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

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REITS:
BUILDING
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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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REIT Wise® March 31- April 2 2015

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Accounting Committee

March 31, 2015

Panelists

Keri Shea (Moderator) – AvalonBay Communities, Inc.

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

- 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

Lessors

- 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

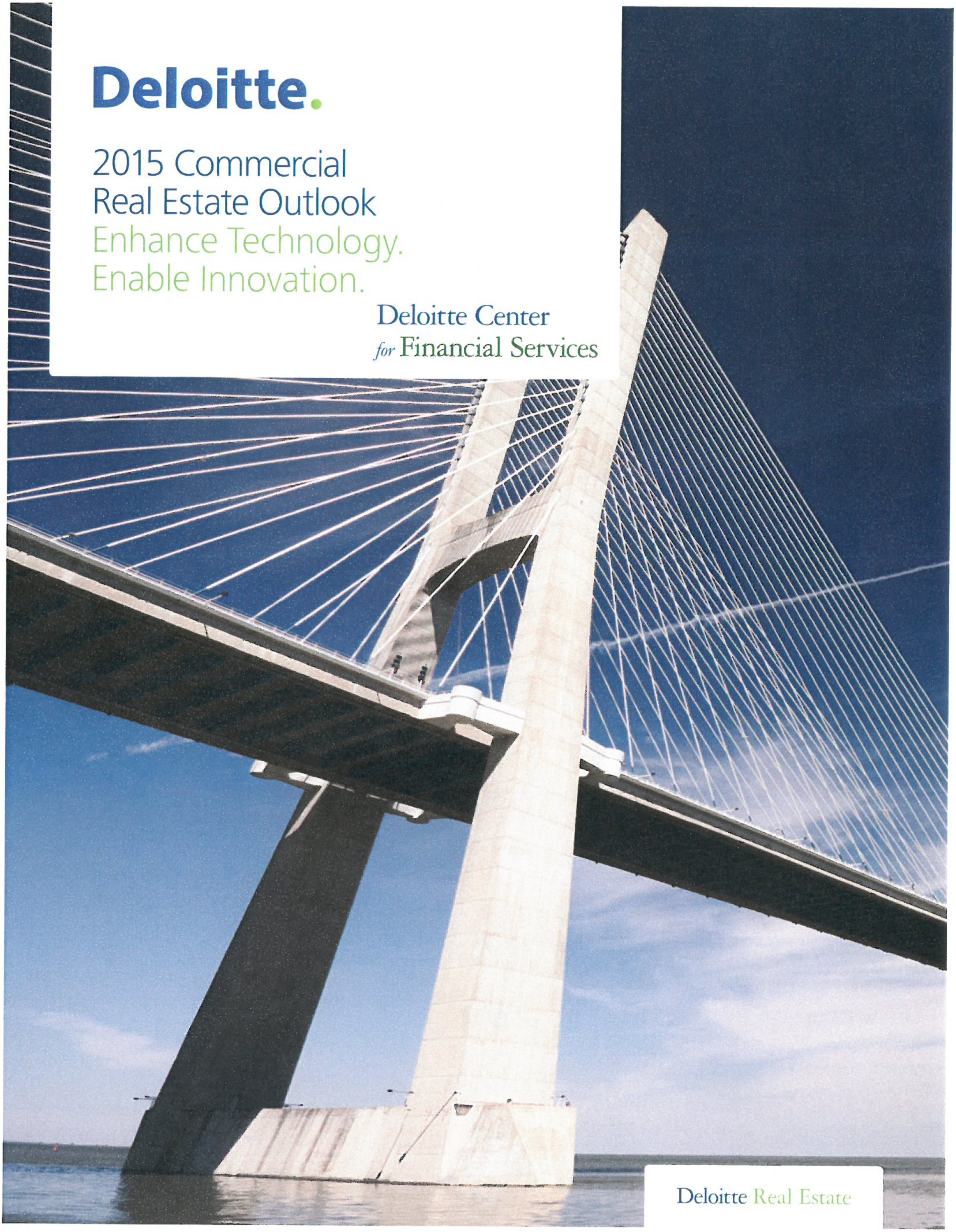
- NAREIT's request – analyst FFO estimates provided to First Call for the 100 largest equity REITs by market cap

- 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



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2015 Commercial Real Estate Outlook
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Deloitte Real Estate

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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.

