
13. Subordinated Incentive Listing Fee Note
14. Amendment to Restricted Share Plan
15. Amended and Restated Advisory Agreement
16. Amended and Restated OP Agreement
17. Notice to stockholders re: amendment and suspension of DRIP and termination of share repurchase program
18. Memo re: trading restrictions / temporary blackouts for directors and officers, employees and respective families
19. Confirm that D&O insurance will continue to provide sufficient coverage after listing
20. EDGAR codes for Section 16 filers
21. Form 3s and 4s for Section 16 filers
22. Confirm Transfer Agent process complete
23. Revise website terms and conditions and privacy policy
24. Board resolutions (listing, tender offer, etc.)
25. Board resolutions (amendments to credit agreement, OP agreement, etc.)
26. Form 8-K re: amended agreements and bylaws
Tender Offer
1. Schedule TO and Offer to purchase
2. Letter of Transmittal
3. Notice of guaranteed delivery
4. Form of letter to stockholders
5. Form of letter to brokers, dealers, commercial banks, trust companies and other nominees

DOCUMENT OR ACTION	
6.	Form of letter to clients (including instructions and forms)
7.	Form of notice of withdrawal for registered stockholders
8.	Form of notice of withdrawal for DTC participants
9.	Form of WSJ/NYT advertisement
10.	Amendment to Credit Agreement
11.	Subordination and Standstill Agreement
12.	Press release announcing preliminary results of tender offer and Form 8-K
13.	Press release announcing final results of tender offer and Form 8-K
14.	Establish satisfaction or waiver of any funding conditions
15.	Press release announcing satisfaction or waiver of funding conditions
16.	[Form of letter to Stockholders /Custodians for stockholders expressing an interest in other ARC alternative investment products]
17.	Settlement of Tendered Shares
18.	“Sweep up” of fractional shares
Shelf Registration Statement	
1.	File Form S-3ASR
2.	Legal opinion re legality of securities
3.	Legal opinion re tax matters
4.	Consent of independent accounting firm
5.	Form of “open-ended” indenture
6.	Ratio of earnings to fixed charges exhibit 12.1

January 13, 2014

The Honorable Thomas Perez
Secretary
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Dear Secretary Perez:

We would like to congratulate you on your new position as Secretary of Labor. As members of the New Democrat Coalition, we look forward to working with you on the important challenges and opportunities facing our country.

The New Democrat Coalition played a major role with respect to the Dodd-Frank Wall Street Reform and Consumer Protection Act in advocating for a regulatory approach that would reduce systemic risk and increase transparency and certainty in our markets. With respect to fiduciary standards, a key objective of the Dodd-Frank Act was to protect investors while reducing confusion. That should be an important consideration in the Department's coordination with other regulators.

In this regard, Members of the New Democrat Coalition had written Secretary Solis in 2011 with concerns about the Department's proposal to redefine the term "fiduciary" for purposes of the Employee Retirement Income Security Act of 1974 and for purposes of certain Internal Revenue Code provisions affecting Individual Retirement Accounts and similar arrangements. We were very pleased that Secretary Solis agreed with our recommendation that the rule as initially proposed needed to be withdrawn, so that further work could be done on the issue.

As you consider a re-proposal of this regulation, we write to express our strong interest in establishing a dialogue with you, particularly with respect to our two core concerns regarding the fiduciary definition.

First, we continue to believe that any new definition should not limit access to investment education and information. We certainly want to protect plan participants, IRA owners, and plan sponsors from unfair and deceptive practices. But this should be done in a way that does not restrict access to critical investment assistance. While the original rule would have had little effect on wealthy investors or large businesses, it inadvertently could have significantly restricted the availability of investment help to low- and middle-income individuals and small businesses. Additionally, the original rule could have created problems under existing prohibited transaction rules and limited access plan participant's access to investment advice even when it was in their best interest. We ask you to work with us to ensure that any re-proposal does not have similar effects.

Second, we strongly believe that there needs to be coordination with other regulators to ensure that all regulatory efforts with respect to fiduciary standards work together in a way that serves retirement savers effectively.

We were heartened by your commitment in your confirmation hearing to work with the Hill on this critical project. Given our history with respect to the Dodd-Frank Act and the fiduciary issue, we would very much like to establish a dialogue with you on the fiduciary project. As you consider the future path of any proposal, and before you send any proposal to the Office of Management and Budget, we respectfully request the opportunity to have a dialogue on how to best protect low and middle-income individuals and small businesses, while ensuring access to investment education, information, and affordable investment products and services.

Sincerely,

Rush Holt

RUSH HOLT
Member of Congress

Carolyn McCarthy

Carolyn McCarthy
Member of Congress

Ron Kind

Ron Kind
Member of Congress

Patrick Murphy

Patrick Murphy
Member of Congress

Ann McLane Kuster

Ann M. Kuster
Member of Congress

Terri Sewell

Terri A. Sewell
Member of Congress

Joe Garcia

Joe Garcia
Member of Congress

Mike McIntyre

Mike McIntyre
Member of Congress

James A. Himes
Member of Congress

John Barrow
Member of Congress

Cedric L. Richmond
Member of Congress

William L. Owens
Member of Congress

Loretta Sanchez
Member of Congress

Bradley S. Schneider
Member of Congress

Ron Barber
Member of Congress

Juan Vargas
Member of Congress

Kurt Schrader
Member of Congress

Bill Foster
Member of Congress

Daniel B. Maffei
Member of Congress

Gregory W. Meeks
Member of Congress

Gerald E. Connolly
Member of Congress

David Scott
Member of Congress

Pedro R. Pierluisi
Member of Congress

Elizabeth H. Esty
Member of Congress

Adam B. Schiff
Member of Congress

Sean Patrick Maloney
Member of Congress

John K. Delaney
Member of Congress

Scott H. Peters
Member of Congress

John C. Carney, Jr.
Member of Congress

Joe Courtney
Member of Congress

NYSE Listing and Tender Offer

Closing Checklist

DOCUMENT OR ACTION
NYSE Listing
1. NYSE Listing Application
a. Reserve ticker symbol
b. Obtain CIK number
c. Obtain CUSIP number
2. Certification re: Corporate Governance Documents
a. Copy of Audit Committee Charter
b. Copy of Nominating & Corporate Governance Committee Charter
c. Copy of Compensation Committee Charter
d. Copy of Amended and Restated Code of Business Conduct and Ethics
e. Copy of Corporate Governance Guidelines
3. Pay Application Fee
4. Pay Registration Fee
5. Listing Agreement
6. Written confirmation from Transfer Agent that the security to be listed is eligible for a Direct Registration Program
7. File Form 8-A
8. Request that NYSE file its Form 8-A certification with the SEC
9. Interview market makers
10. Notice of Issuance from NYSE
11. Respond to comments from NYSE
12. Amended and Restated Bylaws

DOCUMENT OR ACTION	
13.	Articles of Amendment re: Name Change
14.	Second Amended and Restated Charter
15.	2014 Outperformance Award Agreement
16.	Subordinated Incentive Listing Fee Note
17.	Amendment to Restricted Share Program
18.	Sixth Amended and Restated Advisory Agreement
19.	Fourth Amended and Restated OP Agreement
20.	Notice to stockholders re: amendment and suspension of DRIP and termination of share repurchase program
21.	Memo re: trading restrictions / temporary blackouts for directors and officers, employees and respective families
22.	Confirm that D&O insurance will continue to provide sufficient coverage after listing
23.	EDGAR codes for Section 16 filers
24.	Form 3s and 4s for Section 16 filers
25.	Confirm Transfer Agent process complete
26.	Revise website terms and conditions and privacy policy
27.	Board resolutions (listing, tender offer, etc.)
28.	Board resolutions (amendments to credit agreement, OP agreement, etc.)
29.	Form 8-K re: name change and FAQs
30.	Form 8-K re: amended agreements and bylaws
31.	Press release re Listing on NYSE
32.	Press release re commencement of tender offer

DOCUMENT OR ACTION
33. Press release re television appearances
34. Contribution and Exchange Agreement
Tender Offer
1. Schedule TO and Offer to purchase
2. Letter of Transmittal
3. Notice of guaranteed delivery
4. Form of letter to stockholders
5. Form of letter to brokers, dealers, commercial banks, trust companies and other nominees
6. Form of letter to clients (including instructions and forms)
7. Form of notice of withdrawal for registered stockholders
8. Form of notice of withdrawal for DTC participants
9. Form of WSJ/NYT advertisement
10. Credit Agreement
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5. Form of “open-ended” indenture
6. Ratio of earnings to fixed charges exhibit 12.1

RECENT NON-TRADED REIT LIQUIDITY EVENTS

NON-TRADED REIT	LIQUIDITY EVENT	LIQUIDITY TYPE	DATE OF LIQUIDITY EVENT	AMEND & RESTATE CHARTER BEFORE LISTING?
Cole Corp. Income Trust	Merged with SIR		Jan-15	
Griffin Am Healthcare II	Merged with NorthStar		Dec-14	
Monogram Residential	Listed on NYSE	Mod. Dut. Auction TO	Nov-14	No (Amended Dec-14)
Inland Diversified	Merged with Kite Realty		Jul-14	
New York REIT	Listed on NYSE	Tender Offer	Apr-14	No (Amended June-14)
ARC Healthcare	Listed on NASDAQ	Tender Offer	Apr-14	No (Springing charter effective on listing)
Bluerock Residential	Listed on NYSE	Phased-In Liquidity & TO	Mar-14	Yes
CPA 16	Merged with WP Carey		Jan-14	
ARCT IV	Merged with ARCP		Jan-14	
Columbia Prop Trust	Listed on NYSE	Mod. Dut. Auction TO	Oct-13	Yes
Retail Prop America	Listed on NYSE	Phased-In Liquidity	Oct-13	Yes
Cole Credit Property Trust II	Merged with Spirit Realty		Jul-13	
Cole RE/Cole III	Listed on NYSE	Mod. Dut. Auction TO	Jun-13	Yes
Apple REIT Six	Acquired by Blackstone		May-13	
Chambers Street	Listed on NYSE	Mod. Dut. Auction TO	May-13	No (Amended June-14)
ARCT III	Merged with ARCP		Feb-13	
CPA 15	Merged with WP Carey		Sep-12	

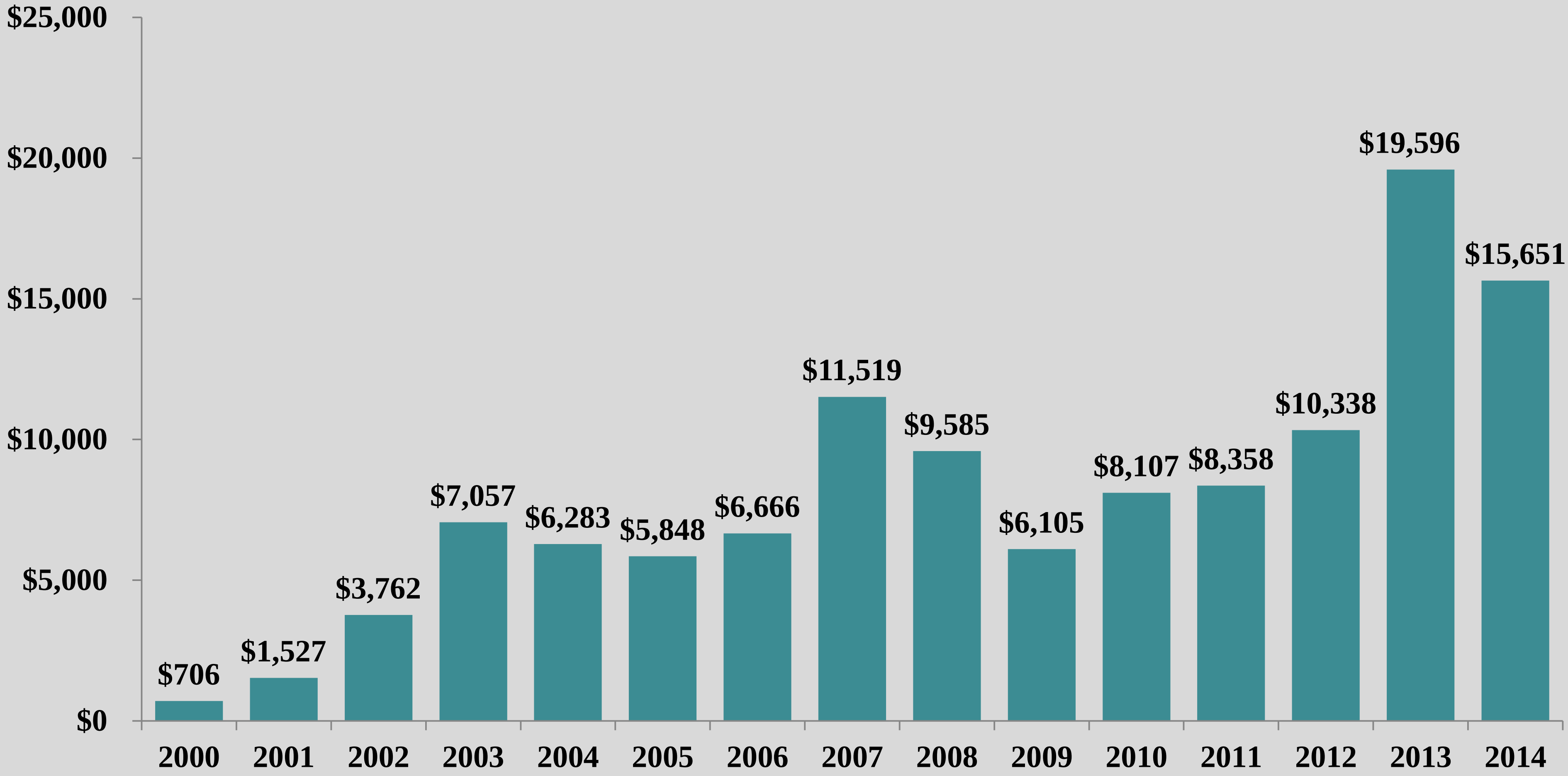
NON-TRADED REIT	LIQUIDITY EVENT	LIQUIDITY TYPE	DATE OF LIQUIDITY EVENT	AMEND & RESTATE CHARTER BEFORE LISTING?
HTA	Listed on NYSE	Phased-In Liq. & Mod. Dut. Auction TO	Jun-12	Yes
ARCT	Listed on NASDAQ	Mod. Dut. Auction TO	Mar-12	No (Amended July-12)
CPA 14	Merged w/CPA 16 – Global		May-11	

Retail Investor Capital Flows

Public Non-Listed REIT Fundraising

2000 – 2014

($ millions)



Source: The Stanger Market Pulse

2013 Top Real Estate Sponsors

(Dollars in Millions)

#	Sponsor	2013	Market Share
1	American Realty Capital	$7,805.0	39.8%
2	Cole Capital	3,567.9	18.2%
3	Griffin Capital Corporation	2,103.1	10.7%
4	Hines Interest Limited Partnership	772.2	3.9%
5	Dividend Capital	770.8	3.9%
6	W.P. Carey Inc.	655.7	3.3%
7	NorthStar Asset Management Group I	649.2	3.3%
8	Carter/Validus Advisors	514.2	2.6%
9	Steadfast REIT Investments, LLC	506.4	2.6%
10	CNL Financial Group	476.2	2.4%
	Totals - Top Ten	**$17,820.6**	**90.8%**

Source: The Stanger Market Pulse

2014 Top Real Estate Sponsors

(Dollars in Millions)

#	Sponsor	2014	Market Share
1	American Realty Capital	$6,064.0	38.8%
2	Griffin Capital Corporation	1,698.1	10.9%
3	W.P. Carey Inc.	1,483.2	9.5%
4	Cole Capital	1,315.2	8.4%
5	NorthStar Asset Management Group Inc.	1,129.6	7.2%
6	Carter/Validus Advisors	1,037.0	6.6%
7	CNL Financial Group	622.0	4.0%
8	KBS Capital Advisors LLC	576.9	3.7%
9	Hines Interest Limited Partnership	380.3	2.4%
10	Inland Real Estate Investment Corp	344.4	2.2%
	Totals - Top Ten	**$14,650.4**	**93.6%**

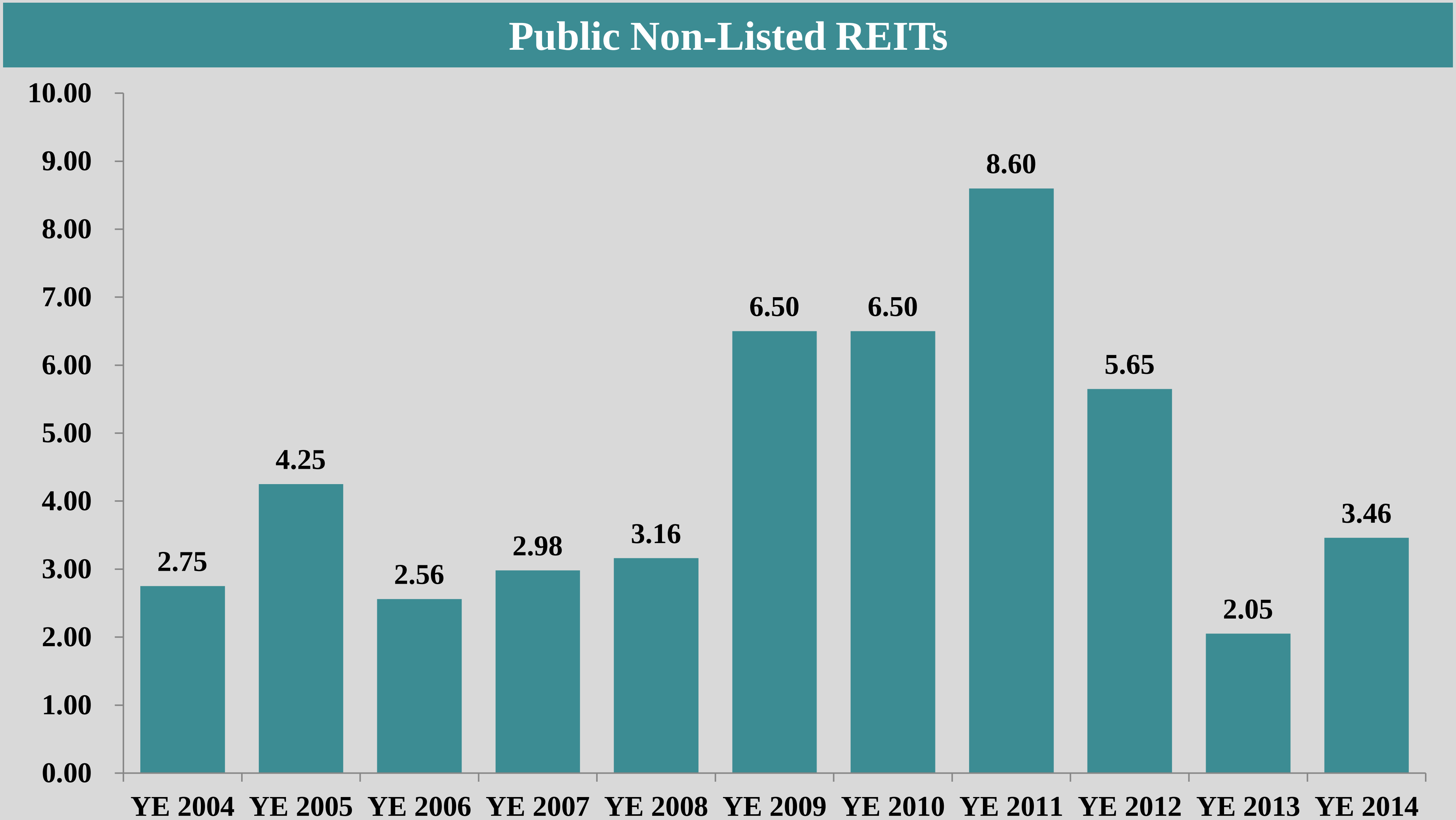
2015 Top Real Estate Sponsors

Sorted by February 2015 Sales

(Dollars in Millions)

#	Sponsor	January	February
1	American Realty Capital	$152.0	$194.8
2	Griffin Capital Corporation	855.4	99.4
3	KBS Capital Advisors LLC	52.2	74.2
4	NorthStar Asset Management Group Inc.	151.8	51.8
5	Inland Real Estate Investment Corp	37.1	47.9
6	Dividend Capital	28.5	38.5
7	Carter/Validus Advisors	24.5	34.1
8	CNL Financial Group	125.7	32.9
9	Steadfast REIT Investments, LLC	28.8	30.6
10	W.P. Carey Inc.	19.0	29.3
	All Others	56.4	78.1
	Totals	**$1,531.4**	**$711.6**

Stanger Market Clearing Index:



Liquidity Events

2012 Non-Listed REIT Liquidity Events

(Dollars in Millions, Except Per Share)

REIT	Initial Liquidity Date	Capital Raised	Issue Price	Price at Monetization	Price 3/10/2015
ARCT American Realty Capital Trust ARCT / NASDAQ	3/1/2012	$1,832.1	$10.00	$10.49/$13.01	$14.51
RPAI Retail Properties of America, Inc.	4/9/2012	4,219.7	$25.00	$8.00	$15.66
CPA:15	9/28/2012	1,476.2	$10.00	$12.65	$16.69
HTA Healthcare Trust of America	6/6/2012	2,195.7	$20.00	$19.84	$26.60
2012 Total		**$9,723.7**			

2013 Non-Listed REIT Liquidity Events

(Dollars in Millions, Except Per Share)

REIT	Initial Liquidity Date	Capital Raised	Issue Price	Price at Monetization	Price 3/10/2015
American Realty Capital Trust III, Inc.	2/28/2013	$1,700.0	$10.00	$13.23	$8.86
COLE II	7/17/2013	1,969.6	$10.00	$9.45	$11.72
Apple REIT Six	5/14/2013	963.1	$11.00	$11.50	$11.10
Chambers Street	5/21/2013	2,388.0	$10.00	$10.00	$7.69
COLE	6/20/2013	4,555.6	$10.00	$11.14	$10.20
Columbia Property Trust	10/16/2013	5,150.1	$40.00	$22.54	$25.71
CatchMark Timber Trust	12/12/2013	295.1	$25.00	$13.50	$11.91
2013 Total		**$17,021.5**			

2014 Non-Listed REIT Liquidity Events

(Dollars in Millions, Except Per Share)

REIT	Initial Liquidity Date	Capital Raised	Issue Price	Price at Monetization	Price 3/10/2015
American Realty Capital Trust IV, Inc.	1/3/2014	$1,736.5	$25.00	$30.54	$27.79
Paladin REIT	1/30/2014	75.3	$10.00	$7.25	$7.25
CPA:16 Global	1/31/2014	1,103.3	$10.00	$11.25	$12.15
American Realty Capital Healthcare Trust, Inc.	4/7/2014	1,738.0	$10.00	$10.55	$11.73
NYRT New York REIT	4/15/2014	1,715.6	$10.00	$10.75	$10.02
Cole I	5/19/2014	100.9	$10.00	$7.25	$7.25
UDF IV United Development Funding IV	6/4/2014	607.0	$20.00	$19.60	$17.27
Inland Diversified Real Estate Trust, Inc.	7/1/2014	1,105.1	$10.00	$10.67	$11.35
KBS Real Estate Investment Trust II	7/7/2014 Asset Sale	500.0	$10.00	NA	NA
Monogram Residential Trust	11/21/2014	1,459.8	$10.00	$9.25	$9.30

2014 Non-Listed REIT Liquidity Events

(Dollars in Millions, Except Per Share)

REIT	Initial Liquidity Date	Capital Raised	Issue Price	Price at Monetization	Price 3/10/2015
GRIFFIN-AMERICAN HEALTHCARE REIT II	12/3/2014	2,840.6	$10.00	$11.50	$11.53
2014 Total		**$12,982.1**			

2015 Non-Listed REIT Liquidity Events

(Dollars in Millions, Except Per Share)

REIT	Initial Liquidity Date	Capital Raised	Issue Price	Price at Monetization	Price 3/10/2015
Announced					
Inland American Real Estate Trust, Inc.	Pending Spin Off	1,804.4	$10.00	NA	NA
Cole Corporate Income Trust, Inc.	Pending Merger	1,642.0	$10.00	$9.07	$8.49
Plymouth REIT	Pending IPO	10.6	$10.00	NA	NA
Signature Office REIT	Pending Merger	496.5	$25.00	NA	NA
2015 Total		**$3,953.5**			
Prospective					
Apple Hospitality REIT	Prospective Listing	4,000.0	$11.00	N/A	N/A

Mountain of Non-Listed REITs to Recycle

(Dollars in Millions)

#	Non-Listed REIT	Offering Close Date	Shares / OP Units Outstanding 9/30/2014	Latest Reported Price	Market Capitalization
1	American Realty Capital - Retail Centers of America, Inc.	9/12/2014	86,433,947	$10.00	$864.3
2	American Realty Capital Global Trust, Inc.	6/30/2014	176,205,378	10.00	1,762.1
3	American Realty Capital Healthcare Trust II, Inc.	11/17/2014	81,457,535	25.00	2,036.4
4	American Realty Capital Trust V, Inc.	9/30/2013	64,821,722	25.00	1,620.5
5	Apple Hospitality REIT, Inc.	12/9/2010	373,820,814	10.25	3,831.7
6	Apple REIT Ten, Inc.	7/31/2014	91,334,230	11.00	1,004.7
7	Behringer Harvard Opportunity REIT I, Inc.	12/28/2007	56,500,472	3.58	202.3
8	Behringer Harvard Opportunity REIT II, Inc.	3/15/2012	25,908,217	9.72	251.8
9	Carey Watermark Investors Incorporated	12/19/2014	91,491,484	10.00	914.9
10	Carter Validus Mission Critical REIT, Inc.	6/6/2014	173,412,008	10.00	1,734.1
11	CNL Growth Properties, Inc.	4/11/2014	22,526,171	9.90	223.0
12	CNL Lifestyle Properties, Inc.	4/6/2011	325,214,000	6.85	2,227.7
13	Cole Corporate Income Trust, Inc.	9/30/2013	197,817,978	10.00	1,978.2
14	Cole Credit Property Trust IV, Inc.	2/25/2014	302,462,883	10.00	3,024.6
15	Corporate Property Associates 17 - Global, Inc.	12/20/2012	325,903,988	9.50	3,096.1
16	Global Income Trust, Inc.	4/23/2013	8,419,689	8.90	74.9
17	Griffin Capital Essential Asset REIT, Inc.	4/22/2014	133,907,451	9.56	1,280.2
18	Hines Global REIT, Inc.	4/11/2014	269,486,000	8.90	2,398.4
19	Hines Real Estate Investment Trust, Inc	12/31/2009	242,877,419	6.50	1,578.7
20	Industrial Income Trust, Inc.	7/18/2013	210,254,000	10.40	2,186.6
21	Inland American Real Estate Trust, Inc.	4/6/2009	861,824,767	6.94	5,981.1
22	KBS Legacy Partners Apartment REIT, Inc.	3/31/2014	19,970,415	10.14	202.5
23	KBS Real Estate Investment Trust II, Inc.	12/31/2010	190,753,163	5.86	1,117.8
24	KBS Real Estate Investment Trust, Inc.	5/30/2008	188,474,659	4.52	851.9

Mountain of Non-Listed REITs to Recycle

(Dollars in Millions)

#	Non-Listed REIT	Offering Close Date	Shares / OP Units Outstanding 9/30/2014	Latest Reported Price	Market Capitalization
25	KBS Strategic Opportunity REIT, Inc.	11/14/2012	59,903,681	$12.24	$733.2
26	Landmark Apartment Trust of America	7/17/2011	66,998,759	8.15	546.0
27	Lightstone Value Plus REIT II, Inc.	9/27/2014	18,380,020	10.00	183.8
28	Lightstone Value Plus REIT, Inc.	10/10/2008	26,303,061	11.80	310.4
29	NorthStar Real Estate Income Trust, Inc.	7/19/2013	117,099,835	10.02	1,173.3
30	Phillips Edison - ARC Shopping Center REIT, Inc.	12/11/2013	180,573,225	10.00	1,805.7
31	Plymouth Industrial REIT, Inc.	5/6/2014	1,325,792	10.00	13.3
32	Resource Real Estate Opportunity REIT, Inc.	12/13/2013	6,835,343	10.00	68.4
33	Sentio Healthcare Properties, Inc.	4/29/2011	16,147,780	11.63	187.8
34	Signature Office REIT, Inc.	6/10/2013	20,473,024	25.00	511.8
35	SmartStop Self Storage, Inc.	9/22/2013	60,799,150	10.81	657.2
36	Steadfast Income REIT, Inc.	12/20/2013	76,507,922	10.24	783.4
37	Strategic Realty Trust, Inc.	2/7/2013	11,403,029	7.11	81.1
38	Summit Healthcare REIT, Inc.	11/23/2010	23,028,014	2.09	48.1
39	TIER REIT, Inc.	12/31/2008	299,696,686	4.48	1,342.6
					$48,890.9

Regulatory Initiatives

SR-FINRA 2014-06
Final Rule Approved By SEC

- Value Must Be Reported on Account Statement
  (Unless Deemed Unreliable)
- Member Firm Can Only Participate in Offerings Where Issuer Agrees to Disclose Valuations Conforming to Rule
  (Including Methodology, Scope, Date, Basis for Value)
- Two Presumptively Reliable Methods
  - Net Investment
  - Appraised Value
- Enhanced Disclosure Re: Distributions > "Earnings"
- Accelerated Timing of First Valuation
- Implementation Period

SR-FINRA 2014-06
Valuation Methodologies

- **Net Investment**
  - "Amount Available For Investment" From Estimated Use of Proceeds In Prospectus
  - Aggregate $ Registered Less % Deduction for Sales Commissions, Dealer Manager Fees and O&O

    (Based on Max Offering, Unless Reason to Believe Unreliable)
  - May Use Until 150 Days After 2nd Anniversary of Escrow Break

- **Appraised Value**
  - May Disclose at Any Time, But Must Disclose no Later Than Limitation Date for Net Investment Use
  - Based on Valuations of Program Assets and Liabilities
  - Performed at Least Annually
  - By or With Material Assistance/Confirmation of 3rd Party Expert
  - Methodology Conforms to Standard Industry Practice

SR-FINRA 2014-06
Other Provisions

- **Enhanced Disclosure Regarding Excess Distributions**
  - Prior to Disclosure of Appraised Valuation, Account Statement Must Include, If Applicable, This Required Disclosure:

    "IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."
  - Must be Prominent and Proximate to Disclosure of Distributions and Per Share Estimated Value.

- **Acceleration of Appraised Valuations**
  - No Later Than 150 Days After 2nd Anniversary of Escrow
  - Previously Was 18 Months After Closing of Offering Period.

- **Implementation (To be Defined by FINRA in Final RN)**
  - Final: April 11, 2016

SR-FINRA 2014-06
Industry Responses

1. Sell Through With Greater Education of Broker and Investors

2. Product Innovation

    - Deferred Commission Structures/ Daily NAV

Non-Listed REIT Sales by Share Class

Dollars in Millions

Sponsor/Program	Effective Date	Amount Registered	Class	Max Up-Front Fee	Most Recent 3 Months October	November	December	Total	Total Sales by Class	% Sales by Class
American Realty Capital										
ARC Daily Net Asset Value Trust, Inc.	8/15/2011	$1,500.0	Retail	7.0%	0.1	0.2	0.1	0.4	12.9	50%
			Institutional	0.7%	0.1	0.0	0.1	0.3	13.1	50%
			TOTAL		**0.3**	**0.2**	**0.2**	**0.6**	**26.0**	
Carter/Validus Advisors										
Carter Validus Mission Critical REIT II, Inc.	5/29/2014	$2,250.0	**Class A**	**7.0%**	**12.9**	**18.1**	**20.8**	**51.8**	**70.1**	100%
			Class T	**3.0%**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	0%
			TOTAL		**12.9**	**18.1**	**20.8**	**51.8**	**70.1**	
Cole Capital										
Cole Real Estate Income Strategy (Daily NAV), Inc.	12/6/2011	$3,500.0	Class A	3.75%	0.6	0.2	0.1	0.9	3.0	2%
			Class I	None	0.3	0.1	0.0	0.4	1.7	1%
			Class W	None	6.6	1.5	0.5	8.7	129.7	97%
			TOTAL		**7.5**	**1.8**	**0.6**	**9.9**	**134.4**	
Dividend Capital										
Dividend Capital Diversified Property Fund, Inc.	1/27/2006	$4,044.0	Class A	3.0%	0.4	0.3	0.7	1.4	8.5	8%
			Class I	None	2.6	1.7	0.7	5.0	88.6	81%
			Class W	None	2.2	0.2	0.1	2.4	11.8	11%
			TOTAL		**5.2**	**2.2**	**1.5**	**8.9**	**108.9**	
LaSalle Investment Management, Inc.										
Jones Land LaSalle Income Property Trust, Inc.	10/1/2012	$2,700.0	A Shares	3.5%	8.7	6.5	7.1	22.3	207.3	80%
			M Shares	None	4.8	1.5	3.6	10.0	50.8	20%
			TOTAL		**13.5**	**8.0**	**10.7**	**32.3**	**258.1**	
RREEF America LLC										
RREEF Property Trust, Inc.	1/3/2013	$2,250.0	Class A	3.0%	0.3	0.7	0.9	1.9	22.2	49%
			Class B	None	0.2	0.3	1.5	2.0	23.2	51%
			TOTAL		**0.5**	**1.0**	**2.4**	**3.9**	**45.4**	

Non-Listed REIT Sales by Share Class

Dollars in Millions

Sponsor/Program	Effective Date	Amount Registered	Class	Max Up-Front Fee	Most Recent 3 Months: October	November	December	Total	Total Sales by Class	% Sales by Class
W.P. Carey Inc.										
Corporate Property Associates 18 - Global, Inc.	5/7/2013	$1,250.0	Class A	7.0%	0.0	0.0	0.0	0.0	977.4	86%
			Class C	1.5%	19.5	15.1	18.0	52.5	165.7	14%
			TOTAL		**19.5**	**15.1**	**18.0**	**52.5**	**1,143.1**	
Summary by Commission Structure:										
Retail Commission					13.0	18.3	20.9	52.2	1,060.4	59%
Low/No Commission					46.3	28.2	33.3	107.8	725.6	41%
Total					**59.4**	**46.5**	**54.2**	**160.0**	**1,786.1**	

**Low commission is defined as less than 7% up front fee*

Non-Traded Equity REIT Fundraising – 2013

(Dollars in Millions)

Sector	Equity Raised	Exit Opportunity
Net Lease	$7,206.6	Strong
Healthcare	3,491.3	Strong
Diversified	3,242.7	Moderate
Retail	1,674.2	Moderate
Multifamily	990.9	Moderate
Industrial	740.5	Moderate
Hotel	612.5	Moderate
Other	514.2	N/A
Self Storage	106.3	Strong
Office	68.2	Moderate
	$18,647.4	

Non-Traded Equity REIT Fundraising 2014

(Dollars in Millions)

Sector	Equity Raised	Exit Opportunity
Healthcare	$5,219.5	Strong
Net Lease	4,628.0	Strong
Diversified	2,220.2	Moderate
Retail	1,439.6	Weak
Hotel	1,049.4	Moderate
Industrial	224.7	Moderate
Multifamily	194.9	Weak
Self Storage	17.5	Strong
	$14,993.7	

*Healthcare includes NorthStar Healthcare Income

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The White House

Office of the Press Secretary

For Immediate Release February 23, 2015

FACT SHEET: Middle Class Economics: Strengthening Retirement Security by Cracking Down on Backdoor Payments and Hidden Fees

"That's what middle-class economics is—the idea that this country does best when everyone gets their fair shot, everyone does their fair share, and everyone plays by the same set of rules." President Barack Obama, State of the Union Address, January 20, 2015

Middle class economics means that Americans should be able to retire with dignity after a lifetime of hard work. But today, the rules of the road do not ensure that financial advisers act in the best interest of their clients when they give retirement investment advice, and it's hurting millions of working and middle class families.

A system where Wall Street firms benefit from backdoor payments and hidden fees if they talk responsible Americans into buying bad retirement investments—with high costs and low returns—instead of recommending quality investments isn't fair. These conflicts of interest are costing middle class families and individuals billions of dollars every year. On average, they result in annual losses of 1 percentage point for affected investors. To demonstrate how small differences can add up: A 1 percentage point lower return could reduce your savings by more than a quarter over 35 years. In other words, instead of a $10,000 retirement investment growing to more than $38,000 over that period after adjusting for inflation, it would be just over $27,500. Today, President Obama is taking a step to crack down on those Wall Street brokers who benefit from backdoor payments or hidden fees and don't put the best interest of working and middle class families first.

Many advisers do not accept backdoor payments or hidden fees and work on a different business model that puts their customers' best interest first. They are hardworking men and women who got into this work to help families achieve their dreams and want a system that provides a level playing field for offering quality advice. But outdated regulations, loopholes, and fine print make it hard for working and middle class families to know who they can trust.

During the financial crisis, we saw the devastation caused on Main Street when outdated policies let lenders steer their customers into bad mortgage products. That's why in the wake of the crisis, the President fought to create the Consumer Financial Protection Bureau. Since then, the CFPB has cracked down on many of the abusive lending practices that led borrowers to lose their homes.

Because of outdated rules protecting retirement savings, we're seeing similar types of bad incentives and bad advice lead to billions of dollars of losses for American families saving for retirement every year—with some families losing tens of thousands of dollars of their retirement savings. That's why today, the President directed the Department of Labor to move forward with a proposed rulemaking to protect families from bad retirement advice by requiring retirement advisers to abide by a "fiduciary" standard—putting their clients' best interest before their own profits.

- **Backdoor Payments & Hidden Fees Are Hurting the Middle Class:** Today's report from the White House Council of Economic Advisers (CEA) shows conflicts of interest cost middle-class families who receive conflicted advice huge amounts of their hard-earned savings. It finds conflicts likely lead, on average, to:
  - 1 percentage point lower annual returns on retirement savings.
  - $17 billion of losses every year for working and middle class families.
- **A Wide Array of Research Shows Why Conflicts Hurt Working and Middle Class Families:** A strong set of independent research shows that these losses result from brokers getting backdoor payments or hidden fees for:
  - Steering clients' savings into funds with higher fees and lower returns even before fees.
  - Inappropriate rollovers out of lower-cost retirement plans into higher-cost vehicles.
- **President Obama is Cracking Down on Conflicts of Interest:** Today, the President called on the Department of Labor to crack down on Wall Street and protect families from conflicted and bad retirement advice. DOL will move forward with a proposed rulemaking that would require retirement advisers to abide

LATEST BLOG POSTS

March 12, 2015 5:45 PM EDT
Announcing the Fifth White House Science Fair!
The President is hosting the fifth White House Science Fair on March 23, welcoming more than one hundred of the nation's brightest young minds with some showcasing innovative inventions, discoveries, and science projects. The President will meet with and congratulate these students, who, as budding engineers, scientists, and researchers are on deck to help solve some of the greatest challenges of our time.

March 12, 2015 3:00 PM EDT
The Promise of Wind Energy
Wind energy continues to be one of America's best choices for low-cost, zero-pollution renewable energy – and it is one of our strongest tools to combat climate change.

March 12, 2015 11:57 AM EDT
Protecting Vital Waters as Marine Sanctuaries
NOAA is expanding two existing sanctuaries off California's North-central coast. The expansion will more than double the current size of the Gulf of the Farallones and Cordell Bank national marine sanctuaries, ensuring that we are protecting all that the region has to offer.

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by a “fiduciary” standard—putting their clients’ best interest before their own profits.

- **Proposed Rule Coming Soon:** In the coming months, the Department of Labor will issue a notice of proposed rulemaking, beginning a process in which it will seek extensive public feedback on the best approach to modernize the rules on retirement advice and set new standards, while minimizing any potential disruption to good practices in the marketplace.

Our Retirement Rules Have Not Kept Up with Seismic Shifts in How People Save

Over the past several decades, the share of Americans’ employer-based retirement savings that takes the form of traditional pensions—where investment decisions are generally made by professionals—has fallen sharply. Today, Americans are largely responsible for making their own choices about how much to save and how to invest their retirement savings.

To help make informed choices, families often look for trusted advice on how to manage their hard-earned nest egg. However, despite the significant changes in the retirement landscape, the regulations that set the basic rules of the road on giving investment advice to retirement savers have not been updated in almost forty years. Under these outdated rules, savers cannot count on receiving the unbiased advice that they need and expect. In other words, today’s rules allow brokers to put their bottom line ahead of their clients’ retirement security. A system where middle class families shoulder 100% of the risk for their investments, but brokers receive incentives for directing them into investments that aren’t in their best interest isn’t fair.

If more retirement advisers were fiduciaries, they would have to put the customer’s best interest before their own.

Report Released Today Finds Huge Losses to the Middle-Class from Conflicts of Interest

A new report from the President’s Council of Economic Advisers shows that that the current, broken regulatory environment creates misaligned incentives that cost working and middle class families billions of dollars a year—with some individual families losing tens of thousands of dollars of their retirement savings. These incentives cause some Wall Street brokers to encourage working and middle class families to move from low-cost employer plans to IRA accounts that typically entail higher fees—and to steer working and middle class families into higher-cost products within the IRA market. Many advisers currently act as fiduciaries and provide advice in their clients’ best interest, but many others do not. CEA’s analysis of the latest academic research finds that:

- Conflicted advice leads to lower investment returns for working and middle class families. Working and middle class families receiving conflicted advice earn returns roughly 1 percentage point lower each year (for example, conflicted advice reduces what would be a 6 percent return to a 5 percent return).
- An estimated $1.7 trillion of IRA assets are invested in products that generally provide payments that generate conflicts of interest. Thus, CEA estimates the aggregate annual cost of conflicted advice is about $17 billion each year.
- A typical worker who receives conflicted advice when rolling over a 401(k) balance to an IRA at age 45 will lose an estimated 17 percent from her account by age 65. In other words, if a worker has $100,000 in retirement savings at age 45, without conflicted advice it would grow to an estimated $216,000 by age 65 adjusted for inflation, but if she receives conflicted advice it would only grow to $179,000—a loss of $37,000 or about 17 percent.
- A retiree who receives conflicted advice on how to invest his IRA at retirement will lose an estimated 12 percent of the value of his savings if drawn down over 30 years compared to a retiree who receives unconflicted advice.

A marketplace where some advisers are encouraged to steer their clients into inferior products based on these payments creates bad incentives and an unfair playing field for the many firms who choose instead to put their clients’ interests first.

Updating our Outdated Retirement Protections

Since 1974, the Department of Labor has protected America’s tax-preferred retirement savings under the Employee Retirement Income Security Act (ERISA), working closely with the Treasury Department and the Pension Benefit Guaranty Corporation. ERISA provided the Department of Labor with this authority, recognizing the special importance of consumer protections for a basic retirement nest egg and the large tax subsidies provided for them. In the coming months, the Department of Labor will propose a new rule that will seek to:

- **Require retirement advisers to put their client’s best interest first, by expanding the types of retirement investment advice subject to ERISA:** The definition of retirement investment advice has not been meaningfully changed since 1975, despite the dramatic shift in our private retirement system away from defined benefit plans and into self-directed IRAs and 401(k)s. The Department’s proposal will update the definition to better match the needs of today’s working and middle class families. Whether you are an employer trying to design a quality plan for your workers, a worker starting to save, or a retiree trying to avoid spending down your nest egg too quickly, you deserve access to quality advice, without fear that financial bias is clouding your broker’s judgment.
- **Preserve the ability of working and middle class families to choose different types of advice:** The

Department's proposal will continue to allow private firms to set their own compensation practices by proposing a new type of exemption from limits on payments creating conflicts of interest that is more principles-based. This exemption will provide businesses with the flexibility to adopt practices that work for them and adapt those practices to changes we may not anticipate, while ensuring that they put their client's best interest first and disclose any conflicts that may prevent them from doing so. This fulfills the Department's public commitment to ensure that all common forms of compensation, such as commissions and revenue sharing, are still permitted, whether paid by the client or the investment firm.

- **Preserve access to retirement education:** The Department's proposal will allow advisers to continue to provide general education on retirement saving across employer-sponsored plans and IRAs without triggering fiduciary duties.

The Department's proposal will seek to crack down on irresponsible behavior in today's market for financial advice by better aligning the rules between employer-based retirement savings plans and IRAs. To balance increased protection for working and middle class families while minimizing disruptions to their access to advice, the Administration is committed to a robust and transparent process for receiving input on the proposal. When the Department of Labor issues a Notice of Proposed Rulemaking (NPRM) in the coming months, there will be opportunities to submit comments in writing and in a public hearing. The Administration welcomes and invites stakeholders from all perspectives to submit comments as the proposal moves forward. Only after reviewing all the comments will the Administration decide what to include in a final rule—and even once the Department of Labor ultimately issues a final rule, it will not go into effect immediately.

To learn more, visit DOL.gov/ProtectYourSavings.

Retail REITs Roundtable Meeting

Thursday, April 2nd
9:30am – 10:45am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Robert McCadden, EVP & CFO, Pennsylvania REIT
Jeff Curry, Chief Legal Officer, CBL & Associates Properties, Inc.
Farzana Mitchell, EVP, CFO & Treasurer, CBL & Associates Properties, Inc.

AGENDA

REITWISE ROUNDTABLE: RETAIL REITS

Thursday, April 2, 2015
9:30 am – 10:45 am

Discussion Leaders:

Jeffery Curry, Chief Legal Officer, CBL & Associates Properties, Inc.
Farzana Mitchell, EVP, CFO & Treasurer, CBL Associates Properties, Inc.
Robert McCadden, EVP & CFO, Pennsylvania REIT

Shopper Experience

- Wi-Fi
- Mobile App (android and iPhone)
- Web sites
- Loyalty program
- Digital Contests
- Beacons
- Traffic counting (camera or censors)
- Shopper Analytics (wifi, credit card data, beacon, Traffic counting)
- Social Media listening and engagement – Products (HootSuite, Salesforce, Adobe)
- Car charging stations
- Parking digital signage to display available spaces or notifications
- Digital Signage – Focus on content management
- Wayfinding

Evolution of Enclosed Malls

What Will the Industry Look Like in Ten Years?

- View of Millennials, Gen X'ers, Baby Boomers
- Urbanization of suburbs
- Residential mixed with retail

Smart Buildings

- Centralized or decentralized management
- Building Automation Systems
    - Smart Meters
    - Lighting Controls
    - Energy Management System (Triduum)
- Analytic Platform
- Demand Response
- Energy Procurement

Enterprise Systems and Tools

- DealFlow/CRM – (Salesforce, Oracle, Microsoft, Custom)
- Mapping Tools (Google, Bing, ect)
- Virtual Tours (Oculus Rift, Microsoft HoloLens, Googleglass)
- ERP – (JD Edwards, Oracle, MRI, Yardi, SAP)
- Business Intelligence/Reporting (SAP, Microsoft, IBM Cognos, Oracle Hyperion)
- Intranet – How is it used?
- Mobile Devices
    - Management Tools
    - Bring your own device policy
    - Custom applications
- Data retention policies
- Accounts Payable automation and T&E

Budgeting & Forecasting

- Budget process start and end dates
- Top down, bottoms up or combination of approaches
- "Who makes the call" – leasing, operations, asset management?
- When is the final budget "final"
- Budget systems
    - Argus
    - Excel
    - Enterprise systems – JDE AREF
    - Others
- Use of scenario planning models – optimistic vs. worst case?
- What works and what doesn't
- Frequency of forecasting

Compensation

- Compensation philosophy
- Incentive compensation
    - Mix of performance-based vs. discretionary
    - Metrics used for incentive compensation
    - How deep in the organization
    - Impact of post budget developments – unusual level of tenant bankruptcies, etc.
- Leasing rep compensation
    - Bonus vs. commissions
    - Key metrics used for bonus based comp

Operating Metrics

- Difficulty of comparing performance across organizations
    - Leased vs. occupied
    - Renewal spreads
    - Same Store NOI
    - Sales reporting
    - Others

1. They are the largest buying group in America.
2. In 2015 they're between the ages of 51 – 69 (Born between 1946 and 1964)
3. Boomers today have $2.4 trillion in income
4. By 2018, 50% of America's population will be over age 50.
5. By 2018 they will control 70% of the U.S. disposable income

6. They are the "TV Generation" (TV ads still connect with them)
7. They grew up on fast food, disposable diapers, microwaves, dishwashers, and "frozen dinners".
8. Most are 2-income families, with more to spend than their parents or grandparents did.
9. With good health care options, most will work past "normal" retirement ages, thus having even more disposable income.

10. They shop for Customer Service, Ease of Purchase, Flexibility, and High Performance. (Save time, money, and aggravation)
11. You please them by pleasing their children and grandchildren.
12. They still prefer Mail Order Catalogs to peak interest
13. BUT, will shop online for the products they see in catalogs.

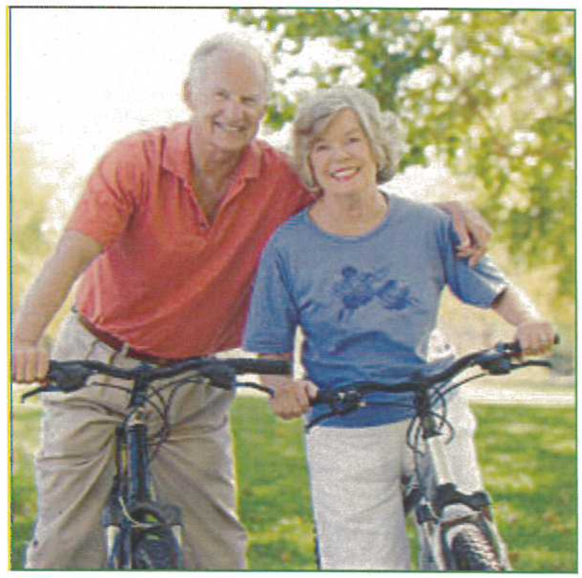
14. They own BIG screen TV's (and don't watch movies and shows on their iPads or phones)

15. They eat out at least 3 times per week.

16. They prefer "oldies" music, and are 33% of the music buying market, but they won't download it. They want CD's.

17. They renovate their kitchens and baths and are the largest buyers of new appliances, paint, cabinets....generally anything that will increase re-sale value of their homes.

18. They PRE-RESEARCH their purchases online at home, vs on their smartphones while at the shopping center or in a store.



19. They are the most physically fit generation ever with golf, tennis, rock climbing, swimming and hiking. They love hobbies like photography, gardening, painting, cooking, and home improvement projects.

20. Boomers represent almost 80% of all "premium" travel, and want to spend time exploring new life experiences.

21. 80% of Boomers own their homes. 25% own second homes.

- SO WHAT DOES THIS MEAN FOR OUR SHOPPING CENTERS?
- HOW DO WE RENOVATE, RE-PURPOSE, RE-MERCHANDISE, AND RE-CONNECT WITH THIS DYNAMIC GROUP OF CONSUMERS?

Millennial Facts

Facts:

- Born in the late 1970's through the early 2000's
- 75-80 million Millennials in the US. This is approximately 24% of the population, which is about the same percentage of the overall as the Baby Boomers.
- Millennials have $2.45 trillion dollars in worldwide spending power.

Characteristics:

- Tolerant of difference.
- Religiously and Politically unaffiliated.
- Follow dreams – act with confidence – some to the point of narcissism.
- Optimistic about the future despite the fact that they will be the first generation in 60 years to be less economically successful than parents.
- Send a lot of TEXT Messages.
- Millennials grew up in a world of technology – computers, internet and social networking.

Technology:

- It is this, above all else that has and is forging a difference between the Millennials as compared to previous generations.

- Different interactions with technology, shopping and physical world is changing the way we need to look at our shopping center.

- The Millennials are MORE likely to listen to their friends and social network than traditional marketing/PR materials.

What are we going to do?:

- **Millennial Meeting** – disciplined in that we will keep meeting and we will not quit if the meeting does not produce immediate success.

- Create and Cultivate Relationship with New Retailers:

  - Millennials are more likely to spend money on fresh fruit and organic foods than luxury goods and soda. Whole Foods, Chipolte, H&M

- Bring Properties up to speed – Wi-Fi Infrastructure; Charging Stations.

- Incubate – We have excellent properties in places like Madison, College Station, Cary, Chattanooga where we can take some chances on different programs aimed at the Millennials.

  - Take some calculated risks on proven local restaurants.

  - Reimagine spaces and uses in food courts, 10 yard line space with things such as virtual walls, soft seating.

Finally, talked about the word **MALL** and how it is limiting term we cannot be bound by as we re-imagine our assets.