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

Real Estate Industry Focus
- ● (blue) Issue turned out the way we thought
- ● (green) Issue still to be resolved
- ● (grey) 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.

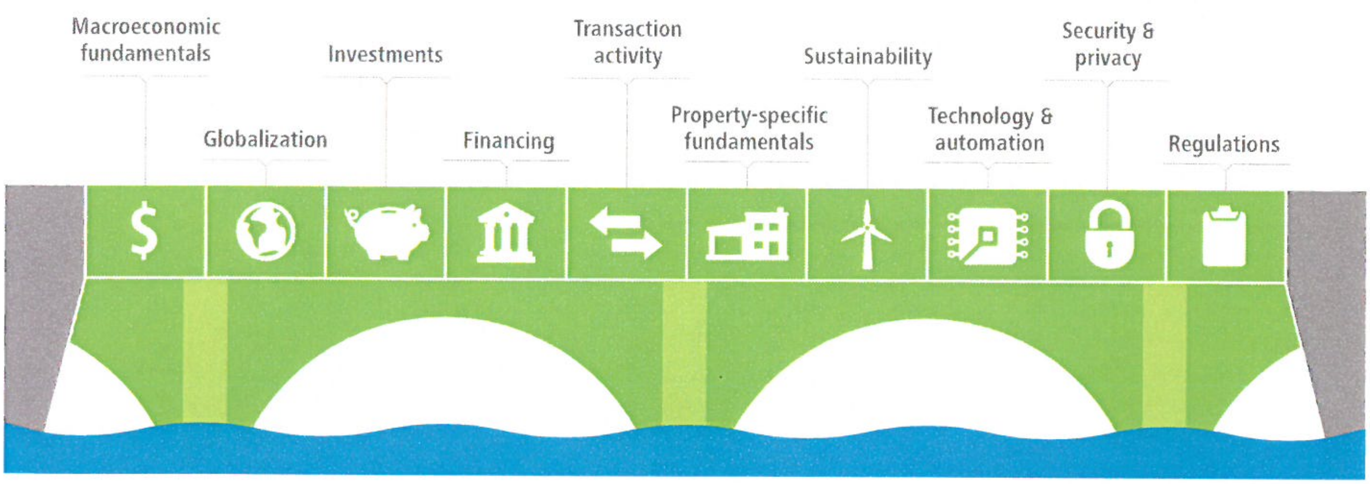
From a CRE fundamentals perspective, rents and vacancies will potentially continue to improve across property types, although development activity coming online may have a greater impact on this improvement in 2015, especially in the multifamily and office markets. We believe that tenants' sustainability 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

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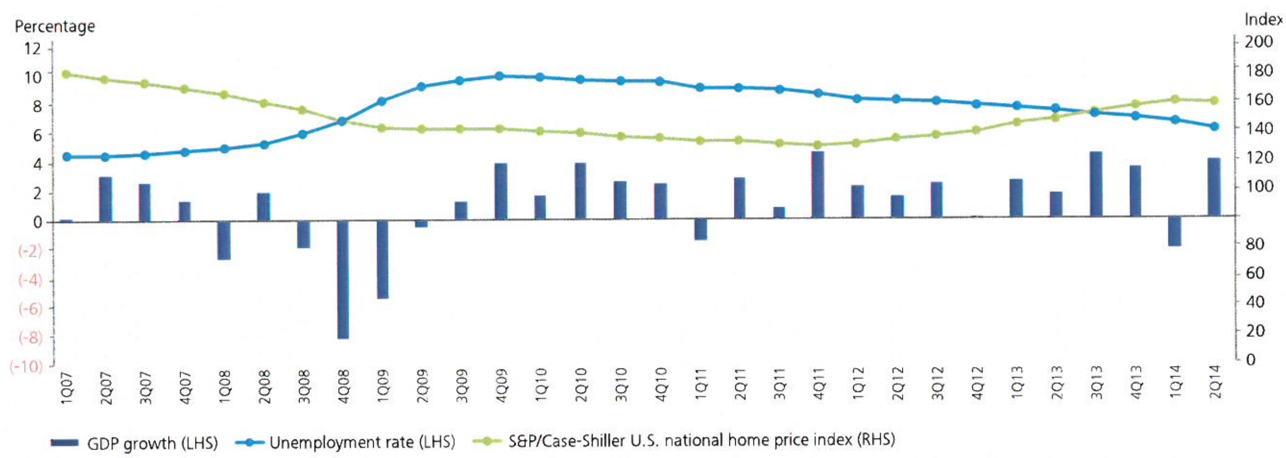
The global economy appears to be settling into a new normal of modest growth in developed economies, stabilization of growth in emerging economies, and a decline in systemic risks emanating from policy mistakes.[1] While geopolitical risks have emerged in 2014, financial market volatility has been low. 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.