CBL®

Sustainability Developments Roundtable Meeting

Thursday, April 2nd
9:30am – 10:45am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Jeffrey Bedell, VP-Sustainability, Macerich
Jody Clark, VP, Hannon Armstrong Sustainable Infrastructure Capital, Inc.
Marla Thalheimer, Director-Sustainability, Liberty Property Trust

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

NAREIT SUSTAINABILITY ROUNDTABLE AGENDA
JW Marriott Desert Ridge Resort & Spa – Phoenix, AZ
April 2, 2015

Discussion Leaders:

Jeffrey Bedell, VP-Sustainability, *Macerich*
Jody Clark, VP, *Hannon Armstrong Sustainable Infrastructure Capital, Inc.*
Marla Thalheimer, Director-Sustainability, *Liberty Property Trust*

NAREIT Executive Staff:

Sheldon Groner, EVP, Finance & Operations

- Investor relations – benchmarks and certification (CDP, GRESB)
- Growing legislation- reporting and disclosures (Energy Star, LEED), what is the future?
- Green bonds, PACE and other financing options

♦ ♦ ♦

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.reit.com

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Green Days Ahead for REITs

07/08/2014 | By Ronald L. Havner
Published July/August 2014

Sustainability is no longer a buzzword or niche in business. It is becoming a core aspect of corporate social responsibility and is increasingly embraced within the REIT community. For REITs, sustainability started with an initial focus on cutting energy usage. That has developed into a broader view of "going green."

In practice, that means not only investing in technology and infrastructure, but also embracing sustainability at the highest levels in the organization. REITs that are flourishing under society's green mandate have committed to putting standard operating procedures under the green microscope. These companies are incorporating principles of conservation and efficiency into everything they do.

At Public Storage (NYSE: PSA), we consistently invest in initiatives that cut costs and reduce our consumption of resources while seeking to maintain a top-notch customer experience. Part of that responsibility lies in making investments that reduce the components of our various utility requirements and reducing our contribution to the nation's landfills. Some REITs have even started looking at the financing of their businesses through the lens of sustainability. Earlier this year, shopping center REIT Regency Centers Corp. (NYSE: REG) became the first REIT to issue "green" bonds. The $250 million generated by the bond sale has been earmarked by Regency Centers specifically to build or buy assets certified under the U.S. Green Building Council's Leadership in Energy & Environmental Design (LEED) program. Vornado Realty Trust (NYSE: VNO) followed suit with a $450 million green bond offering in June.

NAREIT is also doing its part to promote and facilitate sustainability in real estate. NAREIT hosts an annual working forum for executives tasked with sustainability initiatives to meet with their peers to review recent developments and best practices. The annual Leader in the Light Awards honor NAREIT corporate member companies that have demonstrated superior and sustained energy use practices and sustainability initiatives.

NAREIT is doing its part to promote and facilitate sustainability in real estate

In 2012, NAREIT integrated the Leader in the Light award program with the international Global Real Estate Sustainability Benchmark (GRESB). Doing so publicly reinforced the important place of sustainability in our industry. Of equal importance, GRESB offers participating companies and institutional investors a measuring stick by which they can evaluate the impact of sustainability programs. Last year, the nearly 550 property companies and funds that participated in the GRESB survey covered almost half of the FTSE EPRA/NAREIT Global Real Estate Index and accounted for $6.1 trillion in institutional capital.

Although the marriage of sustainability and business remains fairly new, the rapid evolution of strategies and tactics for companies to enhance their sustainability has shown no signs of slowing. REITs have proved more than capable of keeping up with — and exceeding — industry standards and investors' expectations.

RONALD L. HAVNER, JR.
NAREIT Chair
Chairman, President & CEO
Public Storage

Categories: Sustainability
Column/Department: Taking Stock

OTHER FEATURES

Real Estate Re-Classified

01/20/2015

As the REIT industry has grown and matured, it has had to deal with the misperception that Equity REITs generally are part and parcel of "Financials...

The Long View

10/30/2014

I'm honored to be taking over as NAREIT Chair at REITWorld 2014: NAREIT's

Annual Convention for All Things REIT. Thankfully, my predecessors,...

International Reach

09/18/2014

This edition of REIT magazine highlights the growth of the REIT approach to real estate investment across the globe. With the latest news from India...

Spotlighting Transparency

05/19/2014

AS THE ARTICLE on "The Capital of Transparency" in this issue of REIT makes clear, transparency is entral to the REIT business model and the value...

Beneficial Influence of REITs

03/28/2014

THE ROLE THAT securitization of subprime residential mortgages played in the Great Financial Crisis has been well documented, but the beneficial role...

REITs Deserve a Place in Your Portfolio

01/29/2014

This issue of REIT features an interview with Burton Malkiel, Chemical Bank Chairman's Professor of Economics, Emeritus, at Princeton University and...

The Beginnings of an Era

11/06/2013

I am pleased to have the opportunity to serve the REIT industry as NAREIT's Chair for 2014. I will assume my new responsibilities at REITWorld 2013:...

REITs Gone Global

09/16/2013

As the articles in this issue of REIT clearly demonstrate, REITs and REIT investment today are global in their scope. Nearly 30 countries around the...

Sustainable Progress

07/17/2013

The focus of this issue of REIT is sustainability—specifically, taking sustainability to the "next level." Sustainability in commercial real estate...

On the Way to the Forum

05/16/2013

It is NAREIT's mission to present and explain the REIT investment proposition to all of our industry's audiences, but one of the most important of...

See more

1

SUSTAINABILITY INVESTMENT ANALYSIS

Sustainability means different things to different people. To help you understand our approach, please read below.

Background

We believe that sound investing practices should include analysis of the environmental benefit of the proposed investment. It is our practice to invest in projects that increase energy efficiency, provide cleaner energy, positively impact the environment, or make more efficient use of natural resources. As such, we apply a clear and transparent set of policies when evaluating the environmental impact of any proposed investment.

What we mean by "sustainability"

We define sustainability as positively impacting the environment while being neutral or reducing greenhouse gas (GHG) emissions. In addition to GHG emissions, projects are screened for other environmental benefits, such as water use reduction. The quantification of environmental benefits is part of our investment screening process.

Measuring the Impact of Hannon Armstrong's Investment

We analyze project specific data, for example the expected reduction in annual energy consumption resulting from the installation of energy efficiency upgrades or the energy produced by a clean energy project, to determine expected environmental benefit associated with such projects. For example, to measure the carbon impact, we calculate the annual metric tons of carbon emissions offset by the project, taking into consideration the fuel mix percentages and carbon intensities of fuel in the state where the project is located.1 We then evaluate the relative impact of our potential investment by calculating the pounds of carbon emissions reduced annually per dollar invested.

Disclosure Standards

For competitive reasons, it is a general policy of Hannon Armstrong to not disclose specific investment information. However, we plan to release annually the CO2 equivalent impact of each project we finance to provide appropriate transparency of the environmental profile of our portfolio.

In summary, we believe that our investments have and will continue to have significant environmental benefits. Our promise to be on the right side of the climate change issue will continue to be a defining principle of the Company, and we are committed to disclosing the environmental impact of our financed projects to all interested parties.

[1] Data Source: U.S. Environmental Association's eGRID 2012

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Regency Centers Sells $250 Million of 10-Year 'Green Bonds'

05/16/2014 | By Sarah Borchersen-Keto

Shopping center REIT Regency Centers Corp. (NYSE: REG) has completed the sale of $250 million of 10-year "green bonds," the first time a U.S. REIT has issued bonds that exclusively target investment in environmental sustainability projects.

Lisa Palmer, Regency Centers' CFO, said market reaction to the bonds was "extremely positive."

"There is a growing market of environmentally conscious investors, and we found it was a good way to connect our commitment to sustainability with the socially responsible investing community while maintaining our overall goals and strategy," she explained.

Regency Centers noted that this is also only the second issuance of green bonds by a U.S. corporate entity. Until recently, green bond issuers were predominantly international finance organizations such as the World Bank and European Investment Bank. Earlier this year, Unibail-Rodamco SE (EuroNext: UL), a listed real estate company headquartered in Paris, announced that it had placed the first green bond issuance for a real estate company in the European market.

Regency Centers Seeking to be at Forefront of Socially Responsible Business Practices

Palmer said the decision to issue green bonds was "a natural evolution of where our sustainability efforts have been going." Part of Regency Centers' strategy, she noted, is to be at the forefront of innovative and creative ways to implement socially responsible business practices.

Regency Centers made the decision to invest in sustainability more than seven years ago, according to Palmer. She pointed out that since 2009, approximately two-thirds of the company's developments and redevelopments have received certification from the U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) program, "with more to follow." Net proceeds from the new bonds will be used to finance Regency Centers' existing properties and properties under development where the company is seeking or has already been awarded LEED certification.

Steven Marks, managing director at Fitch Ratings, noted that the bond issuance "could be a significant development in that it might broaden the bond investor universe" for Regency Centers. In addition, it may also encourage other REITs to focus more on sustainability and to develop green or LEED-certified projects, he added.

Deloitte Report Shows Investors Placing Greater Value on Green Buildings

Separately, a new report from accounting firm Deloitte & Touche LLP shows that commercial real estate investors are placing greater value on green buildings as tenant demand for environmentally sophisticated properties grows.


Bob O'Brien

"We think investors are looking at green real estate in a different way," said Bob O'Brien, partner and U.S. and global real estate services leader at Deloitte.

Investors recognize the growing level of tenant demand for green buildings and that there is more income potential in those properties, he said. At the same time, investors are cognizant of the risk that properties without LEED certification will face "functional obsolescence," O'Brien added.

"Increasingly we're finding tenants that will only move into LEED-certified buildings as part of their own green strategies," O'Brien said. Meanwhile, "investors increasingly tout some of the green-type investments that are within their portfolios, and pointing to REITs who have developed sustainability strategies is one way to do that," he added.

Categories: Capital Markets, Retail, Sustainability

Vornado Prices Notes to Fund Eligible Green Projects - Analyst Blog

By Zacks.com, June 10, 2014, 11:10:00 AM EDT

Vornado Realty Trust (VNO) disclosed the pricing of 2.50% senior unsecured notes worth $450 million. In particular, the company's operating arm, Vornado Realty L.P., priced the 5-year senior notes at 99.619% of their face amount, with a yield of 2.581%. The offering is expected to close on Jun 16, upon fulfillment of customary closing conditions.

Beginning Dec 30, 2014, the interest on these notes are payable semiannually on Jun 30 and Dec 30 of every year. The company will use the reaped amount of around $445 million to invest in its Eligible Green Projects.

Eligible Green Projects refers to all the new or existing assets developments that have achieved or are expected to get any LEED certification level (Certified, Silver, Gold or Platinum). Also, it includes all the company's tenant improvement projects and capital projects, which are likely to get this energy efficiency label.

Several renowned financial institutions assisted Vornado in this public offering. Deutsche Bank Securities Inc. of **Deutsche Bank AG** (DB), Wells Fargo Securities, LLC of **Wells Fargo & Company** (WFC) and RBS Securities Inc. of **The Royal Bank of Scotland Group plc** (RBS) are among those who acted as joint book-running managers.

The aforementioned notes offering is a strategic fit for Vornado, as this will increase its financial flexibility and enable the company to pursue its portfolio enhancement activity. This will go a long way in boosting its top line.

As of Mar 31, 2014, Vornado had $1.2 billion of cash and cash equivalents, up from $583.3 million as of Dec 31, 2013. In addition, the company's FFO payout ratio (based on FFO as adjusted for comparability) in the quarter was 60.8%, lower than 64.6% in the year-ago quarter.

Vornado currently carries a Zacks Rank #3 (Hold).

Note: *FFO, a widely used metric to gauge the performance of REITs, is obtained after adding depreciation and amortization and other non-cash expenses to net income.*

ROYAL BK SC-ADR (RBS): Free Stock Analysis Report

VORNADO RLTY TR (VNO): Free Stock Analysis Report

To read this article on Zacks.com click here.

Zacks Investment Research

This article appears in: Investing , Business , Stocks

Referenced Stocks: DB , WFC , RBS , VNO

Timber REITs Roundtable Meeting

Wednesday, April 1st
2:45pm – 4pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Daniel McKeithen, Partner, Sutherland
Paul Stamnes, VP-Tax, Plum Creek Timber Company, Inc.

AMERICAN BUSINESS COMPETITIVENESS ACT

A PATH TO ECONOMIC TRANSFORMATION

A plan to **wipe away the tax system** imposed on American businesses and **replace it with a simple, fair and flat alternative.**

The American Business Competitiveness Act establishes a permanent tax rate of 25% on all businesses- no matter how they are organized. It eliminates all special deductions and credits, as well as complex inventory rules. In their place is 100% expensing.

This revolutionary change in the way we tax business can be achieved **without adding a penny to the debt**.

THE ABC ACT - JUST THE BASICS

The **American Business Competitiveness Act (ABC Act)** would establish the most aggressive pro-growth business tax policy in the developed world. If implemented, it would result in massive investments and job creation throughout the United States.

Lower Business Income Tax

All businesses, no matter how they are organized, will be taxed at the same low rate; ***25 percent***.

The taxation of non-business income remains unchanged, except that interest income is taxed at the same rate as dividends and capital gains.

Pro-Growth

The ABC Act will allow ***100 percent expensing***, meaning firms will deduct their full investment costs from their current year tax liabilities.

- This includes land, buildings and inventory, as well as other tangible or intangible property.
- Expensing that exceeds taxable income can be carried to future tax years with interest or backwards to reduce taxes from prior years.

This will create a powerful incentive for businesses of all sizes to invest and grow, generating new jobs across America.

No Loopholes

The ABC Act eliminates all special loopholes. The complex tax code, with its high compliance costs and distorting impact on the economy, is wiped away and replaced with a **simple, fair and flat tax.**

Less Complex & Fewer Distortions

The elimination of deductions and credits simplifies the tax code and reduces compliance costs.

- Complex property and inventory rules such as depreciations, amortization and depletion are replaced by full expensing.
- The tax code's pressure on firms to carry debt is removed by eliminating the business interest deduction while lowering the individual income tax on interest income.

International Tax Reform

Territorial tax rules will make U.S. businesses more globally competitive.

Simple, Fair, Flat & Fiscally Responsible

The Tax Foundation has analyzed the ABC Act and concluded that it would increase baseline GDP growth by 6.8%.

Based on analysis by the Joint Committee on Taxation, the ABC Act has been crafted in a way that is both budget neutral and economically transformative.

Under the ABC Act, businesses can plan for the future based on easy to understand rules that are not subject to constant expiration.

Congressman Nunes is seeking comments on the ABC Act. Contact us at: ABCtaxplan@mail.house.gov.

HOW TO MAKE AMERICA A GLOBAL TAX HAVEN

An expert from Bloomberg - March 25, 2013

....Nunes suggests a new approach: a "business consumption tax" that treats all businesses the same, whatever their organizational form. Instead of taxing their income, it taxes their cashflow -- income minus expenses, except for interest payments. That way, businesses would no longer write off their investments according to a complicated depreciation schedule. Investments would be tax-free.

Both U.S. and foreign companies would have more reason to invest here, Nunes says. "This would make the U.S. the largest tax haven in human history."

I've run across two objections to Nunes's idea. The first is that it is simply too ambitious to be politically viable: If Congress is having trouble reforming the corporate tax, goes the argument, it won't be able to digest an entirely new approach to taxing business income. What this objection ignores is that the moderately ambitious proposals all face obstacles that are probably insuperable -- obstacles this proposal avoids.

The second objection is that Nunes's proposal would cost the federal government a lot of revenue. A Joint Committee on Taxation estimate of the proposal's budget impact would make it possible to evaluate this claim, but it sounds plausible. If it turns out to be expensive, though, the concept can still work: The tax rate would just have to be higher than the 25 percent that Nunes has tentatively put forward.

Even if the rate were left at the 35 percent that currently applies to corporations, the shift to the new tax would still be a boon for the economy. The statutory rate would be higher than that of other countries, but the number that matters -- the effective tax rate on investments -- would be a very competitive zero, thanks to companies' ability to write off their costs immediately. Eliminating the deduction for interest, meanwhile, would end a destabilizing distortion in the economy: the federal tax code's preference for corporate financing via debt rather than equity. That preference also gives an advantage to established firms that have greater borrowing capacity than startups.

If Congress still finds the Nunes proposal too ambitious to contemplate, it could undertake reform on a much smaller scale. Leave tax rates alone, keep the separate schedules for different types of companies, and just make a trade: Companies would get immediate write-offs on investments and in return lose the interest deduction. That trade would probably leave the government's revenue at roughly the same level. It would certainly be simpler than most other proposals to reform business taxation. And it would encourage more investment and less debt.

Tax Foundation Analysis of the ABC Act

Individual And Business Changes Modeled:
Cut Corporate Rate to 25%
Assorted changes in Corporate Tax Base
Revenue Effect due to reduced Profit Shifting
Full Expensing*
Cap Tax Rate on Noncorp Business Income at 25%
Tax Individual Interest Income at Capital Gains Rate**

ECONOMIC AND BUDGET CHANGES VERSUS 2013 LAW	
(billions of 2013 dollars except as noted)	
GDP	6.80%
GDP ($ billions)	$1,107.8
Private business GDP	7.07%
Private business stocks	20.63%
Wage rate	5.72%
Private business hours of work	1.28%
Full-time equivalent jobs (in thousands)	1,228.4
Static federal revenue estimate, GDP assumed constant ($ billions)	-$129.0
Dynamic federal revenue estimate after GDP gain or loss ($ billions)	$96.2
Weighted Average service price	% Change
Corporate	-11.40%
Noncorporate	-10.87%
All business	-11.24%

High Rates Are A Large Burden For Small Business

We need more jobs, in California and throughout the country.

By Devin Nunes: Originally printed in the Orange County Register

America's official 7.6 percent unemployment rate reflects a worse situation than it seems, since the figure does not account for millions of jobless Americans who have stopped looking for work. In fact, the number of Americans who work or are seeking work fell by a half million people in March, yielding the lowest monthly rate – 63.3 percent – since May 1979.

What it takes to create jobs is no secret. We need to provide a reasonable, stable regulatory and tax environment that encourages business start-ups and coaxes existing companies to invest, expand and hire new workers. But that's not what we have.

The revolutionary "green economy" promised by the Obama administration has turned out to be a textbook example of the failures of command economies. As central planners issue a morass of regulations, taxes and subsidies designed to support certain companies and industries while punishing others, they create perverse incentives that make lobbying and government favoritism – not good business models – the arbiter of a company's success. This system enables corruption and empowers big government and big business at the expense of small businesses and everyday Americans.

We need comprehensive economic reform that promotes simplicity, fairness, economic growth and job creation. A good place to begin is by reforming business taxes.

There is widespread bipartisan agreement that we ne We need more jobs, in California and throughout the country.
ed to reform the federal business tax code – an impossibly complex array of rates and rules featuring a top rate of 35 percent that is the highest in the industrialized world. Most reform proposals focus on lowering the rates while leaving the code's complex structure mostly intact. I am proposing something different – that we completely overhaul the code to make it simple, fair, and most important, to create jobs.

My plan, called the American Business Competitiveness tax reform, is designed to complement current congressional efforts to reform taxes. It would replace the business tax structure with a new form of consumption tax. This is neither a sales tax nor a value-added tax (VAT). Instead, the ABC tax reform would encourage business investment by allowing 100 percent expensing in the current year. This means that companies of any size, no matter how they're organized, would pay no taxes on any of their spending for personnel, equipment, property, or other expenditure related to the operation of their business in the United States.

Expensing, essentially tax deductions for business investment, is allowed under the current tax code but is subject to innumerable and ever-changing conditions and limits; what a company can expense depends on a firm's size and industry, the type of asset bought and its cost, the amount of time over which the firm can deduct costs ("depreciation") and whether the business is entitled to "bonus depreciation" measures. By replacing this convoluted system with a uniform rule of 100 percent expensing, the ABC tax reform would quickly spark economic growth and job creation. Simply put, the more a company invests and expands, the more it reduces the percentage of its income that is taxed.

To boost growth even further, non-expensed income for all businesses would be taxed at one low, globally competitive rate – 25 percent – and all credits, special deals and loopholes on the business side would be eliminated. That would subject all businesses, whether a mom-and-pop grocery or a billion-dollar conglomerate, to the same clear rules and the same tax rate, eliminating the ability of special interests and big business to manipulate the tax code.

Democrats and Republicans alike should support a reform that levels the playing field for all businesses, brings certainty and clarity to the tax code, undercuts the power of special interests, incentivizes the return of money parked in foreign tax havens, and encourages business start-ups.

Free-market reform is urgently needed throughout the country, but especially in California. Our excessive tax and regulatory regime is killing businesses and driving them to other states. The ABC tax reform will create jobs here and in all other states, in all industries, to the benefit of all Americans. Instead of tinkering with tax rates, let's make a bolder move to get the economy moving again.

The American Business Competitiveness Act (ABC Act)

A BUDGET NEUTRAL PLAN TO CREATE JOBS

FEATURES:

- **A path to permanent tax reform and a 25% rate on all businesses:** Under the ABC Act, the income tax imposed on American businesses, no matter how they are organized, will decline uniformly over a period of ten years. **In year ten, business taxes will reach a final permanent rate of 25%.**

- **A flat, fair and easily understood system:** The business tax system will undergo a radical transformation. All credits and deductions will be wiped away immediately. Complex inventory rules and depreciation schedules will disappear. In place of these complex and often unfair rules will be a relatively simple system of expensing.

  Annual business taxes will be determined by deducting all of the costs associated with operating in the United States from all of the income generated in the United States. Everything will be deducted immediately, including property and heavy equipment which has traditionally been subject to complex depreciation schedules.

- **A tax on actual profits without taxing job creation**: by allowing 100% expensing, with the ability to carry forward excess, businesses face minimal tax in their formative years or when they are investing heavily (thereby creating opportunity in America). However, they pay their full tax when they earn income – no loopholes and no exceptions.

- **An economically sound plan that is fiscally responsible**: the ABC Act will not add to the debt. It is designed to be a budget neutral yet economically powerful. Economists agree that this form of taxation is pro-growth. The Tax Foundation indicates the ABC Act will fundamentally transform the American economy.

  The ABC Act has been extensively reviewed by the Joint Tax Committee. Based on their analysis the bill has been carefully crafted to achieve budget neutrality without sacrificing the end goal of a **fair, flat tax system and a competitive 25% tax rate.**

Please send your comments to ABCtaxplan@mail.house.gov.

The American Business Competitiveness Act

REDUCE TAXES ON ALL JOB CREATORS – a 25% business income tax

- ✓ All businesses, no matter how they are organized, will be taxed at the same low rate, 25 percent.
- ✓ Individual income taxes are not changed.

PRO-GROWTH – encourages job creation

- ✓ Allows 100 percent expensing, meaning firms will deduct their full operating costs from their current year tax liability.
    - o This includes land, buildings, inventory, as well as other tangible or intangible property.
    - o Expensing that exceeds taxable income can be carried to future tax years with interest or backwards to reduce taxes from prior years.
- ✓ Growth and investment are the only mechanisms by which a business can reduce their taxes. This creates a powerful incentive for domestic job growth.

NO LOOPHOLES – all special tax provisions are eliminated

- ✓ Eliminates tax credits and deductions for all businesses. There are no special loopholes that advantage one business model or product over another. The government will no longer pick winners and losers.

LESS COMPLEX – the rules are easy to understand for everyone

- ✓ The elimination of deductions and credits simplifies the tax code.
- ✓ Complex property and inventory rules such as depreciations, amortization and depletion are replaced by full expensing.
- ✓ Government-preferences will no longer incentivize the inefficient allocation of resources.
- ✓ Debt will no longer be preferred under the tax code, reducing the pressure on firms to carry debt.

SIMPLIFIED INTERNATIONAL TAX SYSTEM – allows stranded income to return

- ✓ Territorial tax rules will make the U.S. more globally competitive.

[DISCUSSION DRAFT]

JANUARY 26, 2015

114TH CONGRESS
1ST SESSION

H. R. ____

To amend the Internal Revenue Code of 1986 to tax business income on a cash flow basis, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

Mr. NUNES introduced the following bill; which was referred to the Committee on ______________________________

A BILL

To amend the Internal Revenue Code of 1986 to tax business income on a cash flow basis, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "American Business Competitiveness Act of 2015".

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents is as follows:

SEC. 2. CONGRESSIONAL FINDINGS.

(a) FINDINGS RELATING TO THE DEPRECIATION SYSTEM OF FEDERAL BUSINESS TAXATION.—Congress finds the depreciation system—

(1) is rife with outdated asset classifications, inaccurate depreciation schedules, targeted credits and deductions, and targeted expensing provisions;

(2) rewards some business activities over others;

(3) reduces savings and investment in the United States by increasing the rate of return that is required for investments to be viable; and

(4) creates complexity for both the Internal Revenue Service and businesses.

(b) FINDINGS RELATING TO THE DEDUCTION OF BUSINESS INTEREST.—Congress finds that the business interest deduction—

(1) encourages businesses to finance their operations with debt;

(2) results in negative effective tax rates for some investments; and

(3) heightens bankruptcy risk during periods of economic distress.

(c) FINDINGS RELATING TO THE EXPENSING OF INVESTMENT.—Congress finds that allowing businesses to expense their investments—

(1) will make more investment opportunities profitable for businesses to undertake;

(2) will promote investment in the United States;

(3) will limit the Government's ability to reward specific business activities through the tax code; and

(4) will simplify business taxation.

SEC. 3. MAXIMUM TAX RATE FOR NET BUSINESS INCOME.

(a) INDIVIDUAL NET BUSINESS INCOME.—

(1) MAXIMUM RATE OF 25 PERCENT.—

(A) IN GENERAL.—Paragraph (1) of section 1(h) is amended—

(i) in subparagraph (A)—

(I) by striking "the net capital gain" in clause (i) and inserting "the sum of the net capital gain and the net business income"; and

(II) by striking "the adjusted net capital gain" in clause (ii)(II) and inserting "the sum of the adjusted net capital gain and the net business income"; and

(ii) in subparagraph (D)(i) by striking "unrecaptured section 1250 gain" and inserting "25-percent rate gain".

(B) 25-PERCENT RATE GAIN.—Subsection (h) of section 1 is amended by adding at the end the following:

"(12) 25-PERCENT RATE GAIN.—For purposes of this subsection—

"(A) unrecaptured section 1250 gain, plus

"(B) net business income.".

(2) PHASEIN OF 25-PERCENT RATE FOR NET BUSINESS INCOME.—Subsection (h) of section 1, as

amended by paragraph (1), is amended by adding at the end the following:

"(13) PHASEIN OF 25-PERCENT RATE FOR NET BUSINESS INCOME.—

"(A) IN GENERAL.—During the 10-calendar-year period beginning after December 31, 2014, paragraph (1) shall be applied with the following modifications with respect to net business income:

"(i) In the case that the applicable percentage for a taxable year is greater than 28 percent—

"(I) paragraph (1)(F) shall be applied by subtracting net business income (to the extent it has not been taken into account under the preceding subparagraphs of this paragraph) from the excess described therein, and

"(II) paragraph (1), after the application of subparagraphs (A) through (F) (as modified by subclause (I) of this clause) thereof), shall be applied by adding to the sum thereof the applicable percentage of net business income which has not been taken into account under the preceding subparagraphs of this paragraph.

"(ii) In the case that the applicable percentage for a taxable year exceeds 25 percent but does not exceed 28 percent, paragraph (1), after the application of subparagraphs (A) through (E), shall be applied by adding to the sum thereof the applicable percentage of net business income which has not been taken into account under the preceding subparagraphs of this paragraph.

"(B) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A), the applicable percentage for a taxable year shall be determined under the following table:

"For taxable years beginning in:	The applicable percentage is:
2015	38.14 percent
2016	36.68 percent
2017	35.22 percent
2018	33.76 percent
2019	32.3 percent
2020	30.84 percent
2021	29.38 percent
2022	29.72 percent
2023	26.46 percent
2024	25 percent.

"(C) COORDINATION.—During the 10-year period referred to in subsection (a), paragraph (1) shall be applied without regard to the amendment made by section 3(a)(1) of the American Business Competitiveness Act of 2015.

"(D) ADJUSTMENT OF TABLES.—The Secretary shall adjust the tables prescribed under subsection (f) to carry out this paragraph.".

(b) CORPORATE INCOME TAX RATE REDUCTION; TAX IMPOSED ONLY ON CORPORATION'S NET BUSINESS INCOME.—

(1) IN GENERAL.—Section 11 is amended to read as follows:

"SEC. 11. TAX IMPOSED.

"(a) CORPORATIONS IN GENERAL.—A tax is hereby imposed for each taxable year on the net business income of every corporation.

"(b) AMOUNT OF TAX.—The amount of the tax imposed by subsection (a) shall be the sum of—

"(1) 15 percent of so much of the net business income as does not exceed $50,000, and

"(2) 25 percent of so much of the net business income as exceeds $50,000 but does not exceed $75,000, and

"(3) the applicable percentage of so much of the net business income as exceeds $75,000.

In the case of a corporation which has net business income in excess of $100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) $5,000.

"(c) PHASEIN.—For purposes of subparagraph (A), the applicable percentage for a taxable year shall be determined under the following table:

"For taxable years beginning in:	**The applicable percentage is:**
2015	34 percent
2016	33 percent
2017	32 percent
2018	31 percent
2019	30 percent
2020	29 percent
2021	28 percent
2022	27 percent
2023	26 percent
2024 and thereafter	25 percent".

(2) CONFORMING AMENDMENT.—Paragraphs (1) and (2) of section 1445(e) are each amended by striking "35 percent" and inserting "applicable percentage (as determined under section 11)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning on or after January 1, 2014.

SEC. 4. DEFINITION OF NET BUSINESS INCOME TAX BASE.

(a) IN GENERAL.—Subtitle A is amended by inserting after chapter 2A the following new subchapter:

"CHAPTER 2B—BUSINESS INCOME

"SUBCHAPTER A. BASIC RULES.

"SUBCHAPTER B. CAPITAL CONTRIBUTIONS, MERGERS, ACQUISITIONS, AND DISTRIBUTIONS.

"SUBCHAPTER C. INTERNATIONAL PROVISIONS.

"SUBCHAPTER D. FINANCIAL INSTITUTIONS.

"SUBCHAPTER E. OTHER DEFINITIONS.

"Subchapter A—Basic Rules

"SEC. 1421. NET BUSINESS INCOME.

"(a) IN GENERAL.—For purposes of this title, the term 'net business income' means, for a taxable year with respect to a business entity, the amount by which the taxable receipts of the business entity for the taxable year exceed the deductible amounts for the business entity for the taxable year.

"(b) TAXABLE RECEIPTS.—

"(1) IN GENERAL.—The term 'taxable receipts' means all receipts from the sale of property, use of property, and performance of services.

"(2) GAMES OF CHANCE.—Amounts received for playing games of chance by business entities engaging in the activity of providing such games shall be treated as receipts from the sale of property or services.

"(3) IN-KIND RECEIPTS.—The taxable receipts attributable to the receipt of property, use of property or services in whole or partial exchange for property, use of property or services equal the fair market value of the services or property received.

"(4) TAXES.—The term 'taxable receipts' does not include any excise tax, sales tax, custom duty, or other separately stated levy imposed by a Federal, State, or local government received by a business entity in connection with the sale of property or services or the use of property.

"(5) FINANCIAL RECEIPTS.—

"(A) IN GENERAL.—The term 'taxable receipts' does not include financial receipts.

"(B) FINANCIAL RECEIPTS.—The term 'financial receipts' includes—

"(i) interest,

"(ii) dividends and other distributions by a business entity,

"(iii) proceeds from the sale of stock, other ownership interests in business entities, or other financial instruments,

"(iv) proceeds from life insurance policies,

"(v) proceeds from annuities,

"(vi) proceeds from currency hedging or exchanges, and "(vii) proceeds from other financial transactions.

"(C) FINANCIAL INSTRUMENT.—The term 'financial instrument' means any—

"(i) share of stock in a corporation,

"(ii) equity ownership in any widely held or publicly traded partnership, trust, or other business entity,

"(iii) note, bond, debenture, or other evidence of indebtedness,

"(iv) interest rate, currency, or equity notional principal contract,

"(v) evidence or interest in, or a derivative financial instrument in, any financial instrument described in clause (i), (ii), (iii), or (iv), or any currency, including any option, forward contract, short position, and any similar financial instrument in such a financial instrument or currency, and

"(vi) a position which—

"(I) is not a financial instrument described in clause (i), (ii), (iii), or (iv), "(II) is a hedge with respect to such a financial instrument, and

"(III) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into.

"(c) DEDUCTIBLE AMOUNTS.—

"(1) IN GENERAL.—The term 'deductible amounts' includes for a taxable year with respect to a business entity—

"(A) the cost of business purchases in the taxable year (as determined under subsection (d)),

"(B) compensation expenses for an individual (other than amounts paid to an individual in his capacity as a business entity), or

"(C) the cost of employer-provided health insurance for which the employee, members of his family, or persons designated by him or members of his family are the beneficiaries,

"(D) such entity's loss carryover deduction (determined under section 172),

"(E) in the case of an entity which is a real estate investment trust, the amount of any dividend payment made to a shareholder of such trust, and

"(F) the transition basis deduction (as determined under section 5 of the American Business Competitiveness Act of 2015).

"(2) COMPENSATION EXPENSES.—For purposes of subsection (a), the term 'compensation expenses' means—

"(A) wages, salaries or other cash payable for services,

"(B) any taxes imposed on the recipient that are withheld by the business entity,

"(C) the cost of property purchased to provide employees with compensation (other than property incidental to the provision of fringe benefits that are excluded from income under the individual tax), and

"(D) the cost of fringe benefits other than health insurance deductible under paragraph (1)(C).

"(3) PHASEIN OF COMPENSATION DEDUCTION.—

"(A) IN GENERAL.—For purposes of paragraph (2), in the case of compensation expenses described in subparagraphs (A), (C), and (D) of paragraph (2) of an applicable large employer, the amount taken into account under paragraph (2) shall be the applicable percentage of such amount (determined without regard to this paragraph).

"(B) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A), the applicable percentage for a taxable year shall be determined under the following table:

"For taxable years beginning in:	The applicable percentage is:
2015	80 percent
2016	82 percent
2017	84 percent
2018	86 percent
2019	88 percent
2020	90 percent
2021	92 percent
2022	94 percent
2023	96 percent
2024	98 percent
2025 and thereafter	100 percent.

"(C) APPLICABLE LARGE EMPLOYER.—For purposes of subparagraph (A), the term 'applicable large employer' has the meaning given such term by section 4980H(c)(2).

"(4) PASS-THRU WAGES MUST BE REASONABLE.—For purposes of paragraph (2)(A), amounts payable as wages, salaries or other cash payable for services by a S corporation, partnership, or other pass-thru entity shall not be treated as wages, salaries or other cash payable for services unless such amounts are reasonable for the service rendered.

"(d) COST OF BUSINESS PURCHASES.—

"(1) BUSINESS PURCHASES.—

"(A) IN GENERAL.—The term 'business purchases' means the acquisition of—

"(i) property,

"(ii) the use of property, or

"(iii) services,

for use in a business activity.

"(B) EXAMPLES.—Business purchases include (without limitation) the—

"(i) purchase or rental of real property,

"(ii) purchase or rental of capital equipment,

"(iii) purchase of supplies and inventory,

"(iv) purchase of services from independent contractors, and

"(v) imports for use in a business activity.

"(C) EXCLUSIONS.—Business purchases do not include—

"(i) payments for use of money or capital, such as interest or dividends (except to the extent that a portion so paid is a fee for financial intermediation services),

"(ii) premiums for life insurance,

"(iii) the acquisition of savings assets or other financial instruments (as defined in subsection (b)(5)(C)),

"(iv) taxes (except as provided in subsection (b)(2) relating to product taxes), and

"(v) the cost of financial instruments (as defined in subsection (b)(5)(C)).

"(2) COST OF BUSINESS PURCHASES.—

"(A) IN GENERAL.—The term 'cost of a business purchase' is the amount paid or to be paid for the business purchase.

"(B) PROPERTY AND SERVICES ACQUIRED FOR PROPERTY.—If a business entity receives property or services from a business entity in whole or partial exchange for property or services, the property or services acquired shall be treated as if they were purchased for an amount equal to the fair market value of the services or property received. For purposes of this section, property includes stock and other equity interests in business other than stock or an equity interest in the business entity acquiring the property or services. See section 1422 for rules on property or services received in exchange for an equity interest in the recipient.

"(C) GAMBLING PAYMENTS.—In the case of a business involving gambling, lotteries, or other games of chance, business purchases include amounts paid to winners.

"(e) BUSINESS ENTITY AND BUSINESS ACTIVITY.—

"(1) BUSINESS ENTITY.—For purposes of determining business income, the term 'business entity' means any corporation (including any S corporation), unincorporated association, partnership, limited liability company, proprietorship, independent contractor, individual, or any other person, engaging in business activity in the United States. An individual shall be considered a business entity only with respect to the individual's business activities.

"(2) BUSINESS ACTIVITY.—The term 'business activity' means the sale of property or services, the leasing of property, the development of property or services for subsequent sale or use in producing property or services for subsequent sale. The term 'business activity' does not include casual or occasional sales of property used by an individual (other than in a business activity), such as the sale by an individual of a vehicle used by the individual.

"(3) EXCEPTION FOR CERTAIN EMPLOYEES.—

"(A) IN GENERAL.—The term 'business activity' does not include—

"(i) the performance of services by an employee for an employer that is a business entity with respect to the activity in which the employee is engaged, or

"(ii) the performance of regular domestic household services (including babysitting, housecleaning, and lawn cutting) by an employee of an employer that is an individual or family.

"(B) EMPLOYEE DEFINED.—For purposes of this subsection, the term 'employee' includes an individual partner who provides services to a partnership or an individual member who provides services to a limited liability company, or a proprietor with respect to compensation for services from his proprietorship.

"(f) SAVINGS ASSETS.—The term 'savings assets' means stocks, bonds, securities, certificates of deposits, investments in partnerships and limited liability companies, shares of mutual funds, life insurance policies, annuities, and other similar savings or investment assets.

"Subchapter B—Capital Contributions, Mergers, Acquisitions, and Distributions

"SEC. 1422. CONTRIBUTIONS TO A BUSINESS ENTITY.

"(a) BY BUSINESS ENTITY.—

"(1) CASH.—If a business entity contributes cash to a business entity of which it is or becomes a partial or full owner, the amount contributed is not a deductible amount to the contributor or a taxable receipt to the recipient.

"(2) PROPERTY OR SERVICES.—If a business entity contributes property or services to a business entity of which it is or becomes a partial or full owner, the transaction will not result in taxable receipts to the contributor or a deduction for a business purchase for the recipient and will not constitute a sale resulting in taxable receipts to the contributor.

"(b) BY INDIVIDUAL.—

"(1) CASH.—If an individual contributes cash to a business entity, the amount contributed is not a deductible amount to the contributor and the cash received by the business entity is not a taxable receipt.

"(2) NEW PROPERTY.—If an individual contributes to a business entity property that the individual purchased for the business entity but which was not used by any person after its purchase, the property shall be considered purchased by such business entity from the person from which the individual purchased the property and the transaction will not result in a deductible amount to the contributor.

"(3) PERSONAL USE PROPERTY.—

"(A) IN GENERAL.—If an individual contributes personal use property to a business entity in which the individual has an ownership interest or for which the individual receives an ownership interest, the business entity shall not be permitted to deduct the value of the property received as a business expense. The business entity will have a tax basis in the contributed property equal to the contributor's basis.

"(B) PERSONAL USE PROPERTY.—The term 'personal use property' means any property used by an individual at any time other than in a business activity.

"(4) SERVICES.—If an individual contributes services to a business entity in which the individual has an ownership interest or receives an ownership interest, the business entity shall not be permitted to deduct the value of the services received (or the value of the equity interest provided to the services provider).

"SEC. 1422A. DISTRIBUTIONS OF PROPERTY.

"(a) DISTRIBUTIONS OTHER THAN TO CONTROLLING BUSINESS.—If a business entity distributes all or a portion of its assets to its owners (other than a controlling business entity), the business entity will be treated as if it sold the assets to its owners at fair market value. The fair market value will be determined by the distributing business entity and those determinations, unless unreasonable, will be binding on the recipients.

"(b) DISTRIBUTIONS TO A CONTROLLING BUSINESS.—If a business entity distributes all or a portion of its assets to a controlling business entity, the controlling business entity will assume the distributing entity's tax attributes with respect to the assets and neither entity will have taxable receipts or a deduction as a result of the transaction.

"(c) DISTRIBUTION OF PERSONAL USE PROPERTY.—If personal use property is distributed to the individual who contributed the personal use property to a business entity, the fair market value of the property for purposes of subsection (a) shall equal the basis of the property plus any enhancement in value of the property attributable to business purchases with respect to the property.

"(d) CONTROLLING BUSINESS ENTITY.—A business entity is a 'controlling business entity' with respect to another business entity if it, or any person to which it is related, owns directly or indirectly more than 50 percent of the profits or capital interest in the other business entity. For purposes of the preceding sentence, a person is related to a business entity if such person owns directly or indirectly more than 50 percent of the profits or capital interest in the business entity.

"(e) APPLICATION OF THIS SECTION.—This section applies to both liquidating and nonliquidating distributions.

"SEC. 1422B. ASSET ACQUISITIONS.

"(a) IN GENERAL.—If a business entity transfers some or all of its assets, the consideration received for such assets shall be allocated among the assets transferred in the same manner as was required by section 1060 of the Internal Revenue Code of 1986. If the transferee and transferor agree in writing on the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferor and transferee unless the Secretary determines that such allocation (or fair market value) is not appropriate.

"(b) TAX CONSEQUENCES.—The tax consequences of an asset acquisition shall be determined in accordance with the rules of this chapter and shall be dependent upon allocations made under subsection (a). In general, consideration allocable to savings assets, such as stock in another business entity, would not be included in taxable receipts of the transferor and would not be a business purchase of the purchaser, but consideration allocable to the sale of tangible property and intangible property (other than savings assets) will constitute taxable receipts of the seller and a business purchase of the purchaser.

"(c) ELECTION TO TREAT ASSET ACQUISITION AS A STOCK ACQUISITION.—In the case of the sale of substantially all of the assets of a business entity or substantially all of the assets of a line of business or a separately standing business of a business entity, the transferee and transferor can jointly elect to treat the acquisition as if it were an acquisition of the stock of a business entity holding the assets so transferred. In such case, the rules of section 1422C shall apply.

"(d) AUTHORITY TO REQUIRE ALLOCATION AGREEMENT AND NOTICE TO THE SECRETARY.—If the Secretary determines that certain types of asset acquisitions have significant possibilities of tax avoidance, the Secretary may require—

“(1) parties to such types of acquisitions to enter into agreements allocating consideration,

“(2) parties to acquisitions involving certain kinds of assets to enter into agreements allocating part of the consideration to those assets, or

“(3) parties to certain acquisitions to report information to the Secretary.

“(e) ASSET ACQUISITION RULES DO NOT APPLY IF CONSIDERATION INCLUDES EQUITY IN PURCHASER.—

“(1) IN GENERAL.—If a business entity issues its own equity or equity in a subsidiary or other controlled entity as part of the consideration for the transfer of assets to it, the transaction shall be treated as a business purchase and not as an asset acquisition, and the taxpayer shall not be entitled to a loss carryover for any unused deduction attributable to the equity portion of such transfer.

“(2) EQUITY.—For purposes of this subsection, equity means—

“(A) stock, in the case of a corporation, "(B) partnership or similar interest, in the case of a partnership or limited liability company, and

"(C) an ownership interest or interest in profits in the case of any other business entity.

"SEC. 1422C. MERGERS, STOCK ACQUISITIONS, AND SPIN-OFFS, SPLIT-OFFS, ETC.

"(a) MERGERS.—A merger of one business entity into another or two businesses entities into a third business entity or any other similar transaction shall have no direct consequences under the business cash flow tax. The surviving entity shall assume the tax attributes of the merged business entities, including any loss carryovers and credit carryovers.

"(b) STOCK ACQUISITION.—The acquisition of all or substantially all of the ownership interest in one business entity either for cash or in exchange for ownership in the acquiring entity or an entity controlled by the acquired entity shall have no direct consequences under the business cash flow tax.

"(c) SPIN-OFFS, SPLIT-OFFS, ETC.—A spin-off, split-off or split-up of a business entity shall have no direct tax consequences under this chapter.

"Subchapter C—International Provisions

"SEC. 1423. NO TAX IMPOSED ON INCOME DERIVED FROM TRADE OR BUSINESS OUTSIDE THE UNITED STATES.

"(a) IN GENERAL.—Only taxable receipts and deductible amounts which are effectively connected with the conduct of a trade or business within the United States shall be included or deducted in the computation of net business income.

"(b) No tax shall be imposed under this title on income effectively connected with the conduct of a trade or business that is not a trade or business within the United States.

"SEC. 1423A. NO CREDIT ALLOWED FOR FOREIGN TAXES ON INCOME DERIVED FROM TRADE OR BUSINESS OUTSIDE THE UNITED STATES.

"(a) IN GENERAL.—No credit shall be allowed under this title for any income, war profits, or excess profits taxes paid or accrued with respect to income effectively connected with the conduct of a trade or business that is not a trade or business within the United States.

"(b) UNUSED FOREIGN TAX CREDITS.—Under regulations prescribed by the Secretary, any taxpayer that is a corporation may elect to treat foreign tax credit carryovers from taxable years beginning prior to January 1, 2015, as general business credit carryovers.

"SEC. 1423B. 5 PERCENT TOLL CHARGE ON UNDISTRIBUTED FOREIGN EARNINGS.

"There is hereby imposed on any domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation a tax equal to 5 percent of the corporation's post-1986 undistributed earnings for the corporation's last taxable year beginning prior to January 1, 2015. For purposes of this subsection, post-1986 undistributed earnings shall be computed as provided in section 902(c)(1) of the Internal Revenue Code of 1986 (as in effect prior to the enactment of the American Business Competitiveness Act of 2015), except that such undistributed earnings shall be diminished by the dividends distributed during such taxable year. Except as provided in regulations prescribed by the Secretary, the tax imposed by this subsection shall be paid at the same time and in the same manner as the tax imposed by section 11 for the corporation's first taxable year beginning on or after January 1, 2015.

"Subchapter D—Financial Institutions

"SEC. 1424. REAL-PLUS-FINANCIAL TREATMENT OF CERTAIN TRANSACTIONS INVOLVING FINANCIAL INSTITUTIONS.

"(a) TAXATION OF TRANSACTIONS BETWEEN FINANCIAL INSTITUTIONS AND BUSINESSES.—

"(1) GENERAL RULE.—In the case of a taxpayer that is a financial institution, taxable receipts shall include all amounts received in covered financial transactions and deductible amounts and shall include all amounts paid in covered financial transactions.

"(2) FINANCIAL INSTITUTIONS.—For purposes of this section, 'financial institution' shall mean, under regulations prescribed by the Secretary, any business entity that is regulated by any Federal or State agency as a financial institution. Such term includes regulated banks, insurance companies, credit unions, investment banks, securities brokers, and mutual funds.

"(3) COVERED FINANCIAL TRANSACTIONS.—For purposes of this section, 'covered financial transactions' shall mean transactions between a financial institution and a party that is not a business entity as defined in section 1421(e)(1). Under regulations prescribed by the Secretary, transactions that do not involve any significant provision of financial services (other than services for which explicit fees are charged) shall be treated as not being covered financial transactions.

"(b) TRANSITION RULE.—Under regulations prescribed by the Secretary, a tax is imposed on any financial institution equal to 25 percent of the institution's net claims against parties that are not business entities, as defined in section 1421(e)(1). Such claims shall be valued at the end of the financial institution's last taxable year beginning before January 1, 2015, with value measured by the institution's basis in such claims. Except as provided in regulations prescribed by the Secretary, the tax imposed by this subsection shall be paid at the same time and in the same manner as the net business income tax for the financial institution's first taxable year beginning on or after January 1, 2015.

"Subchapter E—Other Definitions

"SEC. 1425. OTHER DEFINITIONS.

"(a) IN GENERAL.—When used in this chapter, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

"(1) UNITED STATES.—The term 'United States' includes the States and the District of Columbia.

"(2) TREATMENT OF POSSESSIONS.—

"(A) IN GENERAL.—For purposes of this chapter, the United States possessions shall not be treated as part of the United States.

"(B) POSSESSION.—For purposes of paragraph (1), 'United States possession' or 'possession' means a possession of the United States and includes the Commonwealth of Puerto Rico, the Commonwealth of the Northern Marianas Islands, Guam, American Samoa, and the United States Virgin Islands.

"(3) DEFINITIONS GENERALLY.—Any definition included in this chapter shall apply for all purposes of this chapter unless—

"(A) such definition is limited to the purposes of a particular chapter, section, or subsection, or

"(B) the definition clearly would not be applicable in a particular context.

"(b) INTERPRETATIONS CONSISTENT WITH REST OF INTERNAL REVENUE CODE OF 1986.—Terms not defined in this chapter, but defined elsewhere in this title, shall be interpreted in a manner consistent with this title, except to the extent such interpretation would be inconsistent with the principles and purposes of this chapter.".

(b) EXEMPT ORGANIZATIONS AND UNRELATED BUSINESS INCOME.—Sections 512 and 514 are both amended by striking "gross income" each place it appears and inserting "net business income".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning on or after January 1, 2015, except to the extent otherwise specifically provided in the text of such amendments.

SEC. 5. ALLOWANCE OF TRANSITION BASIS DEDUCTION.

In the case of any property held by the taxpayer on December 31, 2014, and used in a trade or business of the taxpayer on such date, the following rules shall apply:

(1) BASIS.—The basis of such property shall be zero.

(2) DEDUCTION.—

(A) IN GENERAL.—There shall be allowed to the taxpayer a deduction with respect to such property, other than land.

(B) AMOUNT OF DEDUCTION.—Except as provided in subparagraph (D), such deduction shall be determined for a taxable year by amortizing the basis of such property on the same schedule and method that applied to such property before the enactment of this Act.

(C) DISPOSAL OF PROPERTY.—Subparagraph (A) shall apply with respect to property held by the taxpayer on December 31, 2014, whether or not the taxpayer disposes of such property after December 31, 2014.

(D) INVENTORY.—In the case of inventory, the deduction allowed by subparagraph (A) shall be allowed in the taxable year of the taxpayer which includes January 1, 2015.

SEC. 6. INTEREST INCOME OF INDIVIDUALS TAXED IN SAME MANNER AS DIVIDEND INCOME; REDUCED BY INTEREST EXPENSE.

(a) IN GENERAL.—Subparagraph (A) of section 1(h)(11) is amended by striking ''qualified dividend income'' and inserting ''the sum of qualified dividend income and qualified interest income and reduced by interest expense''.

(b) QUALIFIED INTEREST INCOME.—Paragraph (11) of section 1(h) is amended by adding at the end the following:

''(E) QUALIFIED INTEREST INCOME.—For purposes of this paragraph, the term 'qualified interest income' means—

''(i) interest on deposits with a bank (as defined in section 581), "(ii) amounts (whether or not designated as interest) paid, in respect of deposits, investment certificates, or withdrawable or repurchasable shares, by—

"(I) a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, or credit union, or

"(II) any other savings or thrift institution which is chartered and supervised under Federal or State law, the deposits or accounts in which are insured under Federal or State law or which are protected and guaranteed under State law,

"(iii) interest on—

"(I) evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a domestic corporation in registered form, and

"(II) to the extent provided in regulations prescribed by the Secretary, other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public,

"(iv) interest on obligations of the United States, a State, or a political subdivision of a State (not excluded from gross income of the taxpayer under any other provision of law), and

"(v) interest attributable to participation shares in a trust established and maintained by a corporation established pursuant to Federal law.".

(c) INTEREST EXPENSE.—Paragraph (11) of section 1(h), as amended by subsection (b), is amended by inserting at the end the following:

"(F) INTEREST EXPENSE.—The term 'interest expense' means interest paid by the taxpayer other than qualified residence interest.".

(d) CONFORMING AMENDMENT.—The heading for section 1(h)(11) is amended by inserting "AND INTEREST" after "DIVIDENDS".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2014.

SEC. 7. REPEAL OF DEPRECIATION, INTERNATIONAL, AND OTHER TAX PROVISIONS.

(a) DEPRECIATION AND COST RECOVERY PROVISIONS.—The following sections of the Internal Revenue Code of 1986 are hereby repealed:

(1) Section 167 (relating to depreciation).

(2) Section 168 (relating to accelerated cost recovery system).

(3) Section 169 (relating to amortization of pollution control facilities).

(4) Section 175 (relating to soil and water conservation expenditures; endangered species recovery expenditures).

(5) Section 178 (relating to amortization of cost of acquiring a lease).

(6) Section 179 (relating to election to expense certain depreciable business assets).

(7) Section 179A (relating to deduction for clean-fuel vehicles and certain refueling property).

(8) Section 179B (relating to deduction for capital costs incurred in complying with Environmental Protection Agency sulfur regulations).

(9) Section 179C (relating to election to expense certain refineries).