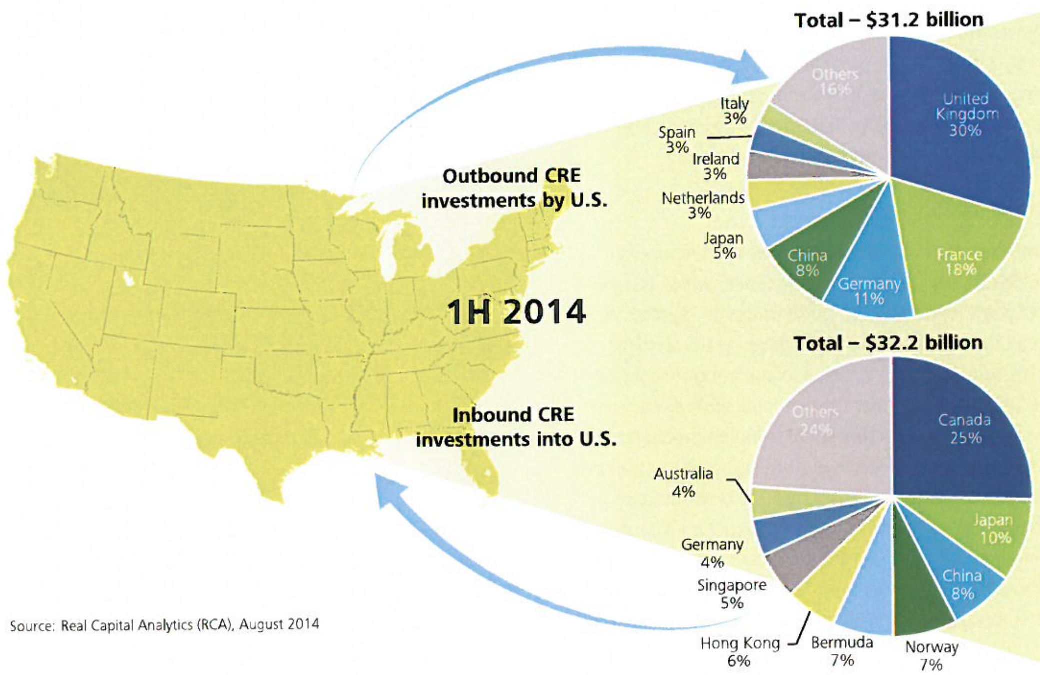
Globalization
U.S. gaining traction as the preferred investment destination

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

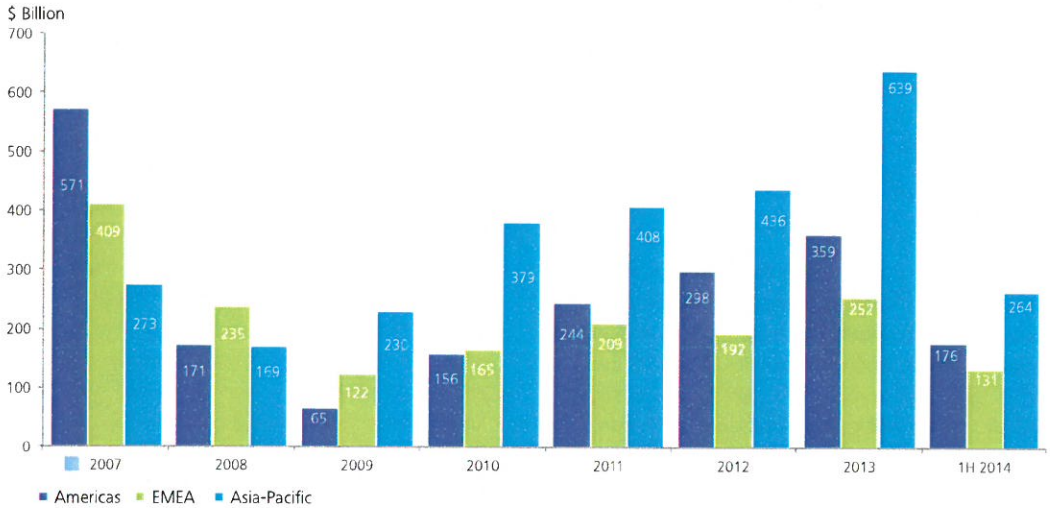
Global CRE transaction volume totaled $570.9 billion in 1H14 (Figure 5), an increase of 10.7 percent compared to 1H13. The 1H14 growth is slower compared to the 29.8 percent YOY volume growth in 1H13. This is primarily because of a relatively lower growth (+3.6 percent) in the Asia-Pacific (APAC) region, 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.