(10) Section 179D (relating to energy efficient commercial buildings deduction).

(11) Section 179E (relating to election to expense advanced mine safety equipment).

(12) Section 190 (relating to expenditures to remove architectural and transportation barriers to the handicapped and elderly).

(13) Section 194 (relating to treatment of reforestation expenditures).

(14) Section 197 (relating to amortization of goodwill and certain other intangibles).

(15) Section 198 (relating to expensing of environmental remediation costs).

(16) Section 198A (relating to expensing of qualified disaster expenses).

(17) Section 199 (relating to income attributable to domestic production activities).

(18) Section 263 (relating to capital expenditures).

(19) Section 263A (relating to capitalization and inclusion in inventory costs of certain expenses).

(20) Section 471 (relating to general rule for inventories).

(21) Section 472 (relating to last-in, first-out inventories).

(22) Section 473 (relating to qualified liquidations of LIFO inventories).

(23) Section 474 (relating to simplified dollar-value LIFO method for certain small businesses).

(24) Section 611 (relating to allowance of deduction for depletion).

(25) Section 612 (relating to basis for cost depletion).

(26) Section 613 (relating to percentage depletion).

(27) Section 613A (relating to limitations on percentage depletion in case of oil and gas wells).

(28) Section 614 (relating to definition of property).

(29) Section 616 (relating to development expenditures).

(30) Section 617 (relating to deduction and recapture of certain mining exploration expenditures).

(b) RECOGNITION OF REVENUE AND TIMING OF DEDUCTION PROVISIONS.—The following provisions of the Internal Revenue Code of 1986 are hereby repealed:

(1) Section 456 (relating to prepaid dues income of certain membership organizations).

(2) Section 458 (relating to magazines, paperbacks, and records returned after the close of the taxable year).

(3) Section 460 (relating to special rules for long-term contracts).

(4) Section 467 (relating to certain payments for the use of property or services).

(5) Section 468 (relating to special rules for mining and solid waste reclamation and closing costs).

(c) INTERNATIONAL PROVISIONS.—The following provisions of the Internal Revenue Code of 1986 are hereby repealed:

(1) Section 902 (relating to deemed paid credit where domestic corporation owns 10 percent or more of voting stock of foreign corporation).

(2) Section 907 (relating to special rules in case of foreign oil and gas income).

(3) Subpart F of part III of subchapter N of chapter 1 (relating to controlled foreign corporations) other than section 965.

(4) Subpart G of part III of subchapter N of chapter 1 (relating to export trade corporations).

(5) Part IV of part III of subchapter N of chapter 1 (relating to domestic international sales corporations).

(d) EFFECTIVE DATE.—

(1) SUBSECTION (a).—The amendments made by subsection (a) shall apply to property placed in service after December 31, 2014, in taxable years ending after that date.

(2) SUBSECTION (b).—The amendments made by subsection (b) of this section shall apply to taxable years beginning on or after January 1, 2015.

SEC. 8. EXPANDED RELIEF FOR NET OPERATING LOSSES.

(a) EXTENDED CARRYBACK; UNLIMITED CARRYFORWARD WITH INTEREST.—Paragraph (1) of section 172(b) is amended to read as follows:

"(1) YEARS TO WHICH LOSS MAY BE CARRIED.—

"(A) IN GENERAL.—A net operating loss for any taxable year—

"(i) shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss, and

"(ii) shall be a net operating loss carryover to the succeeding taxable year and added to the deduction allowable under subsection (a) for such taxable year.

"(B) LIMITATION.—A net operating loss may not be carried back to any taxable year ending before January 1, 2015, except that a loss arising in a taxable year beginning in calendar year 2015 or calendar year 2016 may be carried back to the two preceding taxable years.''.

(b) INTEREST ON CARRYFORWARD.—Section 172(b) is amended by adding at the end the following new paragraph:

''(4) INTEREST ON CARRYFORWARD.—The amount of any net operating loss carryover shall, prior to being carried to a succeeding taxable year, be increased by an amount equal to such carryover multiplied by the Federal short-term rate (as defined in section 1274(d)) for the month in which or with which the taxable year ends.''.

(c) CONFORMING AMENDMENTS.—

(1) Section 172(d)(1) is amended by inserting ''(other than by reason of subsection (b)(1)(B))'' after ''deduction''.

(2) Section 172 is amended by striking subsections (f), (i), and (j) and redesignating subsections (g), (h), and (k) as subsections (f), (g), and (h), respectively.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to net operating losses arising in taxable years beginning after December 31, 2014.

SEC. 9. REPEAL OF CORPORATE AMT AND INDIVIDUAL AMT PREFERENCES AND ADJUSTMENTS THAT PERTAIN TO CAPITAL COST RECOVERY.

(a) CORPORATE AMT.—Section 55(a)(1)(B) is amended by adding at the end the following flush sentence:

"For purposes of this title, the tentative minimum tax of any corporation for any taxable year ending after December 31, 2014, shall be zero.".

(b) INDIVIDUAL AMT.—

(1) Section 56 is amended—

(A) by striking paragraphs (1), (2), (3), (5), and (6) of subsection (a); and

(B) by striking subsection (b)(2).

(2) Section 57 is amended—

(A) by striking paragraphs (1), (2), (6), and (7) of subsection (a); and

(B) by striking subsection (b).

(c) EFFECTIVE DATE.—

(1) CORPORATE AMT.—The amendments made by subsection (a) shall apply to taxable years ending after December 31, 2014.

(2) INDIVIDUAL AMT.—The amendments made by subsection (b) shall apply to amounts paid or incurred after December 31, 2014.

SEC. 10. REPEAL OF BUSINESS TAX CREDITS.

(a) IN GENERAL.—Subparts D and E (other than sections 49 and 50) of part IV of subchapter A of chapter 1 are hereby repealed.

(b) SPECIAL RULE FOR CARRYBACK AND CARRYFORWARD OF UNUSED CREDITS.—Any carryback or carryforward that arose under section 39 of the Internal Revenue Code of 1986 (as in effect before the repeal of such section by subsection (a)) shall be allowed under section 38 of such Code (as in effect before the repeal of such section by subsection (a)), in accordance with the terms of such sections (as so in effect).

(c) EFFECTIVE DATE.—The repeals made by this section shall apply to amounts paid or incurred on or after January 1, 2015.

SEC. 11. DISALLOWANCE OF INTEREST EXPENSE DEDUCTION, EXCEPT QUALIFIED RESIDENCE INTEREST.

(a) IN GENERAL.—Section 163 is amended by adding at the end the following:

(1) in subsection (a) by striking "There" and inserting "Except as provided by subsection (n), there",

(2) by redesignating subsection (n) as subsection (o), and

(3) by inserting after subsection (m) the following new subsection:

"(n) TERMINATION.—

"(1) IN GENERAL.—Except as provided by subsection (h)(2)(D) and paragraph (2), this section shall not apply to interest paid or accrued after December 31, 2014.

"(2) TRANSITION INTEREST DEDUCTION.—

"(A) IN GENERAL.—In the case of a taxpayer who is a corporation, there shall be allowed as a deduction for a taxable year the sum of the monthly transition interest deductions for the taxable year.

"(B) MONTHLY TRANSITION INTEREST DEDUCTION.—For purposes of subparagraph (A)—

"(i) IN GENERAL.—The monthly transition interest deduction for any month is the transition interest amount multiplied by the applicable percentage for such month.

"(ii) APPLICABLE PERCENTAGE DEFINED.—The term 'applicable percentage' means, with respect to a month, 100 percent reduced (but not below zero) by .833 for each month of the transition period occurring before the month for which such percentage is determined.

"(iii) TRANSITION INTEREST AMOUNT.—The transition interest amount is the deduction allowed to the taxpayer under this section for the last full taxable year ending before January 1, 2015.

"(iv) TRANSITION PERIOD.—The term 'transition period' means the 120-month period beginning with January 2015.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to interest paid or accrued on or after January 1, 2015.

SEC. 12. CASH METHOD OF ACCOUNTING.

(a) IN GENERAL.—Subsection (a) of section 446 is amended to read as follows:

"(a) GENERAL RULE.—Taxable income shall be computed under the cash receipts and disbursements method of accounting.".

(b) CONFORMING AMENDMENTS.—

(1) Section 446 is amended by striking subsections (b), (c), and (e).

(2) The following sections of the Internal Revenue Code of 1986 are repealed:

(A) Section 447 (relating to method of accounting for corporations engaged in farming).

(B) Section 448 (relating to limitation on use of cash method of accounting).

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning after December 31, 2014.

(2) CHANGE IN METHOD OF ACCOUNTING.—In the case of any taxpayer required by an amendment made by this section to change its method of accounting for its first taxable year beginning after the date of the enactment of this Act—

(A) such change shall be treated as initiated by the taxpayer;

(B) such change shall be treated as made with the consent of the Secretary of the Treasury; and

(C) the net amount of the adjustments required to be taken into account by the taxpayer under section 481 of the Internal Revenue Code of 1986 shall be taken into account ratably over a period (not greater than 8 taxable years) beginning with such first taxable year.

The American Business Competitiveness Act (ABC Act)

BUSINESS TAX RATES

	Current Maximum Rate	Maximum Rate under ABC
C-Corporation	35%	25%
S-Corporation	39.6%	25%
LLC	39.6%	25%
Sole Proprietorship	39.6%	25%
Independent Contractor	39.6%	25%
Partnerships	39.6%	25%
Interest Income	39.6%	20%*

*same as max dividend/capital gains rate

— Repeals AMT —

— Eliminates special loopholes —

— Simplifies the tax code for businesses —

— Moves to territorial system —

Taxation of Business Income (other than Corporations)

Tax Bracket	Current Maximum Rate	Maximum Rate under ABC
$0-$9,075	10%	10%
$9,076-$36,900	15%	15%
$36,901-$89,350	25%	25%
$89,351-$186,350	28%	25%
$186,351-$405,100	33%	25%
$405,101-$406,750	35%	25%
$406,751+	39.6%	25%

The American Business Competitiveness Act (ABC Act)

SECTION-BY-SECTION SUMMARY

Section 1:

- Short Title – American Business Competitiveness Act of 2015

Section 2:

- Congressional Findings

Section 3:

- The bill would impose a maximum 25% tax rate on the net business income of individuals and corporations. The business tax rate would be phased-in over a ten-year period.

Section 4:

- Moves to cash-flow accounting and full-expensing of business costs. Net business income would be considered taxable receipts minus deductible amounts. Compensation expenses, along with the acquisition of property and use of services for business activity, would be considered deductible amounts. Compensation deductions would be phased-in at 80%, increasing 2% each year, until it reaches 100% in ten years. Mergers, acquisitions, and distributions would not incur any tax penalties. Changes the international tax system to a territorial system. Simplifies the treatment of financial institutions under the code.

Section 5:

- Businesses would be able to preserve depreciation deductions for property. Depreciation deductions for property would continue under current schedules.

Section 6:

- Interest income would be taxed at the same rate as dividends and capital gains.

Section 7:

- Eliminates business depreciation and deductions, with the exception of property as indicated in Section 5.

Section 8:

- Allows businesses to carryback net-operating losses 5 years and carry them forward indefinitely.

Section 9:

- Repeals the Alternative Minimum Tax (AMT) for corporations and individuals in regards to their business income.

Section 10:

- Repeals all business tax credits.

Section 11:

- Eliminates interest expense deduction, with the exception of the home mortgage interest deduction, in regards to business activity. Provides a 10-year phase out for the interest deduction.

Section 12:

- Requires all taxpayers, and businesses, to use the cash method of accounting for tax purposes. Income would be reported in the year received, and expenses would be deducted in the year they are paid.

II

113TH CONGRESS
1ST SESSION

S. 1181

To amend the Internal Revenue Code of 1986 to exempt certain stock of real estate investment trusts from the tax on foreign investments in United States real property interests, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JUNE 18, 2013

Mr. MENENDEZ (for himself, Mr. ENZI, Mr. SCHUMER, Mr. BARRASSO, Mr. BEGICH, Mr. BOOZMAN, Mr. BENNET, Mr. CORNYN, Mrs. BOXER, Mr. CRAPO, Ms. CANTWELL, Mr. ISAKSON, Mr. CARDIN, Mr. ROBERTS, Mr. CARPER, Mr. THUNE, Mr. COONS, Mrs. GILLIBRAND, Mrs. HAGAN, Mr. NELSON, Mrs. SHAHEEN, Ms. STABENOW, Mr. TESTER, and Mr. WYDEN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1986 to exempt certain stock of real estate investment trusts from the tax on foreign investments in United States real property interests, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Real Estate Investment and Jobs Act of 2013".

SEC. 2. EXCEPTION FROM FIRPTA FOR CERTAIN STOCK OF REAL ESTATE INVESTMENT TRUSTS.

(a) IN GENERAL.—Paragraph (3) of section 897(c) of the Internal Revenue Code of 1986 is amended—

(1) by striking all that precedes "If any class" and inserting the following:

"(3) EXCEPTIONS FOR CERTAIN STOCK.—

"(A) EXCEPTION FOR STOCK REGULARLY TRADED ON ESTABLISHED SECURITIES MARKETS.—",

(2) by inserting before the period the following: ". In the case of any class of stock of a real estate investment trust, the preceding sentence shall be applied by substituting '10 percent' for '5 percent' ", and

(3) by adding at the end the following new subparagraph:

"(B) EXCEPTION FOR CERTAIN STOCK IN REAL ESTATE INVESTMENT TRUSTS.—

"(i) IN GENERAL.—Stock of a real estate investment trust held by a qualified shareholder shall not be treated as a United States real property interest except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds (directly or indirectly through the qualified shareholder) more than 10 percent of the stock of such real estate investment trust.

"(ii) QUALIFIED SHAREHOLDER.—For purposes of this subparagraph, the term 'qualified shareholder' means an entity—

"(I) that is eligible for benefits of a comprehensive income tax treaty with the United States which includes an exchange of information program,

"(II) that is a qualified collective investment vehicle,

"(III) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and

"(IV) that maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10 percent of the class of interest described in clause (III).

"(iii) QUALIFIED COLLECTIVE INVESTMENT VEHICLE.—For purposes of this subparagraph, the term 'qualified collective investment vehicle' means an entity that—

"(I) would be eligible for a reduced rate of withholding under such comprehensive income tax treaty with respect to ordinary dividends paid by a real estate investment trust, even if such entity holds more than 10 percent of the stock of such real estate investment trust,

"(II) would be classified as a United States real property holding corporation (determined without regard to this paragraph) at any time during the 5-year period ending on the date of disposition of or distribution with respect to the entity's interests in a real estate investment trust, or

"(III) is designated as such by the Secretary and is either—

"(aa) fiscally transparent within the meaning of section 894, or

"(bb) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.".

(b) DISTRIBUTIONS BY REAL ESTATE INVESTMENT TRUSTS.—Paragraph (1) of section 897(h) of the Internal Revenue Code of 1986 is amended—

(1) by striking "Any distribution" and inserting the following:

"(A) IN GENERAL.—Except as provided in subparagraph (B), any distribution",

(2) by inserting "(10 percent in the case of stock of a real estate investment trust)" after "5 percent of such class of stock",

(3) by inserting ", and any distribution to a qualified shareholder (as defined in subsection (c)(3)(B)(ii)) shall not be treated as gain recognized from the sale or exchange of a United States real property interest to the extent that the stock of the real estate investment trust held by such qualified shareholder is not treated as a United States real

property interest under subsection (c)(3)(B)" before the period at the end of the second sentence, and

(4) by adding at the end the following new subparagraph:

"(B) SPECIAL RULE.—Subparagraph (A) shall not apply to distributions which are treated as a sale or exchange of stock or property pursuant to section 301(c)(3), 302, or 331.".

(c) DEFINITION.—Paragraph (4) of section 897(h) of the Internal Revenue Code of 1986 is amended by adding at the end of subparagraph (B) the following: "In determining whether a qualified investment entity is domestically controlled, any stock in the qualified investment entity held by another qualified investment entity shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled. In making such a determination, a qualified investment entity shall be permitted to presume that stock held by a holder of less than 5 percent of a class of stock regularly traded on an established securities market in the United States is held by United States persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership.".

(d) CONFORMING AMENDMENT.—Subparagraph (C) of section 897(c)(6) of the Internal Revenue Code of 1986 is amended—

(1) by striking "more than 5 percent" and inserting "more than 5 or 10 percent, whichever is applicable,", and

(2) by striking "substituting '5 percent' for '50 percent')" and inserting "substituting '5 percent or 10 percent, whichever is applicable' for '50 percent')".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by subsection (a) shall apply to dispositions on and after the date of the enactment of this Act.

(2) DISTRIBUTIONS.—The amendments made by subsection (b) shall apply to any distribution by a real estate investment trust on or after the date of the enactment of this Act which is treated as a deduction for a taxable year of such trust ending after such date.

(3) DEFINITIONS.—The amendments made by subsections (c) and (d) shall take effect on the date of the enactment of this Act.

SEC. 3. UNITED STATES REAL PROPERTY INTEREST.

(a) UNITED STATES REAL PROPERTY INTEREST.—Subparagraph (B) of section 897(c)(1) of the Internal Revenue Code of 1986 is amended by striking all that precedes "(i) as of the date of the disposition" and inserting the following:

"(B) EXCLUSION FOR INTEREST IN CERTAIN CORPORATIONS.—The term 'United States real property interest' does not include any interest in a corporation (other than a qualified investment entity (as defined in subsection (h)(4)(A)(i))) if—".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

○

HOW TO MAKE AMERICA A GLOBAL TAX HAVEN

An expert from Ramesh Ponnuru's Bloomberg column dated March 25, 2013.

....[Nunes] suggests a new approach: a "business consumption tax" that treats all businesses the same, whatever their organizational form. Instead of taxing their income, it taxes their cashflow -- income minus expenses, except for interest payments. That way, businesses would no longer write off their investments according to a complicated depreciation schedule. Investments would be tax-free.

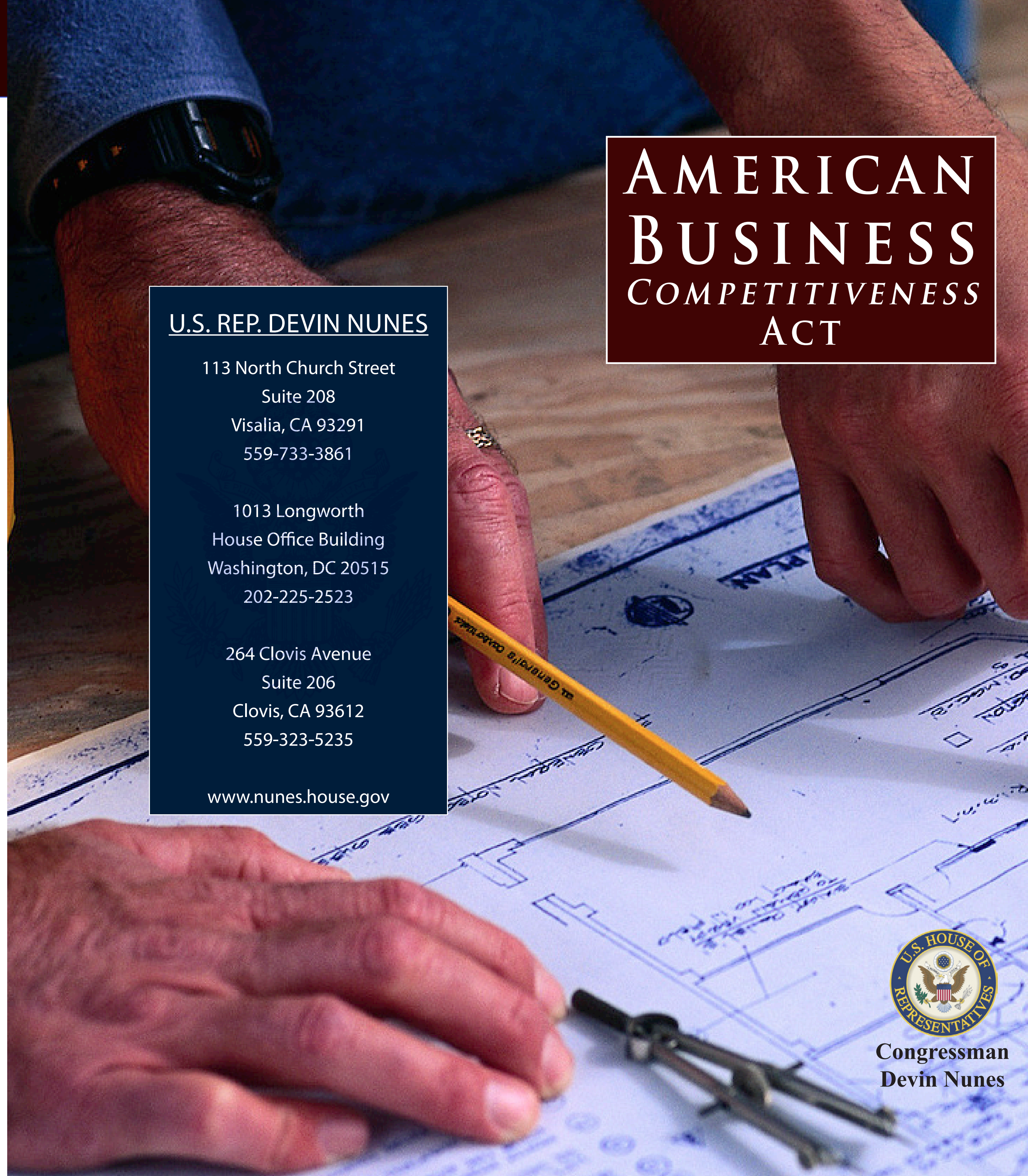
Both U.S. and foreign companies would have more reason to invest here, Nunes says. "This would make the U.S. the largest tax haven in human history."

I've run across two objections to Nunes's idea. The first is that it is simply too ambitious to be politically viable: If Congress is having trouble reforming the corporate tax, goes the argument, it won't be able to digest an entirely new approach to taxing business income. What this objection ignores is that the moderately ambitious proposals all face obstacles that are probably insuperable -- obstacles this proposal avoids.

The second objection is that Nunes's proposal would cost the federal government a lot of revenue. A Joint Committee on Taxation estimate of the proposal's budget impact would make it possible to evaluate this claim, but it sounds plausible. If it turns out to be expensive, though, the concept can still work: The tax rate would just have to be higher than the 25 percent that Nunes has tentatively put forward.

Even if the rate were left at the 35 percent that currently applies to corporations, the shift to the new tax would still be a boon for the economy. The statutory rate would be higher than that of other countries, but the number that matters -- the effective tax rate on investments -- would be a very competitive zero, thanks to companies' ability to write off their costs immediately. Eliminating the deduction for interest, meanwhile, would end a destabilizing distortion in the economy: the federal tax code's preference for corporate financing via debt rather than equity. That preference also gives an advantage to established firms that have greater borrowing capacity than startups.

If Congress still finds the Nunes proposal too ambitious to contemplate, it could undertake reform on a much smaller scale. Leave tax rates alone, keep the separate schedules for different types of companies, and just make a trade: Companies would get immediate write-offs on investments and in return lose the interest deduction. That trade would probably leave the government's revenue at roughly the same level. It would certainly be simpler than most other proposals to reform business taxation. And it would encourage more investment and less debt.



AMERICAN BUSINESS COMPETITIVENESS ACT

U.S. REP. DEVIN NUNES

113 North Church Street
Suite 208
Visalia, CA 93291
559-733-3861

1013 Longworth
House Office Building
Washington, DC 20515
202-225-2523

264 Clovis Avenue
Suite 206
Clovis, CA 93612
559-323-5235

www.nunes.house.gov

U.S. HOUSE OF REPRESENTATIVES

Congressman Devin Nunes

The ABC Act * SIMPLE * FAIR * FLAT *

The **American Business Competitiveness Act (ABC Act)** would establish the most aggressive pro-growth business tax policy in the developed world. If implemented, it would result in massive investments and job creation throughout the United States.

Lower Business Income Tax

All businesses, no matter how they are organized, will be taxed at the same low rate; ***25 percent***.

The taxation of non-business income remains unchanged, except that interest income is taxed at the same rate as dividends and capital gains.

High Rates Are A Large Burden For Small Business

Regardless of income, small businesses face a rate of 30% or higher.

Tax Foundation Analysis

Individual And Business Changes Modeled:
Cut Corporate Rate to 25%
Assorted changes in Corporate Tax Base
Revenue Effect due to reduced Profit Shifting
Full Expensing*
Cap Tax Rate on Noncorp Business Income at 25%
Tax Individual Interest Income at Capital Gains Rate**

ECONOMIC AND BUDGET CHANGES VERSUS 2013 LAW (billions of 2013 dollars except as noted)	
GDP	6.80%
GDP ($ billions)	$1,107.8
Private business GDP	7.07%
Private business stocks	20.63%
Wage rate	5.72%
Private business hours of work	1.28%
Full-time equivalent jobs (in thousands)	1,228.4
Static federal revenue estimate, GDP assumed constant ($ billions)	-$129.0
Dynamic federal revenue estimate after GDP gain or loss ($ billions)	$96.2
Weighted Average service price	% Change
Corporate	-11.40%
Noncorporate	-10.87%
All business	-11.24%

Pro-Growth

The ABC Act will allow ***100 percent expensing***, meaning firms will deduct their full investment costs from their current year tax liabilities.

- This includes land, buildings and inventory, as well as other tangible or intangible property.
- Expensing that exceeds taxable income can be carried to future tax years with interest or backwards to reduce taxes from prior years.

This will create a powerful incentive for businesses of all sizes to invest and grow, generating new jobs across America.

No Loopholes

The ABC Act eliminates all special loopholes. The complex tax code, with its high compliance costs and distorting impact on the economy, is wiped away and replaced with a **simple, fair and flat tax.**

Less Complex & Fewer Distortions

The elimination of deductions and credits simplifies the tax code and reduces compliance costs.

- Complex property and inventory rules such as depreciations, amortization and depletion are replaced by full expensing.
- The tax code's pressure on firms to carry debt is removed by eliminating the business interest deduction while lowering the individual income tax on interest income.

International Tax Reform

Territorial tax rules will make U.S. businesses more globally competitive.

Simple, Fair, Flat & Fiscally Responsible

- The Tax Foundation has analyzed the ABC Act and concluded that it would increase baseline GDP growth by 6.8%.
- Based on analysis by the Joint Committee on Taxation, the ABC Act has been crafted in a way that is both budget neutral and economically transformative.
- Under the ABC Act, businesses can plan for the future based on easy to understand rules that are not subject to constant expiration.

Congressman Nunes is seeking comments on the ABC Act. Contact us at: ABCtaxplan@mail.house.gov.

I

113TH CONGRESS
2D SESSION

H. R. 1

To amend the Internal Revenue Code of 1986 to provide for comprehensive tax reform.

IN THE HOUSE OF REPRESENTATIVES

DECEMBER 10, 2014

Mr. CAMP introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to provide for comprehensive tax reform.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the ‘‘Tax Reform Act of 2014’’.

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference the item relating to such section in the table of sections for such part).

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to productions commencing after December 31, 2013.

SEC. 3117. REPEAL OF SPECIAL RULES FOR RECOVERIES OF DAMAGES OF ANTITRUST VIOLATIONS, ETC.

(a) IN GENERAL.—Part VI of subchapter B of chapter 1 is amended by striking section 186 (and by striking the item relating to such section in the table of sections for such part).

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2014.

SEC. 3118. TREATMENT OF REFORESTATION EXPENDITURES.

(a) ELIMINATION OF EXPENSING ELECTION.—Section 194 is amended by striking subsections (a) and (b), by redesignating subsection (c) and (d) as subsections (b) and (c), respectively, and by inserting before subsection (b) (as so redesignated) the following new subsection:

''(a) IN GENERAL.—In the case of a taxpayer's qualified reforestation expenditures for any taxable year—

"(1) except as provided in paragraph (2), no deduction shall be allowed for such expenditures, and

"(2) the taxpayer shall—

"(A) charge such expenditures to capital account, and

"(B) be allowed an amortization deduction of such expenditures ratably over the 7-year period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.".

(b) QUALIFIED REFORESTATION EXPENDITURES.—Section 194(b), as redesignated by subsection (a), is amended by striking paragraph (2), by redesignating paragraph (1) as paragraph (2), and by inserting before paragraph (2) (as so redesignated the following new paragraph:

"(1) QUALIFIED REFORESTATION EXPENDITURES.—The term 'qualified reforestation expenditures' means, with respect to any taxable year, the reforestation expenditures paid or incurred by the taxpayer during such taxable year with respect to qualified timber property.".

(c) QUALIFIED TIMBER PROPERTY LIMITED TO ORNAMENTAL TREES.—Section 194(b)(2), as redesignated by subsections (a) and (b), is amended to read as follows:

"(2) QUALIFIED TIMBER PROPERTY.—The term 'qualified timber property' means a woodlot or other site located in the United States which—

"(A) will contain evergreen trees in significant commercial quantities which are reasonably expected to be more than 6 years old at the time severed from the roots, and

"(B) is held by the taxpayer for the planting, cultivating, caring for, and cutting of such trees for sale for ornamental purposes.".

(d) DETERMINATION OF RECOMPUTED BASIS.—Section 1245(b) is amended by striking paragraph (7).

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to expenditures paid or incurred in taxable years beginning after December 31, 2014.

SEC. 3119. 20-YEAR AMORTIZATION OF GOODWILL AND CERTAIN OTHER INTANGIBLES.

(a) IN GENERAL.—Subsection (a) of section 197 is amended by striking "15-year period" and inserting "20-year period".

SEC. 3132. REPEAL OF SPECIAL RULES FOR GAIN OR LOSS ON TIMBER, COAL, OR DOMESTIC IRON ORE.

(a) IN GENERAL.—Subchapter I of chapter 1 is amended by striking part III (and by striking the item relating to such part in the table of parts for such subchapter).

(b) CONFORMING AMENDMENTS.—

(1) Section 512(b)(5) is amended by striking the last sentence.

(2) Section 871(a)(1)(B) is amended by striking ''gains described in section 631(b) or (c), and''.

(3) Section 871(d)(1)(A) is amended—

(A) by striking '', (ii) rents'' and inserting ''and (ii) rents'', and

(B) by striking '', and (iii) gains described in section 631(b) or (c)''.

(4)(A) Section 881(a) is amended by striking paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(B) Section 1442(a) is amended—

(i) by striking ''881(a)(3) and (4)'' and inserting ''881(a)(2) and (3)'',

(ii) by striking ''881(a)(3),'' and inserting ''881(a)(2),'', and

(iii) by striking ''881(a)(4)'' and inserting ''881(a)(3)''.

(5) Section 882(d)(1)(A) is amended—

(A) by striking ", (ii) rents" and inserting "and (ii) rents", and

(B) by striking ", and (iii) gains described in section 631(b) or (c)".

(6) Section 1231(b) is amended by striking paragraph (2).

(7) Section 1402(a)(3) is amended by inserting "or" at the end of subparagraph (A) and by striking subparagraph (B) and redesignating subparagraph (C) as subparagraph (B).

(8) Section 1441 is amended—

(A) in subsection (b), by striking ", gains described in section 631(b) or (c)", and

(B) in subsection (c)(5), by striking "gains described in section 631(b) or (c), gains subject to tax under section 871(a)(1)(D)," and inserting "gains subject to tax under section 871(a)(1)(D)".

(9)(A) Part IX of subchapter B of chapter 1 is amended by striking section 272 (and by striking the item relating to such section in the table of sections for such subpart).

(B) Section 1016(a) is amended by striking paragraph (15).

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to taxable years beginning after December 31, 2014.

(2) BASIS ADJUSTMENTS.—The amendment made by subsection (b)(9)(B) shall apply to deductions determined for taxable years beginning after December 31, 2014.

SEC. 3133. REPEAL OF LIKE-KIND EXCHANGES.

(a) IN GENERAL.—Part III of subchapter O of chapter 1 is amended by striking section 1031 (and by striking the item relating to such section in the table of sections for such part).

(b) CONFORMING AMENDMENTS.—

(1) Section 121(d)(10) is amended by inserting ''(as in effect before its repeal by the Tax Reform Act of 2014)'' after ''section 1031''.

(2) Section 197(f)(2)(B)(i) is amended by inserting ''(as in effect before its repeal by the Tax Reform Act of 2014)'' after ''1031''.

(3) Section 453(f) is amended by striking paragraph (6).

(4) Section 470(e)(4) is amended—

(A) by striking ‘‘Sections 1031(a) and’’ in subparagraph (A) and inserting ‘‘Section’’,

(i) by striking ‘‘1031 or’’ in subparagraph (B), and

(ii) by striking ‘‘SECTIONS 1031 AND’’ in the heading thereof and inserting ‘‘SECTION’’.

(5)(A) Section 501(c)(12)(C)(v) is amended by striking ‘‘asset exchange or conversion transaction’’ and inserting ‘‘specified involuntary conversion’’.

(B) Section 501(c)(12)(G) is amended—

(i) by striking ‘‘asset exchange or conversion transaction’’ and inserting ‘‘specified involuntary conversion’’,

(ii) by striking ‘‘voluntary exchange or’’, and

(iii) by striking ‘‘1031 or’’.

(6)(A) Section 704(c) is amended by striking paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(B) Section 704(c)(2), as so redesignated, is amended by striking ‘‘or (2)’’.

(7) Section 857(e)(2) is amended by striking subparagraph (B) and by redesignating subparagraphs (C) and (D) as subparagraphs (B) and (C), respectively.

(8)(A) Section 1035 is amended by striking subsection (d) and inserting the following new subsections:

"(d) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

"(e) LOSS FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

"(f) BASIS.—If property was acquired on an exchange described in this section, section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.''.

(B) Section 1036(c) is amended—

(i) in paragraph (1), by striking ''subsections (b) and (c) of section 1031'' and inserting ''subsections (d) and (e) of section 1035'', and

(ii) in paragraph (2), by striking ''subsection (d) of section 1031'' and inserting ''subsection (f) of section 1035''.

(C) Section 1037(c) is amended—

(i) in paragraph (1), by striking "subsections (b) and (c) of section 1031" and inserting "subsections (d) and (e) of section 1035", and

(ii) in paragraph (2), by striking "subsection (d) of section 1031" and inserting "subsection (f) of section 1035".

(D) Section 83(g) is amended by striking "section 1031" and inserting "section 1035".

(E) Section 424(b) is amended by striking "section 1031" and inserting "section 1035".

(F) Section 424(c)(1)(B) is amended by striking "section 1031" and inserting "section 1035".

(9) Section 1060(c) is amended by striking the second sentence thereof.

(10) Section 1245(b)(4) is amended—

(A) by striking "LIKE KIND EXCHANGES; INVOLUNTARY" and inserting "INVOLUNTARY", and

(B) by striking "1031 or".

(11) Section 1250(d)(4) is amended—

(A) by striking "LIKE KIND EXCHANGES; INVOLUNTARY" and inserting "INVOLUNTARY",

(B) by striking "1031 or" in subparagraph (A), and

(C) by striking "1031 or" in subparagraph (E).

(12) Section 2032A(e)(14)(C) is amended—

(A) in clause (i)(I), by inserting "(as in effect before its repeal by the Tax Reform Act of 2014)" after "section 1031", and

(B) in clause (ii)(I), by inserting "(as so in effect)" after "section 1031".

(13) Section 4940(c)(4) is amended by striking subparagraph (D).

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to transfers after December 31, 2014.

(2) EXCEPTION FOR TRANSFERS PURSUANT TO BINDING CONTRACTS.—Notwithstanding paragraph (1), the amendments made by this section shall not apply to any transfer if—

(A) such transfer is pursuant to a written binding contract entered into before January 1, 2015, and

(B) the exchange of which such transfer is a part is completed before January 1, 2017.

SEC. 3134. RESTRICTION ON TRADE OR BUSINESS PROPERTY TREATED AS SIMILAR OR RELATED IN SERVICE TO INVOLUNTARILY CONVERTED PROPERTY IN DISASTER AREAS.

(a) CLASS LIFE OF REPLACEMENT PROPERTY NOT TO EXCEED CONVERTED PROPERTY.—Section 1033(h)(2) is amended by inserting ''if the class life of such tangible property does not exceed the class life of the property so converted'' before the period at the end.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to disasters declared after December 31, 2014.

SEC. 3135. REPEAL OF ROLLOVER OF PUBLICLY TRADED SECURITIES GAIN INTO SPECIALIZED SMALL BUSINESS INVESTMENT COMPANIES.

(a) IN GENERAL.—Part III of subchapter O of chapter 1 is amended by striking section 1044 (and by striking the item relating to such section in the table of sections of such part).

(b) CONFORMING AMENDMENTS.—

(1) Section 45D(c)(2)(A) is amended to read as follows:

''(A) any partnership or corporation which is licensed by the Small Business Administration under section 301(d) of the Small Business

(A) such change shall be treated as initiated by the taxpayer, and

(B) such change shall be treated as made with the consent of the Secretary of the Treasury.

SEC. 3304. INSTALLMENT SALES.

(a) REPEAL OF EXCEPTIONS TO TREATMENT AS DEALER DISPOSITIONS.—Section 453(l) is amended to read as follows:

"(l) DEALER DISPOSITIONS.—For purposes of subsection (b)(2)(A), the term 'dealer disposition' means any of the following dispositions:

"(1) PERSONAL PROPERTY.—Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan.

"(2) REAL PROPERTY.—Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.".

(b) MODIFICATION OF RULES FOR NONDEALERS.—

(1) REPEAL OF SPECIAL RULE FOR INTEREST PAYMENTS.—Section 453A(b)(2) is amended to read as follows:

"(2) INTEREST PAYMENT EXCEPTION FOR OBLIGATIONS NOT OUTSTANDING AT CLOSE OF TAXABLE YEAR.—Subsection (a)(1) shall apply to an obligation described in paragraph (1) arising during any taxable year only if such obligation is outstanding as of the close of such taxable year.".

(2) REPEAL OF EXCEPTION FOR FARM PROPERTY.—Section 453A(b)(3) is amended—

(A) by striking "from the disposition—" and all that follows and inserting "from the disposition by an individual of personal use property (within the meaning of section 1275(b)(3)).", and

(B) by striking "AND FARM" in the heading.

(3) REPEAL OF SPECIAL RULE FOR TIMESHARES AND RESIDENTIAL LOTS.—Section 453A(b) is amended by striking paragraph (4) and by redesignating paragraph (5) as paragraph (4).

(4) CONFORMING AMENDMENT.—Section 453A(c) is amended—

(A) by striking "the applicable percentage of" in paragraph (2)(A), and

(B) by striking paragraph (4) and by redesignating paragraphs (5) and (6) as paragraphs (4) and (5), respectively.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales and other dispositions after December 31, 2014.

SEC. 3305. REPEAL OF SPECIAL RULE FOR PREPAID SUBSCRIPTION INCOME.

(a) IN GENERAL.—Subpart B of part II of subchapter E of chapter 1 is amended by striking section 455 (and by striking the item relating to such section in the table of sections for such subpart).

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to payments received after December 31, 2014.

SEC. 3306. REPEAL OF SPECIAL RULE FOR PREPAID DUES INCOME OF CERTAIN MEMBERSHIP ORGANIZATIONS.

(a) IN GENERAL.—Subpart B of part II of subchapter E of chapter 1 is amended by striking section 456 (and by striking the item relating to such section in the table of sections for such subpart).

(b) CONFORMING AMENDMENT.—Section 277(b)(2) is amended by inserting ''(as in effect before its repeal)'' after ''section 456(c)''.

(ii) for purposes of applying the regulations and other guidance issued under such section (including any provisions which require accelerated inclusion), the period beginning with the taxpayer's first taxable year beginning after December 31 2014, and ending with the taxable year before the first taxable year referred to in clause (i) shall not fail to be taken into account as part of the period of the adjustment merely because such amount is not otherwise taken into account under clause (i) during such period.

(2) ELECTED TAXABLE YEAR.—For purposes of this subsection, the term ''elected taxable year'' means such taxable year as the taxpayer may elect (at such time and in such form and manner as the Secretary may provide) which begins after December 31, 2014, and is before the taxpayer's second taxable year beginning after December 31, 2018.

SEC. 3312. MODIFICATION OF RULES FOR CAPITALIZATION AND INCLUSION IN INVENTORY COSTS OF CERTAIN EXPENSES.

(a) $10,000,000 GROSS RECEIPTS EXCEPTION TO APPLY TO PROPERTY PRODUCED BY THE TAXPAYER.—

Section 263A(b) is amended by striking all that follows paragraph (1) and inserting the following new paragraphs:

"(2) PROPERTY ACQUIRED FOR RESALE.—Real or personal property described in section 1221(a)(1) which is acquired by the taxpayer for resale.

"(3) EXCEPTION FOR TAXPAYER WITH GROSS RECEIPTS OF $10,000,000 OR LESS.—This section shall not apply to any property produced or acquired by the taxpayer during any taxable year if the average annual gross receipts of the taxpayer (or any predecessor) for the 3-taxable year period ending with the taxable year preceding such taxable year do not exceed $10,000,000. For purposes of this paragraph, rules similar to the rules of paragraphs (2) and (3) of section 448(b) shall apply.

"(4) FILMS, SOUND RECORDINGS, BOOKS, ETC.—For purposes of this subsection, the term 'tangible personal property' shall include a film, sound recording, video tape, book, or similar property.".

(b) REPEAL OF EXCEPTIONS FOR TIMBER AND CERTAIN ORNAMENTAL TREES.—Section 263A(c) is amended by striking paragraph (5).

(c) REPEAL OF EXCEPTION FOR QUALIFIED CREATIVE EXPENSES.—Section 263A is amended by striking subsection (h).

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning after December 31, 2014.

(2) CHANGE IN METHOD OF ACCOUNTING.—In the case of any taxpayer required by the amendments made by this section to change its method of accounting for its first taxable year beginning after December 31, 2014—

(A) such change shall be treated as initiated by the taxpayer, and

(B) such change shall be treated as made with the consent of the Secretary of the Treasury.

SEC. 3313. MODIFICATION OF INCOME FORECAST METHOD.

(a) EXTENSION OF FORECAST PERIOD.—

(1) IN GENERAL.—Paragraph (1) of section 167(g) is amended by striking ''10th'' each place it appears and inserting ''20th''.

(2) MODIFICATION OF RECOMPUTATION YEARS.—Paragraph (4) of section 167(g) is amend-

SEC. 3633. CERTAIN SHORT-LIFE PROPERTY NOT TREATED AS REAL PROPERTY FOR PURPOSES OF REIT PROVISIONS.

(a) IN GENERAL.—Section 856(c)(5) is amended by adding at the end the following new subparagraph:

"(L) REAL PROPERTY.—The term 'real property' shall not include any tangible property with a class life of less than 27.5 years. For purposes of the preceding sentence, class life of tangible property for any taxable year shall be the greater of—

"(i) the class life of such property in the hands of the real estate investment trust, or

"(ii) the class life which would be applicable to such property if such property was placed in service in the taxable year.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2016.

SEC. 3634. REPEAL OF SPECIAL RULES FOR TIMBER HELD BY REITS.

(a) IN GENERAL.—Section 856(c)(5)(L), as added by this Act, is amended by inserting "timber or" after "shall not include".

(b) CONFORMING AMENDMENTS.—

(1) Section 856(c)(2) is amended by inserting ‘‘and’’ at the end of subparagraph (G), by striking ‘‘and’’ at the end of subparagraph (H), and by striking subparagraph (I).

(2) Section 856(c)(5), as amended by the preceding provisions of this Act, is amended by striking subparagraphs (H) and (I) and by redesignating subparagraphs (J), (K), and (L) as subparagraphs (H), (I) and (J), respectively.

(3) Section 856(c), as amended by the preceding provisions of this Act, is amended by striking paragraph (9).

(4) Section 857(b)(6) is amended by striking subparagraphs (D), (G), and (H), and by redesignating subparagraphs (E) and (F) as subparagraphs (D) and (E), respectively.

(5) Section 857(b)(6)(D), as redesignated by paragraph (4), is amended by striking ‘‘subparagraphs (C) and (D)’’ and inserting ‘‘subparagraph (C)’’.

(6) Section 857(b)(6)(E), as redesignated by paragraph (4), is amended—

(A) by striking ‘‘subparagraph (C) or (D)’’ and inserting ‘‘subparagraph (C)’’, and

(B) by striking "subparagraphs (C), (D), and (E)" and inserting "subparagraphs (C) and (D)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2016.

SEC. 3635. LIMITATION ON FIXED PERCENTAGE RENT AND INTEREST EXCEPTIONS FOR REIT INCOME TESTS.

(a) IN GENERAL.—Section 856 is amended by adding at the end the following new subsection:

"(o) LIMITATION ON FIXED PERCENTAGE RENT AND INTEREST EXCEPTIONS.—

"(1) IN GENERAL.—If the fixed percentage rent and interest income received or accrued by a real estate investment trust from a single C corporation (other than a taxable REIT subsidiary of such real estate investment trust) for any taxable year exceeds either—

"(A) 25 percent of the fixed percentage rent income received or accrued by such real estate investment trust for such taxable year, or

"(B) 25 percent of the fixed percentage interest income received or accrued by such real estate investment trust for such taxable year,

(1) conduct a study to determine—

(A) how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries, and

(B) the amount by which transactions between a REIT and a taxable REIT subsidiary reduce taxable income of the taxable REIT subsidiary (whether or not such transactions are conducted at arms length), and

(2) submit a report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate describing the results of such study.

SEC. 3647. C CORPORATION ELECTION TO BECOME, OR TRANSFER ASSETS TO, A RIC OR REIT.

(a) IN GENERAL.—Part IV of subchapter O of chapter 1, as amended by the preceding provisions of this Act, is amended by redesignating section 1062 as section 1063 and by inserting after section 1061 the following new section:

The Timberland REIT Coalition Seeks Your Support in Preserving:

Timberland investment opportunities that bolster personal savings.
Recreational opportunities on millions of acres of scenic land.
Employment for millions of workers here — not overseas.
Environmentally sound forest management practices.
Steady, sustainable supplies of domestic timber.

[STATE] FORESTS FACTS

- The forest products industry supports **more than [number] jobs** and contributes **$[ ] each year** to the state's economy, according to the [insert cite].
- [Insert additional state-specific economic/jobs data – e.g. More than **800 logging and trucking firms** and **1,300 manufacturers** in Michigan rely on the state's commercial timberlands.]

Along with an overwhelming number of policymakers, we agree it is time to thin out our overgrown tax code and restore robust growth to the U.S. economy. However, much like prudent forest management, thinning of the tax code should be achieved strategically—preserving provisions that spur healthy growth, while eliminating or modifying provisions that no longer make sense or inhibit progress.

The timber tax provisions—including the recognition of timberland as qualifying property for real estate investment trust (REIT) status—are essential to keep private and public capital investing in timber for the long-term benefit of our society. These provisions recognize the unique nature of timber investment and stewardship—a capital intensive, long-term undertaking that sustains a critical building block of our national economy, hundreds of local economies, our environment and countless recreational opportunities.

Without the timberland REIT structure and related timber tax provisions, timberland would likely be converted to other land uses or migrate to other single-tax forms of ownership, but will not revert to C corporation ownership. The significant capital expenses required for forest management and the 20-to-80 year growth cycle for marketable timber do not comport with a double-taxed C corporation structure. This is why virtually all integrated forest product companies have shed most, if not all, of their timberland holdings over the past 30 years.

Repealing the timber tax provisions and terminating the timberland REIT structure will not raise corporate tax revenue, but will instead damage our vital timber industry and the many benefits it provides.

Your Support for Timberland REITs Means Support For:

- **Timberland investment opportunities that bolster personal savings and give ordinary investors their only chance to realize the benefits of forest ownership.**

Timberland Real Estate Investment Trusts (REITs) provide the only investment vehicle for ordinary investors to invest in commercial, diversified and professionally managed timberlands. Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. The evolution of timberland REITs, which first formed 15 years ago, is one of the ways the market is working to achieve Congress's original vision.

In 1988, the Internal Revenue Service formally recognized timberlands and income from the sale of standing timber as qualifying real property eligible for REIT status.[1] Prior to the creation of the first publicly traded timberland REITs, access to the equity investment returns of income-producing timberlands as a core portfolio asset was available only to institutions and wealthy individuals having the financial capacity to directly invest in commercial timberland.

Not only do timberland REITs allow ordinary investors to diversify their portfolio, they also provide access to a significant long-term dividend yield. This access to strong income growth is partly due to the fact that the underlying asset, timber, is a renewable resource that when held for the long term historically has appreciated faster than inflation. During the recent Great Recession, timber investments, including timberland REITs, continued to perform well and pay taxable cash dividends.

Middle-class Americans make up the vast majority of timberland REIT investors through mutual funds and other easily accessible savings and investment vehicles. Institutional investors, who invest on behalf of the majority of U.S. employer-sponsored retirement plans, own an average of 82 percent of the four largest timberland REITs' holdings. The five largest institutional investors for each of these four companies are well-known for offering investment management services to ERISA plan sponsors, including the Vanguard Group, State Street Corp., BlackRock and T. Rowe Price. These are funds invested on behalf of American workers saving for retirement.

In addition, approximately 90 public pension funds hold investments in the four largest timber REITs, including the California Public Employees Retirement System (CalPERS), the New York State Common Retirement Fund and the New York State Teachers Retirement System.

- **Recreational opportunities on millions of acres of scenic land across the United States.**

The American public can—and does—access millions of acres of timberland REIT property and other private commercial timberland for recreational uses, either by permit or lease, and, in many cases, at no cost. Millions of acres of privately owned timberlands are prized grounds for hunting, fishing, camping, bird watching, horseback riding, hiking, photography, and many other cherished American pastimes in the Great Outdoors. These lands significantly supplement state and federal recreational lands and open spaces, providing outdoor enthusiasts with diverse options that are sometimes closer to home and always full of adventure.

There are [insert number] **timberland REIT acres** providing recreational opportunities for [state's residents].

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[1] See PLR 8838016.

- **Employment for millions of workers here — not overseas.**

Timberlands provide a critical, renewable resource — and millions of jobs — here in the U.S. Privately owned timberlands directly support one million U.S. jobs and indirectly support two million more in the wood products and related domestic industries. This translates to $223 billion in total timber sales and manufacturing shipments, according to a 2013 study analyzing 2010 economic activity.[2]

Because prices drive the sale of timber in the U.S., eliminating the timber tax provisions and ending the existence of timberland REITs would result in lower productivity and higher prices for U.S. timber, impairing the ability of American wood products and paper manufacturing companies to compete against foreign producers.

Commercial timberlands in [insert state] and the industries they directly support—forestry, logging, wood products, and pulp and paper—accounted for [insert jobs and payroll data if applicable, and any other state-specific economic data.]

- **Environmentally sound and sustainable forestry practices.**

Timberland REITs are good corporate citizens of the communities in which they invest and they are good stewards of the land and the environment. Members of the Timberland REIT Coalition manage their lands in accordance with formally written management plans certified under either the Sustainable Forestry Initiative® or the Forest Stewardship Council®. These timberland owners also engage with conservation groups and others to address long-term conservation goals on a significant scale. Timberland REITs have earned state and global environmental stewardship awards, and a number of timberland REITs are included in the Dow Jones Sustainability Index®, which tracks the financial performance of the leading sustainability-driven companies worldwide.

Publicly traded timberland REITs are accountable to their shareholders and are therefore incentivized to sustainably manage the forests that investors rely on for both short and long-term returns. Sustainable management is good for investors, for clean water, for carbon sequestration, and for future generations.

- **Steady, sustainable supplies of domestic timber.**

The domestic timber supply currently satisfies only 76 percent of today's demand for wood and paper products in the U.S.[3] Any changes to the tax code that would discourage investments in U.S. timberlands threaten to significantly reduce productivity. A reduction of timberland productivity here at home paired with growing domestic and global demand for wood and paper products will mean more foreign imports, higher prices, and, ultimately, what would effectively amount to offshoring of U.S. timber and manufacturing jobs.

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[2] Wan, Yang. *The Economic Impact of Privately-Owned Forests in the United States*. Forest2Market, June 27, 2013.

[3] U.S. Forest Service. *U.S. Forest Resource Facts and Historical Trends.*

Treasurers Circle Roundtable Meeting

Wednesday, April 1st
11:15am – 12:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Discussion Leads:
Leah Stearns, VP-Investor Relations & Treasurer, American Tower Corporation
Michael Smith, VP-Treasury, Ventas, Inc.
Susan Eberly, Assistant Treasurer, Inland Real Estate Corporation

Deloitte.

2015 Global Corporate Treasury Survey

January 2015

Contents

Executive summary

Deloitte is pleased to release its biennial Global Corporate Treasury Survey.

In preparing for the survey this year, our colleagues contemplated the following:

- Is treasury truly a strategic function?
- What mandates are provided by the chief financial officer (CFO) and board to treasury?
- What are the key challenges facing treasury?
- Has automation addressed the needs of treasurers, or is it still a pipe-dream?
- How are operating models evolving?
- What are the emerging trends, and how will these affect the treasurer of the future?