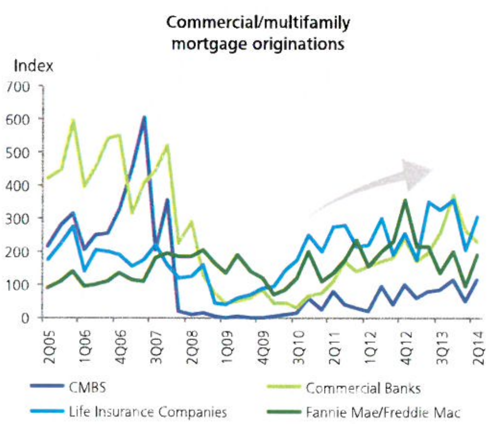
Lending scenario — Banks and CMBS

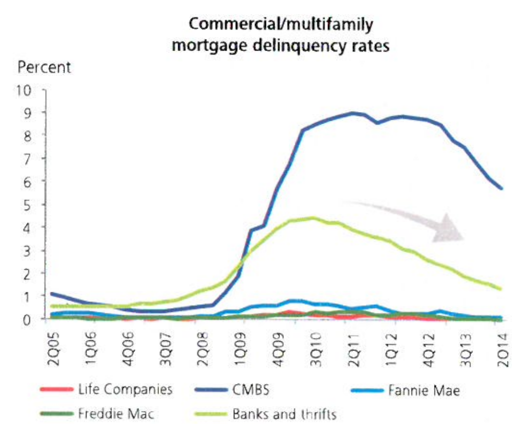
Compared to a year ago, banks continue to ease lending standards on CRE loans, including construction financing, although it varies by purpose and loan terms such as size and maturity.[28] As a result, commercial mortgage originations (CMOs) registered an 18.9 percent YOY growth in 2Q14.[29] Regional 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

Traditional sources





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

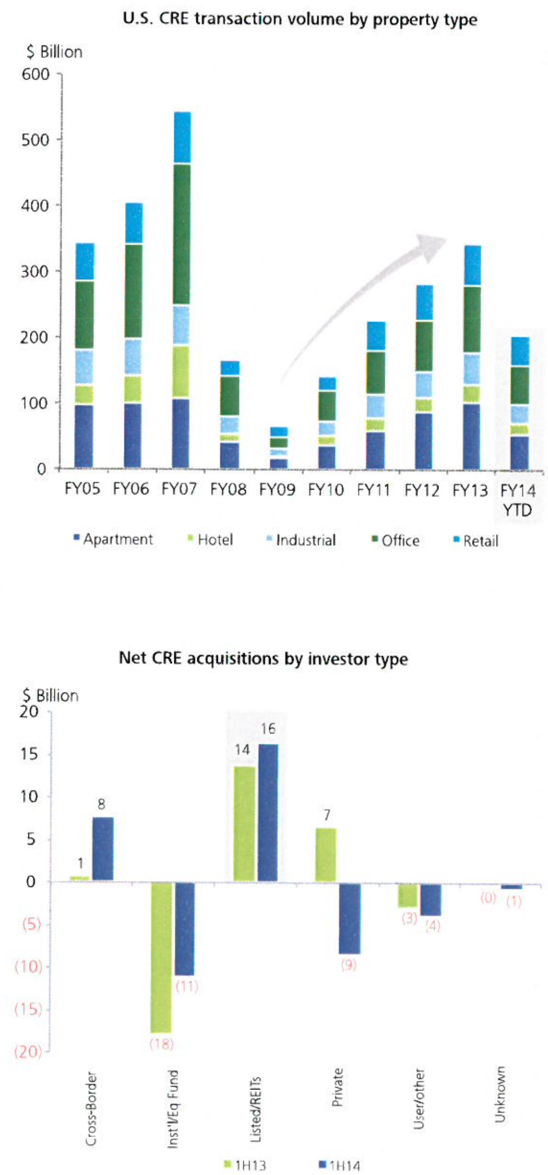
Transaction activity continues to be the highlight of this CRE recovery, with solid growth in both primary and secondary markets. In fact, capital availability is increasing competition as both domestic and international investors show significant interest in CRE as an asset class. Consequently, asset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