Strategic or tactical

Much has been written over the years about the role of treasury. The modern treasury group is strategic, collaborates with the businesses it serves, and is using automation, offshoring and treasury centers of excellence to consolidate and standardize tactical areas.

CFO mandates

Treasurers clearly have strong mandates to be strategic. More than 70% of respondents noted the following mandates from their CFOs:

- Liquidity risk management
- Efficient capital markets access
- Steward for risk management company
- Strategic advisor to the business
- Value-add partner to the CFO in areas such as mergers and acquisitions (M&A)
- Leading, governing and driving working capital improvement initiatives
- Enhanced governance and control over domestic and overseas operations
- Creation of scalable treasury organization to support company growth

Key challenges persist

Fifty percent of treasurers noted their biggest challenges are the ability to repatriate cash and to manage foreign exchange (FX) volatility. These challenges continue, despite the ongoing trend toward leveraging technology solutions.

Technology has not cured all ills

Forty percent of companies remain challenged by visibility into global operations, including cash and financial exposures. Forty percent also cited insufficient technology infrastructure to support their department.

Key causes may include the following:

- Treasury management systems (TMS) may be implemented for the 73–76% of business covered by corporate treasury, preventing the ability to look at the residual business.
- Sufficiency of two-way integration with enterprise resource planning (ERP) systems. Sixty-four percent of respondents noted more than one ERP from which to source and send data.
- Reliable, complete and consistent data, available on a timely basis, as a tool for treasury.

Operating model evolution

Treasury departments are growing more comfortable with the use of centers of excellence to support global operations, including the use of in-house banks (IHB) and shared services centers.

Emerging trends

The sum of the parts may be more than the whole

Should corporate treasury play an integral role in the evolution of company structure? Should a company possess its own skills to value the whole and parts of the business, to support M&A and evolution of company structure and capital structure – including share buy-back strategies? We believe these are core internal skills that should reside in treasury or corporate development groups.

In the technology, life sciences and health care sectors, in particular, Deloitte sees companies taking a decision to split into parts. Suggested preparation for treasury may include the following:

- Learn divisional business models, including supply chain, sales cycles, liquidity flows and related asset concentrations rather than having an aggregated country view
- Map businesses and flows to legal entities
- Consider redundancy in bank account and pooling structures
- Build modularity and redundancy into technology architecture and divestment strategies

Navigating restricted economies

Many companies face the opportunity of emerging market growth with the constraints of repatriation. Treasurers need to be able to speak to their boards and executives about the inter-play (and sometimes divergent outcomes) of these growth opportunities on earnings-per-share vs. cash returns, as well as discuss the liquidity and balance sheet consequences.

Increasing need for substance in foreign jurisdictions

Tax authorities are looking closely at the substance of global financing and treasury activities. Treasury teams should expect to see greater substance (decision making, scope of activities, and scale in offshore teams) in foreign treasury centers. This creates a unique opportunity to gather up the activities of countries not previously supported by treasury centers or shared services organizations.

Cyber threats have made it to treasury

Treasury departments are now being targeted in elaborate phishing, social engineering and hacking attacks. With the growing complexity of the technology infrastructure, data storage surface, and multiple access points for cyber threat, an organization's internal monitoring and surveillance strategies by the organization as a whole may not be covering the assets treasury protects. Many treasury teams have focused on traditional process and financial controls, relying on team members to support systems administration and maintenance within its "four walls."

A big thank you

Thank you to the companies around the world that responded to our survey online or by interview. For those of you who did, please contact your Deloitte professional for a download about how your company responded or compares to your peer group.

We would also like to thank the following Deloitte professionals for their contribution to this publication: Niklas Bergentoft, Joan Cheney, Lisa Hallman, Myla Kozak, Prashant Patri, Carolyn Thompson, and Neha Verma.

Want to engage

Deloitte and DTTL have emerged as the largest global professional services treasury practices. We offer services across all areas of treasury M&A, strategy, operating model and process transformation, treasury technology strategy, selections and implementations. If this survey resonates with the issues that your company faces, please contact us. Our international contact points are provided on page 19.

Sincerely,

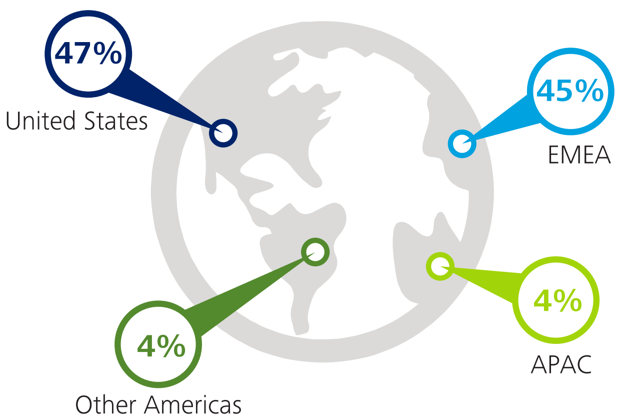
Melissa Cameron
Principal, Deloitte & Touche LLP
Global Treasury Leader

Carina Ruiz
Partner, Deloitte & Touche LLP
M&A and Treasury
Transformation Leader

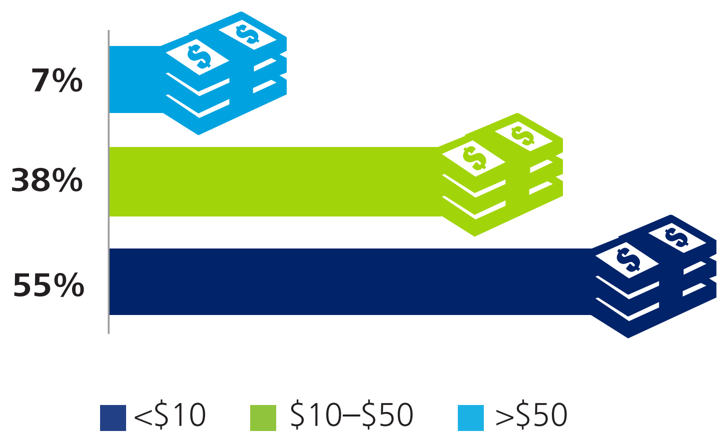
Survey demographics

Responses were received from the treasury groups of more than 100 top corporations from around the globe, representing a wide array of global scales, industrial footprints and geographic headquarters. Benchmarking comparisons are available for clients against peer industry and revenue counterparts.

Geographic location

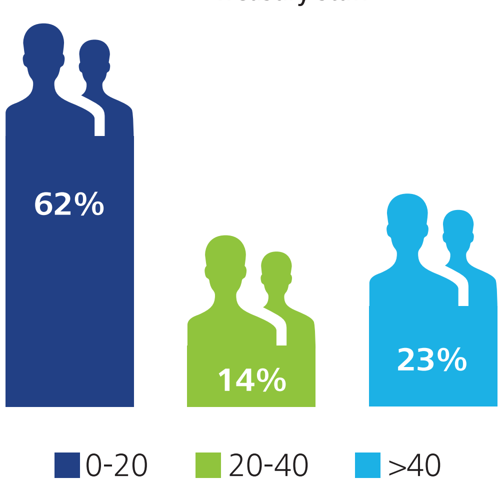


Annual revenue

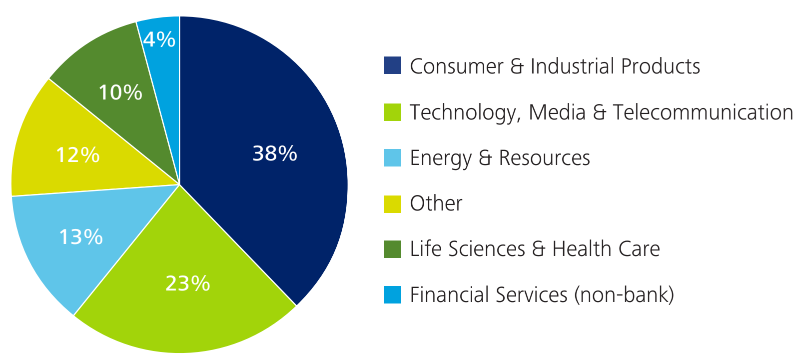


*All revenue amounts in this document are quoted in U.S. billion dollars

Treasury staff

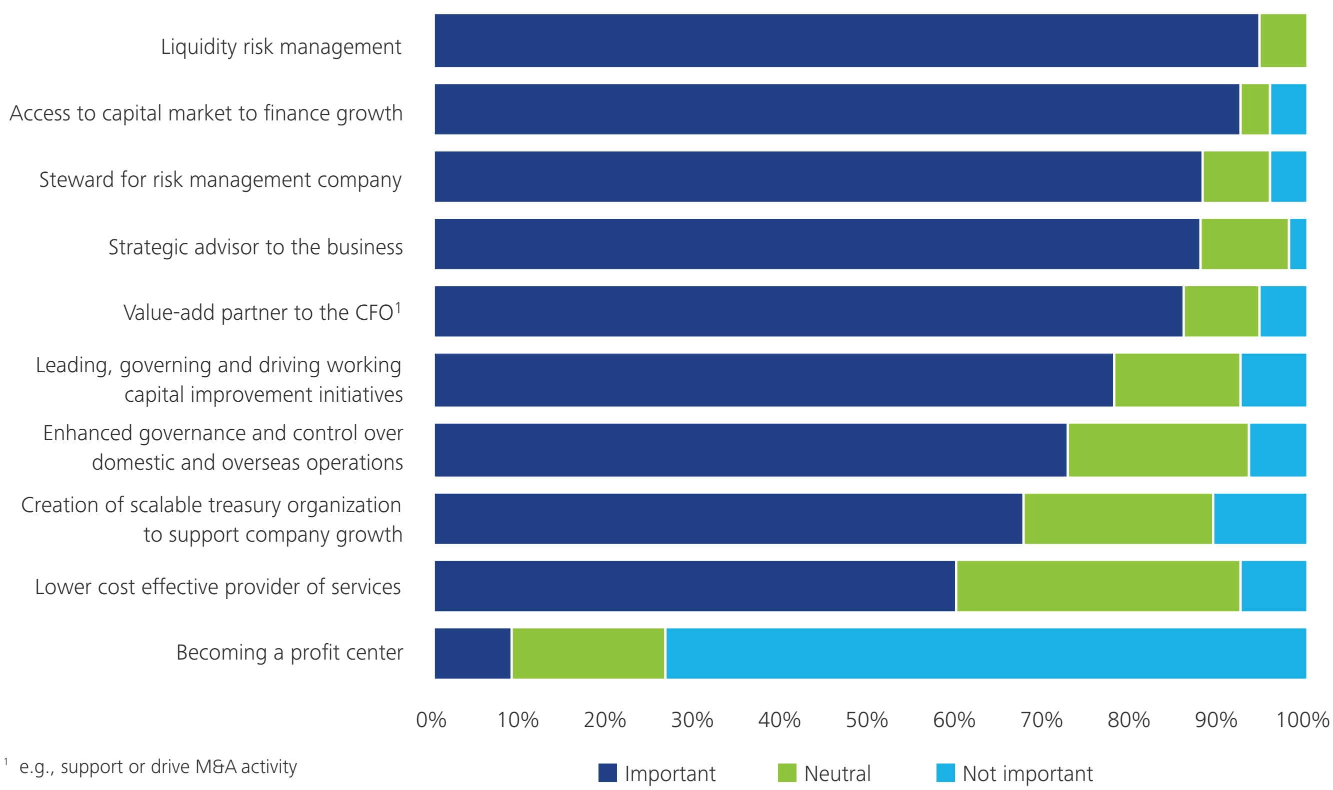


Industries



CFO mandates

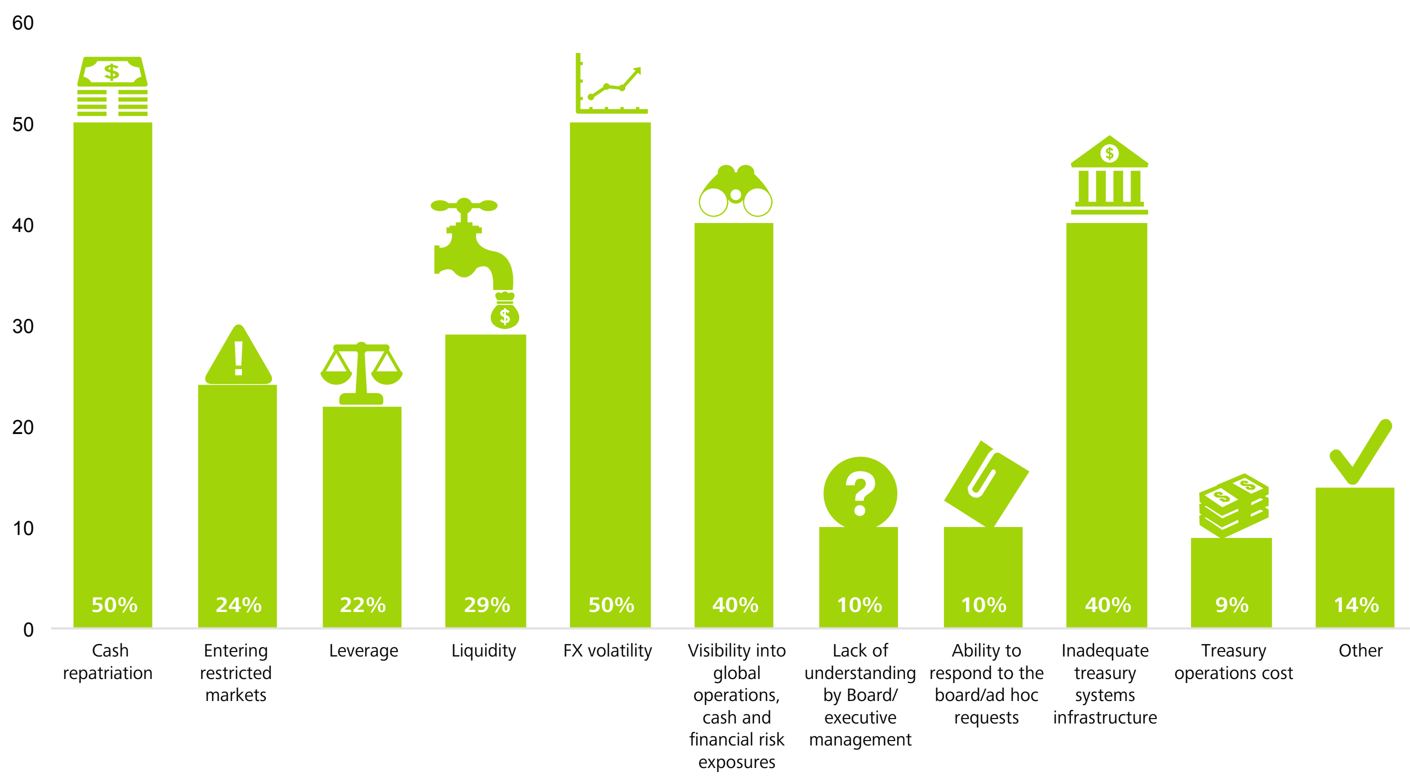
Treasury is increasingly taking on strategic roles with corporations and continues to be viewed as a risk management function. Despite the record amounts of cash that are managed by treasury groups, and the resulting focus on capital markets investments, there is little push from CFOs to transform treasury into a profit center.



[1] e.g., support or drive M&A activity

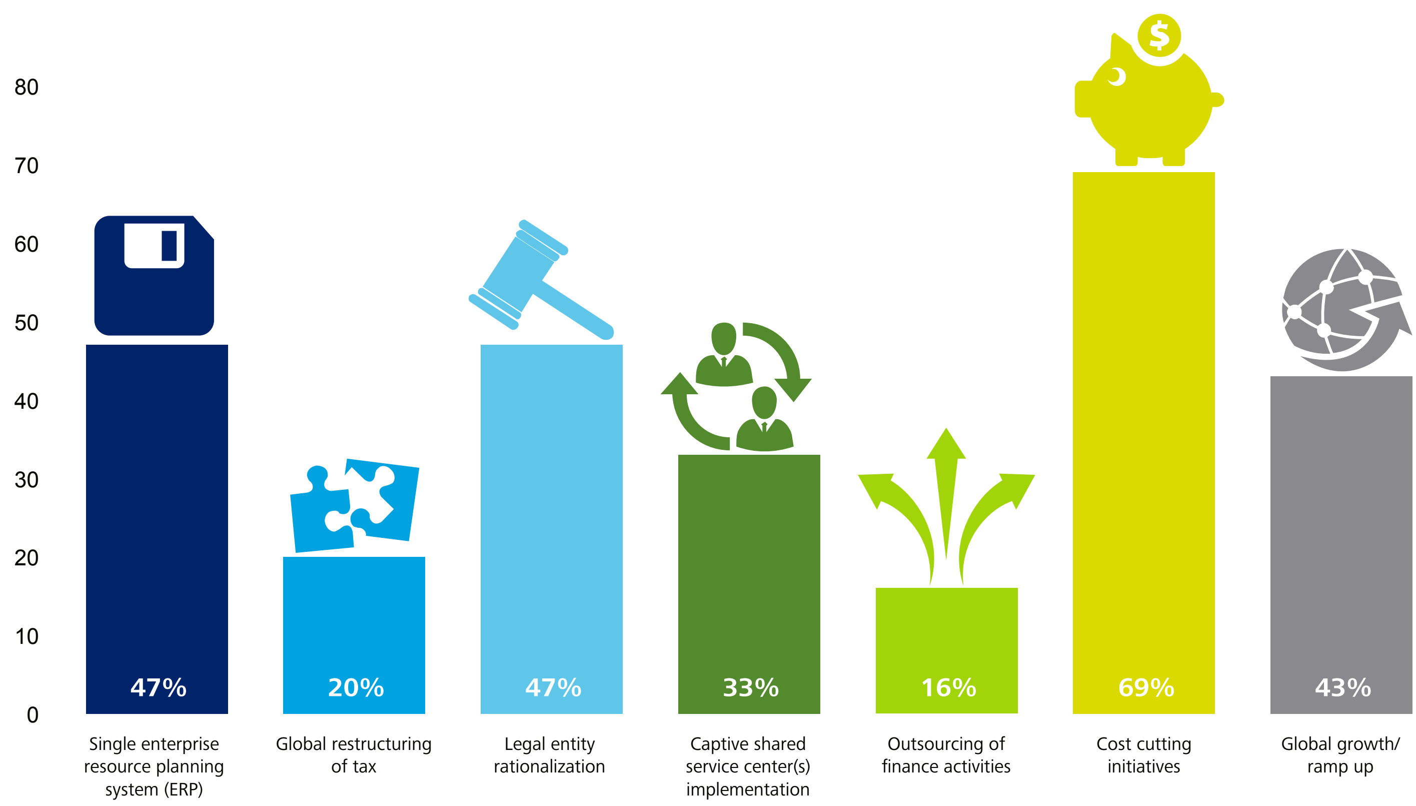
Strategic challenges for treasury organizations

The primary challenges facing treasury groups today have not yet been resolved with the increased investment in treasury technology, a trend over the past few years. Inadequate systems, FX management, and visibility to global operations continue to be difficult. As you will see on page 15, most corporate treasury groups rely on multiple ERPs for data sources and use multiple solutions (some manual) to address their company's needs. This may lead to increased operational difficulties and risk rather than providing sufficient solutions to address these challenges.



Current transformation initiatives

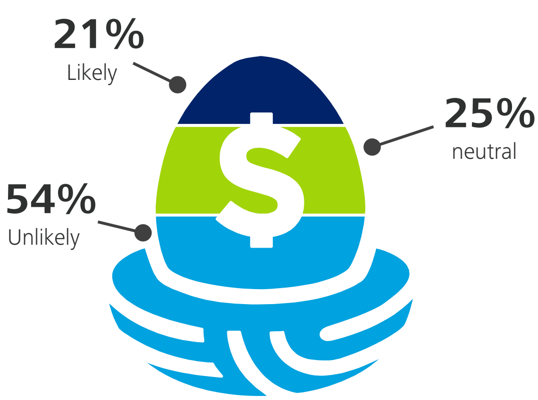
Respondents have the opportunity to leverage broader company-wide transformation initiatives. Transformation in key strategic areas can lead to more streamlined systems and processes and potentially reduce overall costs within treasury. Legal entity rationalization can provide an opportunity for improved liquidity and cash management structures. Migration onto a single ERP platform can allow for improved data sourcing and consolidation. And global restructuring of tax can provide the foundation for intercompany capital and liquidity considerations.



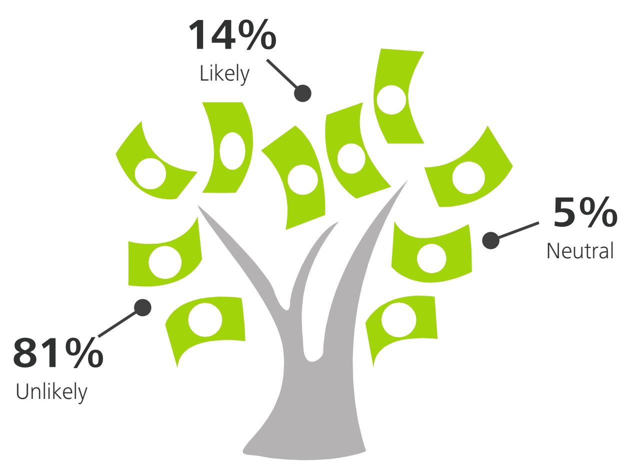
Treasury services likely to be outsourced

While sixteen percent of respondents were looking to outsource in finance over the next three to five years, and a slightly smaller percentage saw this applying to treasury. There is a stronger trend among respondents toward internal offshore methods, such as in-house banks and shared service centers. The three treasury functions that respondents indicated are most likely to be outsourced are retirement plans, international treasury support and long-term investments.

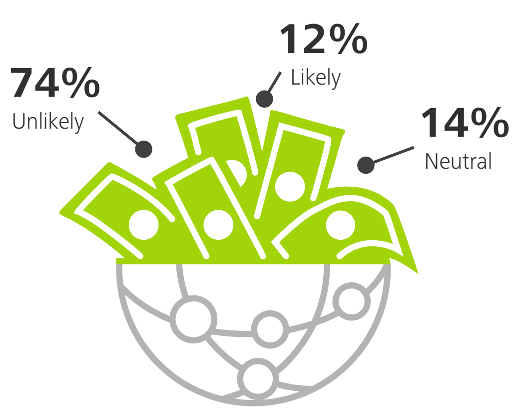
Retirement plans
(e.g., pension, 401k plans) management



Long-term investments

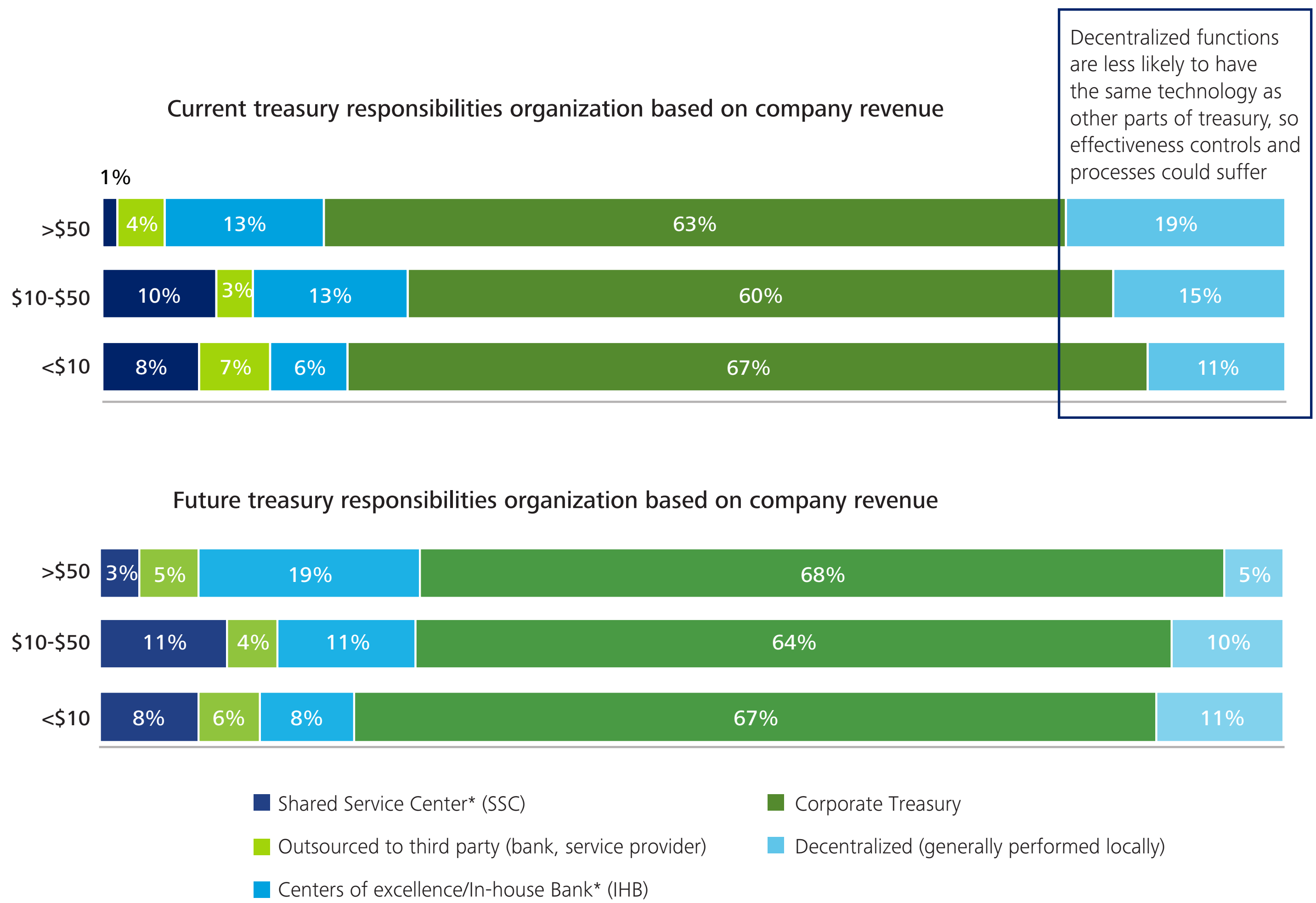


International treasury support
(e.g., treasury IT and treasury accounting)



Current and future state treasury operating models

Corporate treasury is still the most widely used operating model with between 73% and 76% of respondents mentioning that treasury activities are currently being handled there. This trend looks to continue for companies in the largest and smallest brackets. This significant decrease in decentralized operations across all company sizes is strongly indicative of greater interest on the part of the respondents to create more centralized models (e.g., corporate treasury and the use of centers of excellence or in-house banks).