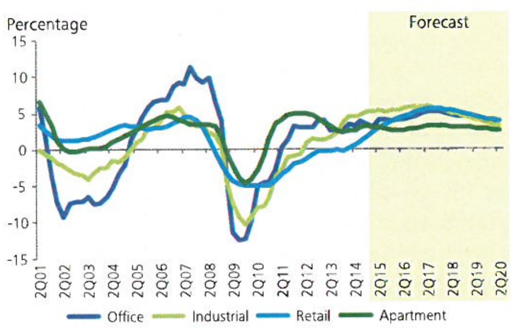
Increase in online shopping, international trade, and manufacturing activity continue to have a positive impact on industrial fundamentals — rent growth for industrial space inched up to a solid 4.5 percent in 2Q14 from 1.6 percent in 2Q13, and vacancy declined to 10.8 percent, compared to 11.9 percent 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

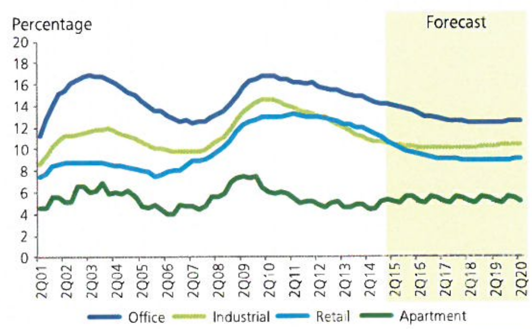
Retail vacancy and effective rents improved as higher consumer confidence led to an increase in spending. Vacancy was down 50 basis points YOY in 2Q14 to 11.7 percent[50] and effective rents increased 0.5 percent YOY, which is better than the 0.2 percent YOY decrease in 2Q13.[51] Further, retailers are 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

National rent growth by property type



National vacancy rate by property type



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

The increase use of technology and online sales in particular is redefining the supply chain

Industrial real estate owners need to be more flexible and responsive to the dynamic inventory levels and space requirements of their tenants

Office tenants continue to focus on flexible work spaces and rental expense reduction through efficient space utilization

Office CRE players will potentially benefit from including design features that meet their tenants' flexibility and sustainability requirements

Apartments demand-supply are comparatively less impacted by the onslaught of technology

Apartment owners need to continue to leverage technology to establish better rapport with existing and potential tenants

Retailers' are positioning physical stores as 'concept stores' for seamless customer engagement

Retail CRE owners/operators need to partner with tenants to understand their technology needs and incorporate them as an integral part of store redesign

Competition from non-traditional and new players will likely disrupt the lodging sector in the long term

Hotel owners should consider adopting technology to offer innovative designs in a cost-efficient manner

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

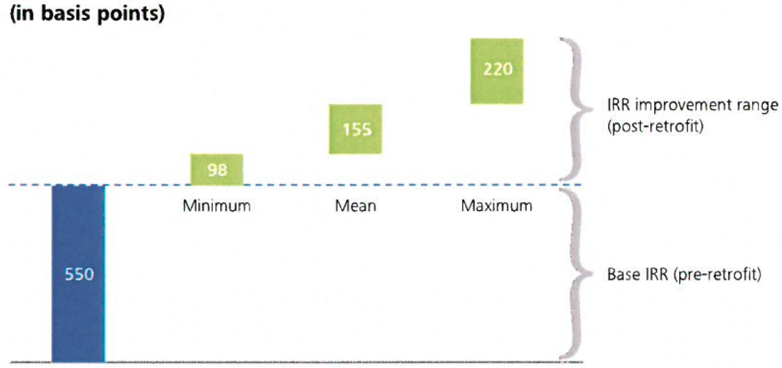
To maintain a positive momentum of rental growth and occupancy in the medium to long term, CRE players should change their demand-supply assessment and factor in the influence of technology and competition from new and innovative players along with traditional macroeconomic factors. While development 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.

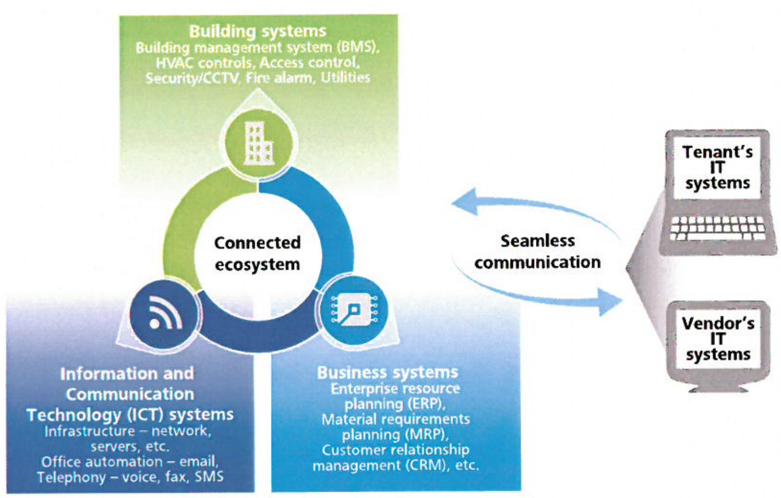
Technology and automation
Adoption integral to enhancing tenant engagement

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.

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Real Estate
Accounting and Financial Reporting Update

November 24, 2014

Financial Services Industry

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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.

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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.

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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.

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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.

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.

Property managers may allocate variable consideration to the period in which the related services were performed, if certain criteria are met.

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.

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 new standard amends the guidance for costs incurred to sell real estate projects.

The standard cites sales commissions as an example of an incremental cost that may require capitalization. For example, sales commissions that are directly related to sales achieved during a time period would likely represent incremental costs that would require capitalization. In contrast, some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not directly related to obtaining a contract. In addition, costs incurred for model units, advertising and sales overhead may not qualify to be capitalized under ASC 340-40 because they are not incremental costs of obtaining a contract.

ASC 340-40 also includes guidance for recognizing costs incurred in fulfilling a contract that are not in the scope of another topic. For most real estate entities, costs incurred in fulfilling a contract (e.g., the costs to construct a building such as materials and labor) are already within the scope of another topic (e.g., ASC 360, *Plant, Property, and Equipment*) and therefore are excluded from the scope of ASC 340-40. ASC 340-40 also provides guidance on amortization and impairment.

Next steps

Real estate entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.

Real estate entities also may want to monitor the discussions of the Boards, SEC staff, the TRG, and hospitality and time-shares industry working groups formed by the AICPA to discuss interpretations and application of the new standard to common transactions. These working groups may address issues that affect all real estate entities.

Public entities also should consider how they communicate the changes caused by the new standard with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

[1] The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following: (1) a public business entity (PBE), (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements with the SEC.

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

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

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

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

[6] Minutes of the 22 May 2014 FASB Board Meeting.

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

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

[9] Refer to Chapter 1 of our Financial reporting developments, *Real Estate Sales*.

[10] Minutes of the 29 May 2013 FASB Board Meeting.

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

[12] ASC 606-10-32-8

[13] ASU 2014-09, *Basis for Conclusions,* paragraph 217

[14] ASC 606-10-32-37

[15] ASU 2014-09, *Basis for Conclusions,* paragraph 285

[16] ASC 606-10-55-15

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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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No. 2014-18
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.

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.

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

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.

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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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June 2014, No. 14-29

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.

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- ***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.

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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.

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- 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

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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

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machine in place.