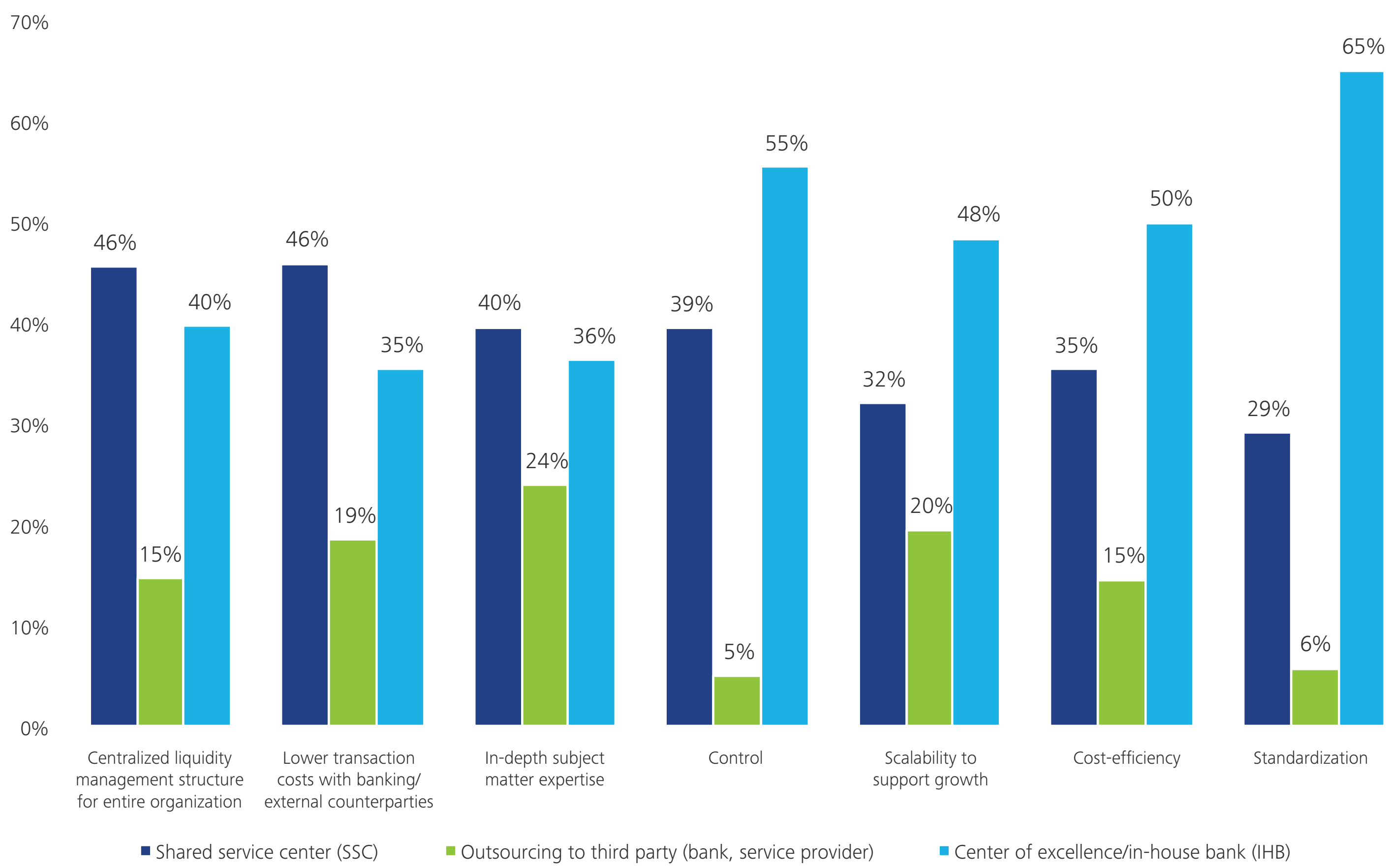


* SSC provides services to the rest of the organization through the execution of specific operational activities, which include primarily accounts payable (A/P), accounts receivable (A/R), accounting, treasury, IT, etc., on behalf of other legal entities.

** IHB is an internal funding vehicle which can be used both for concentrating global liquidity and meeting short- and longer-term capitalization strategies. At its most evolved form, IHB capability can be used to collect and pay on behalf of group subsidiaries and also be the conduit for centralized foreign exchange risk management and improved hedging.

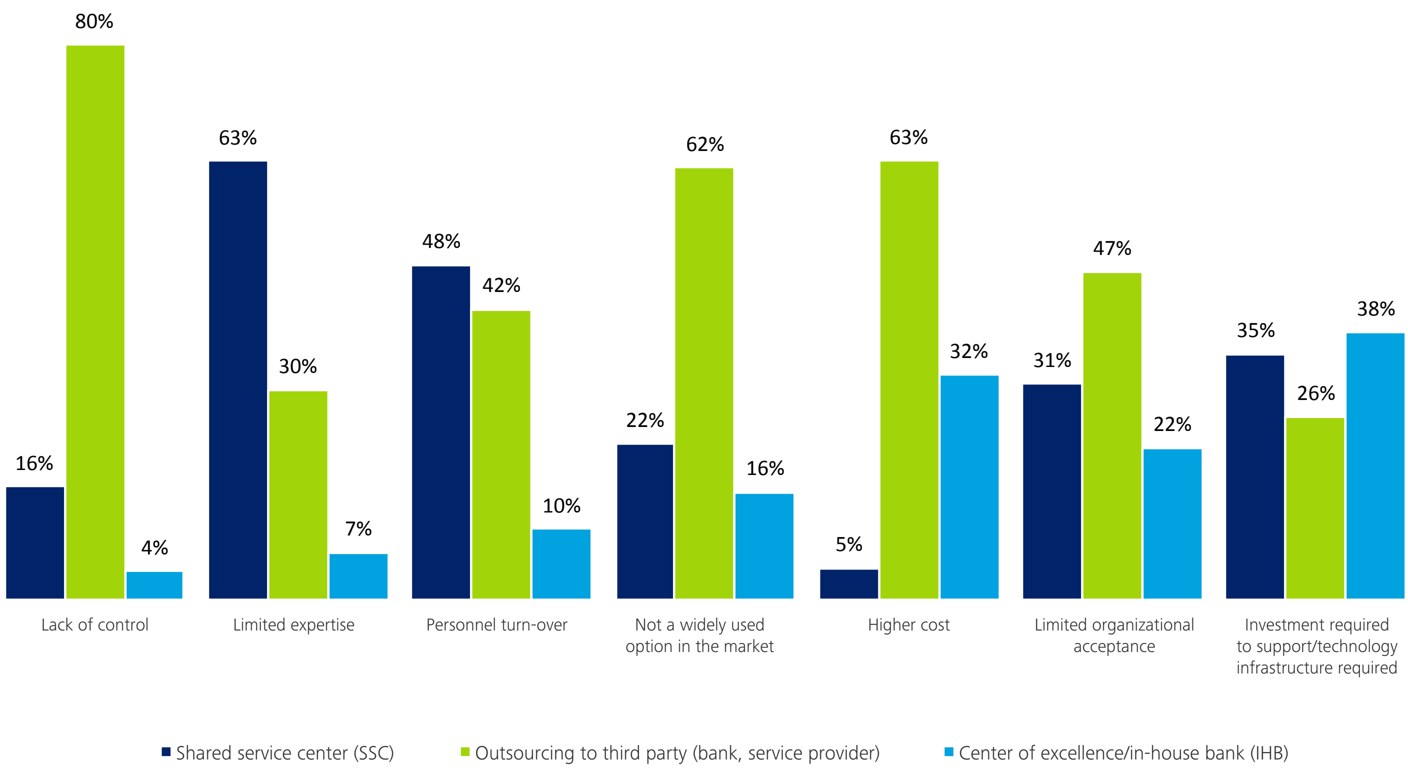
Benefits of centralized treasury organizations

Organizations are acknowledging the benefits to the centralization of treasury, particularly standardization of strategic and tactical activities, controls and liquidity management.



Perceived disadvantages of centralized operating models

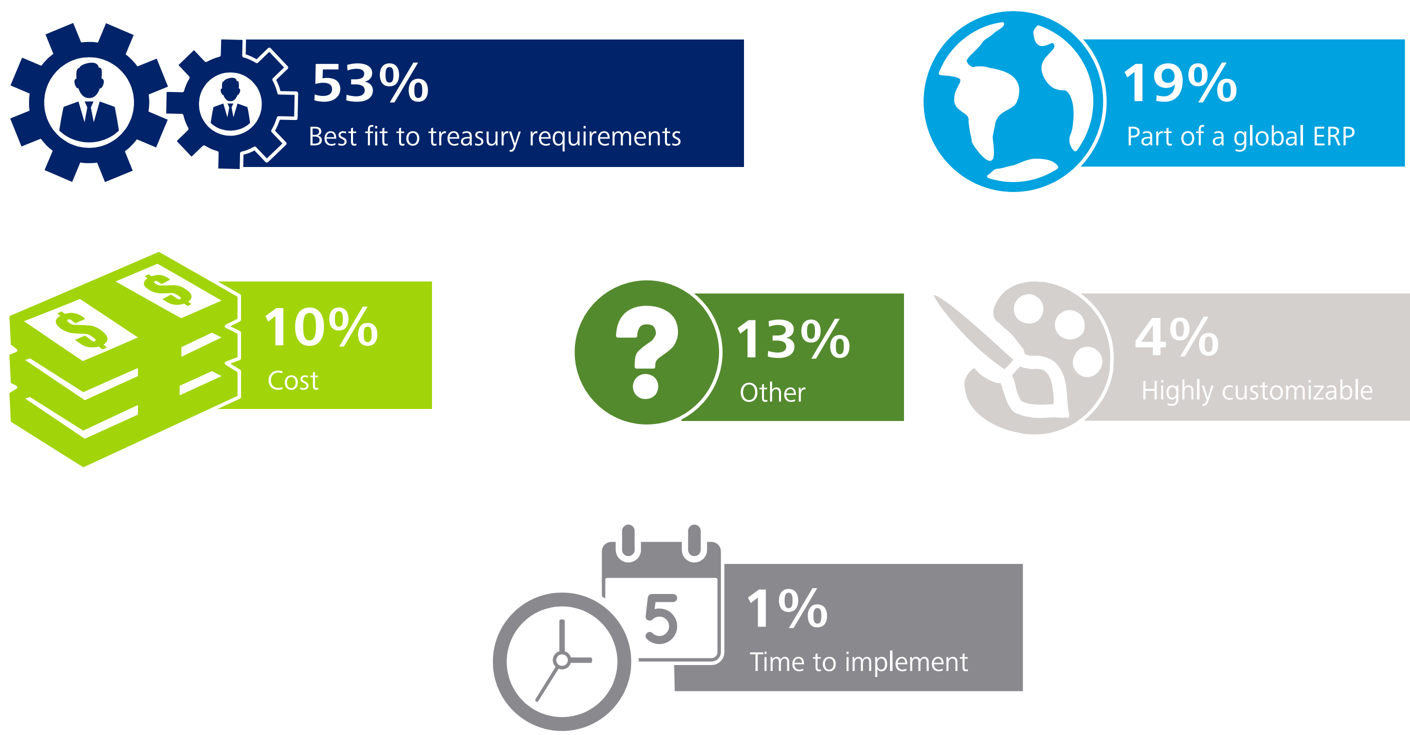
Change management is an important factor in ensuring that a transformation initiative, such as centralization, is embraced throughout the organization. Treasury teams can predict apprehensions from offshore businesses and incorporate change management programs into centralization/regionalization initiatives.



Treasury technology: choosing a treasury management system

Respondents indicate that the primary driver when choosing a new system is the fit to identified treasury requirements. In addition to treasury requirements, the needs of all key system and business stakeholders sending and receiving information from treasury and third-parties (e.g., banks) should be understood and considered as part of the selection and implementation processes. Bank connectivity improvements available outside of treasury, but within the company, may add a compelling business justification to improved technology infrastructure and improve global cash visibility and control.

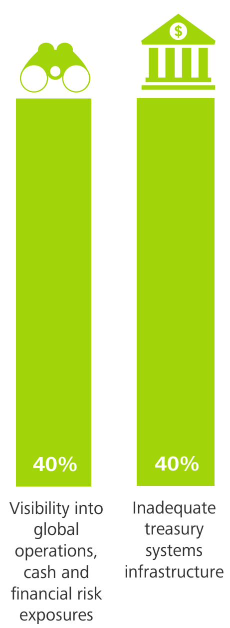
Reasons for choosing current treasury management system



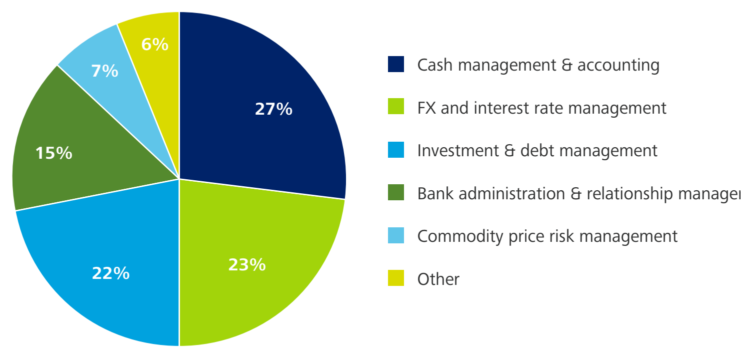
Treasury technology: vendor systems

Leading respondents avoided key challenges by addressing integration requirements with multiple ERPs and source data quality/consistency, to avoid the pitfalls of limited visibility to global operations cash and financial exposures.

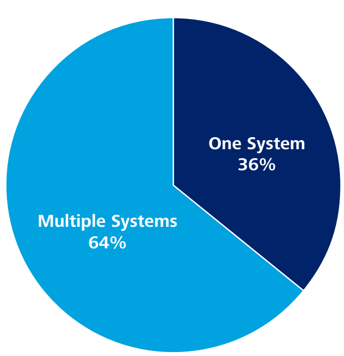
Key challenges



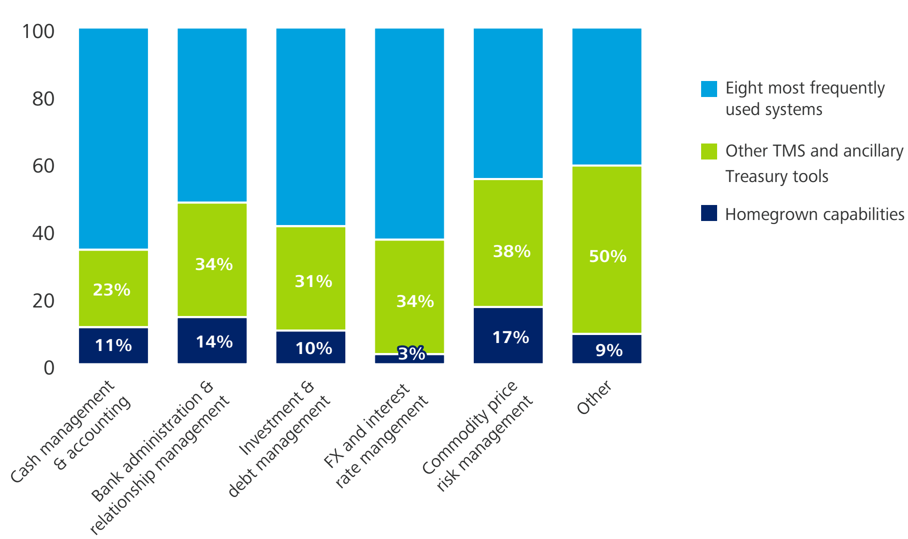
System functionality used by treasury



ERPs to connect to TMS



Use of proprietary and other solutions

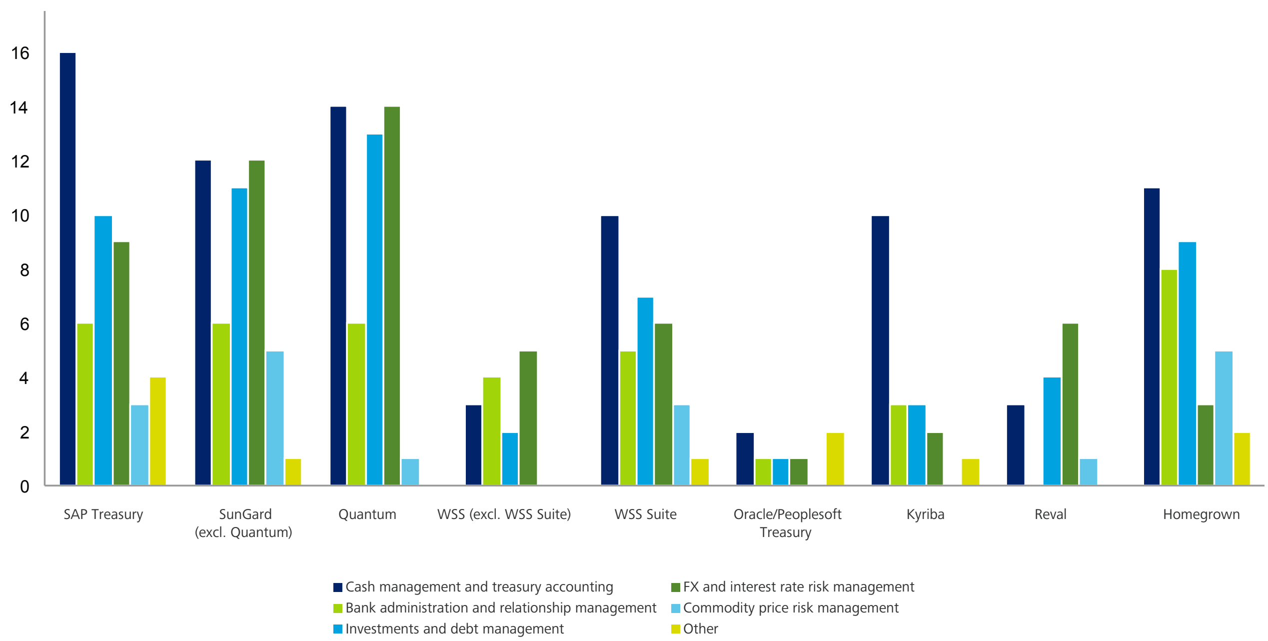


Treasury technology: use of systems by functionality

Respondents sought to leverage full functionality of treasury management systems (TMS), implementing cash management, investment and debt management, and FX capabilities where possible.

Notably, respondents' functional use varied with the primary TMS solutions used.

Systems used by functionality (ex. other systems)

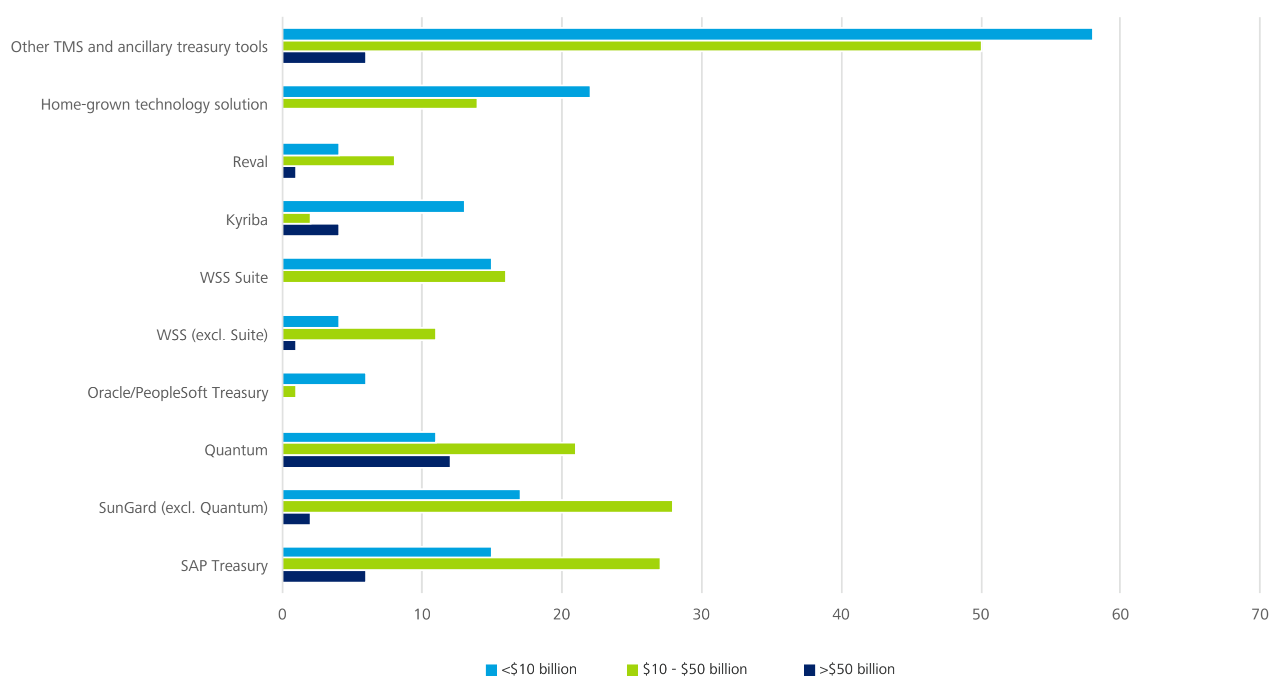


Despite the increasing trend of treasury transformations and deployment of TMS, many are still supported or augmented with the use of homegrown approaches. Homegrown solutions may pose greater cyber and operational risks.

Treasury technology used

Over 30 different vendor solutions were cited as being used by the respondents, often in conjunction with a primary treasury management system. These systems include FX trade execution and trade management platforms, smaller, niche treasury systems, Excel, Access, and banking portals.

Treasury technology solutions used based on revenue

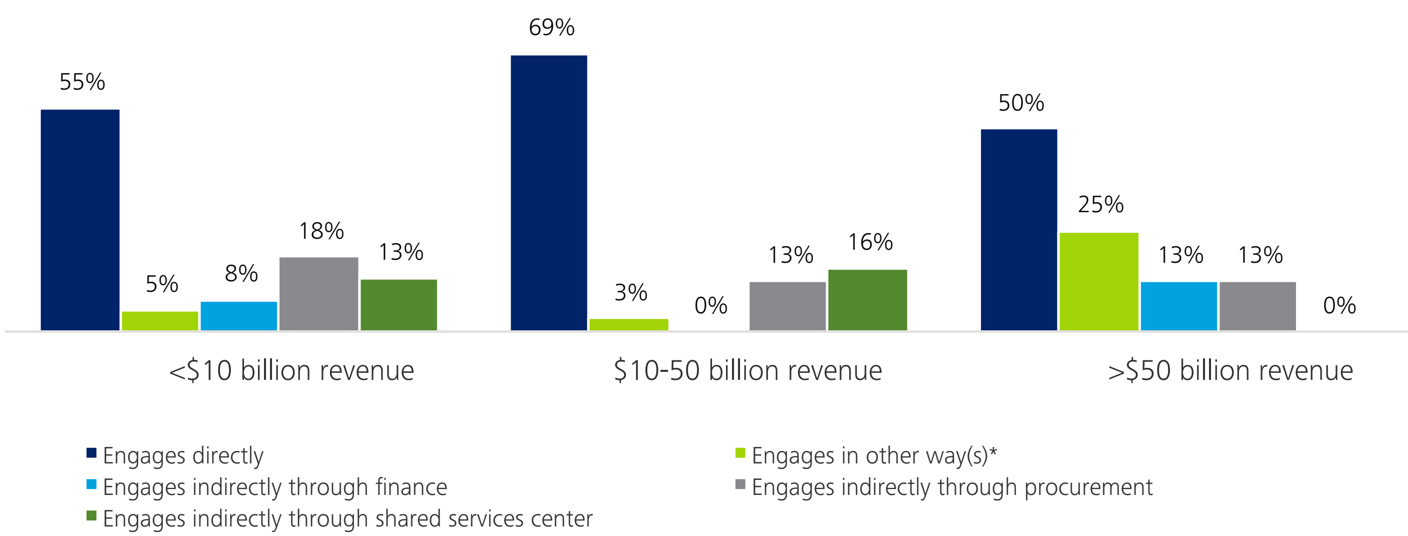


Treasury technology: engagement with third-party vendors

The majority of respondents indicated that the treasury group is engaged directly with its technology vendors.

A key success factor to maximizing the impact of a treasury technology implementation is including all primary stakeholders as part of the implementation and transformation process. These groups often include accounting, accounts payable, collections, finance, and IT internally, and vendors, counterparties, and banking partners externally.

Managing third-party treasury vendors



*Derivatives advisory, IFRS, EMIR, directly and through procurement, procurement & treasury jointly, Saas tool

Contacts

Global & United States
Melissa Cameron
mcameron@deloitte.com
+1 415 706 8227

United States
Scott Gauch
sgauch@deloitte.com
+1 213 996 5792

United States
Carina Ruiz
caruiz@deloitte.com
+1 408 704 2158

Australia
Steven Cunico
scunico@deloitte.com.au
+61 3 9671 7024

Australia
Hussein Hussein
huhussein@deloitte.com.au
+61 2 9322 7485

Belgium
Philippe Delcourt
pdelcourt@deloitte.com
+32 2 800 22 45

Canada
Paul Lech
plech@deloitte.ca
+1 416 643 8037

China
Kang Keng Wee
kkwee@deloitte.com.hk
+852 28526778

Denmark
Michael Vestergaard
mvestergaard@deloitte.dk
+45 20304990

France
Brice Roche
brroche@deloitte.fr
+33 1 58 37 96 05

France
Corrine Sanchez
cosanchez@deloitte.fr
+33 1 40 88 84 37

Germany
Volker Linde
vlinde@deloitte.de
+49 21187722399

Japan
Kaoru Ito
kaito@tohmatsu.co.jp
+81 8045974232

Singapore
Benny Koh
bekoh@deloitte.com
+65 6800 2266

South Africa
Michael Ketz
mketz@deloitte.co.za
+27 112098038

Spain
Alejandro Gonzalez de Aguilar
agonzalezdeaguilar@deloitte.es
+34 914432552

United Kingdom
Dino Nicolaides
dinicolaides@deloitte.co.uk
+44 20 7007 8545

United Kingdom
Karlien Porre
kporre@deloitte.co.uk
+44 20 7303 5153