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

Results:

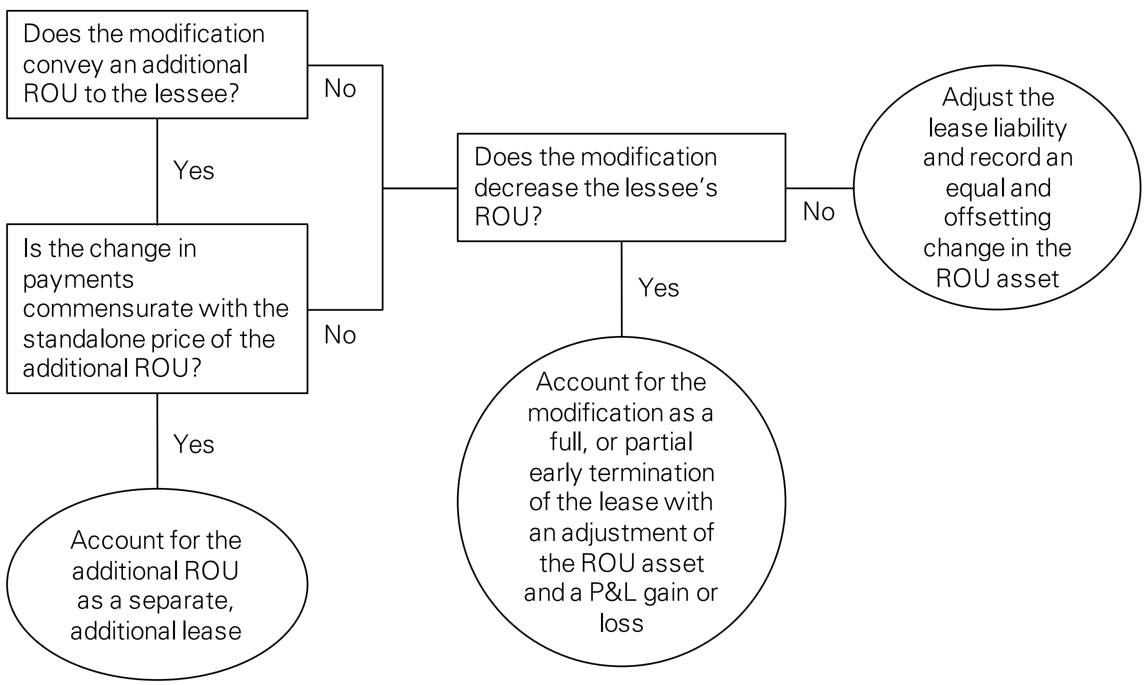
The substitution rights in this example are not considered substantive because the benefits to the vendor of exercising the substitution right would not be expected to outweigh the costs, and the contract therefore contains a lease.

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



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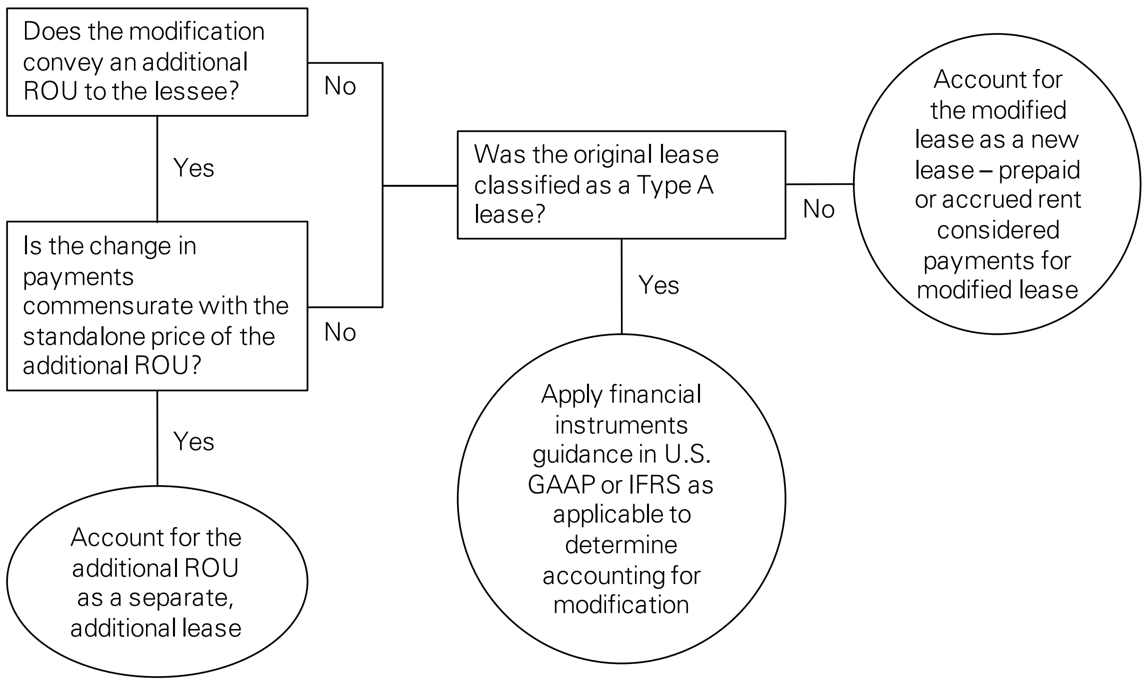
If a lease modification does not meet the criteria to be considered a separate, additional lease, the treatment for lessees is based on the nature of the modification. For all modifications except those that decrease the lessee's ROU, the lessee would adjust the ROU asset by the amount of the change 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.

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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

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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.

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Separating Lease and Non-lease Components

	Lessee	Lessor
When there is an observable standalone price for each component When there is not an observable standalone price for some or all components	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)
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

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- 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.

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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

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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

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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.

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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[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.

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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	

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<table>
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<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>
</table>

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<table>
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<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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<table>
<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.

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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	

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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.

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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. 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.

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- 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.

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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

[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.

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– 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	✓	✓

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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.

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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%

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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.

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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	✓	

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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.

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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.

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<table>
<tr><th>Transition Requirement</th><th>U.S. GAAP</th><th>IFRS</th></tr>
<tr><td>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.</td><td></td><td>✓</td></tr>
<tr><td>Disclosures</td><td></td><td></td></tr>
<tr><td>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.</td><td>✓</td><td></td></tr>
<tr><td>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.</td><td></td><td>✓</td></tr>
</table>

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.

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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.)

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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 rowspan="1">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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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 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	– There will be no restriction on recognizing selling profit on commencement of Type A leases
	• Existing leveraged leases will 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	• 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	
Initial Direct Costs	• 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 – In the initial measurement of the lease receivable if no selling profit is recognized at lease commencement	

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">– In expense at lease commencement if selling profit is recognized at lease commencement
• 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>
</table>

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Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	other reasons (e.g., a reassessment due to a change in the lease term)	– 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)
Arrangements with Lease and Non-lease Components; Contract Combinations	• 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	
Lease Modifications	• Lease modifications will be defined as *any* change to the contractual terms and conditions of a lease that was not part of the original terms and conditions 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	

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<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.

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<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>

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<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 will 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 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>
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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Lessee Presentation – Statement of Cash Flows</td><td>• Lessees will classify cash paid for:
– Principal on 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 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</td></tr>
<tr><td rowspan="2">Lessee Disclosures</td><td colspan="2">• Objective: Enable financial statement users to understand the amount, timing, and uncertainty of cash flows arising from leases</td></tr>
<tr><td>• Lessees will disclose the following qualitative information:
– Nature of leases (and subleases);
– Leases that have not yet commenced, but that create significant rights/obligations;
– Significant lease accounting judgments and assumptions;
– Main terms and conditions of sale-leaseback transactions; and
– Whether an accounting policy election was made for the short-term lease exemption</td><td>• Lessees will disclose other information, in addition to the quantitative disclosures, in sufficient detail to satisfy the lessee disclosure objective</td></tr>
</table>

[10] IAS 7, Statement of Cash Flows.

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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

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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>date and in total thereafter, including a reconciliation of undiscounted cash flows to lease liabilities on the balance sheet</td><td>maturity analysis for other financial liabilities</td></tr>
<tr><td>Lessor Presentation</td><td colspan="2">• 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</td></tr>
<tr><td rowspan="2">Lessor Disclosures</td><td colspan="2">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.</td></tr>
<tr><td colspan="2">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</td></tr>
</table>

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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

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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

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Defining Issues®
March 2014, No. 14-17

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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.

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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. 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.

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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.

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- 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

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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.

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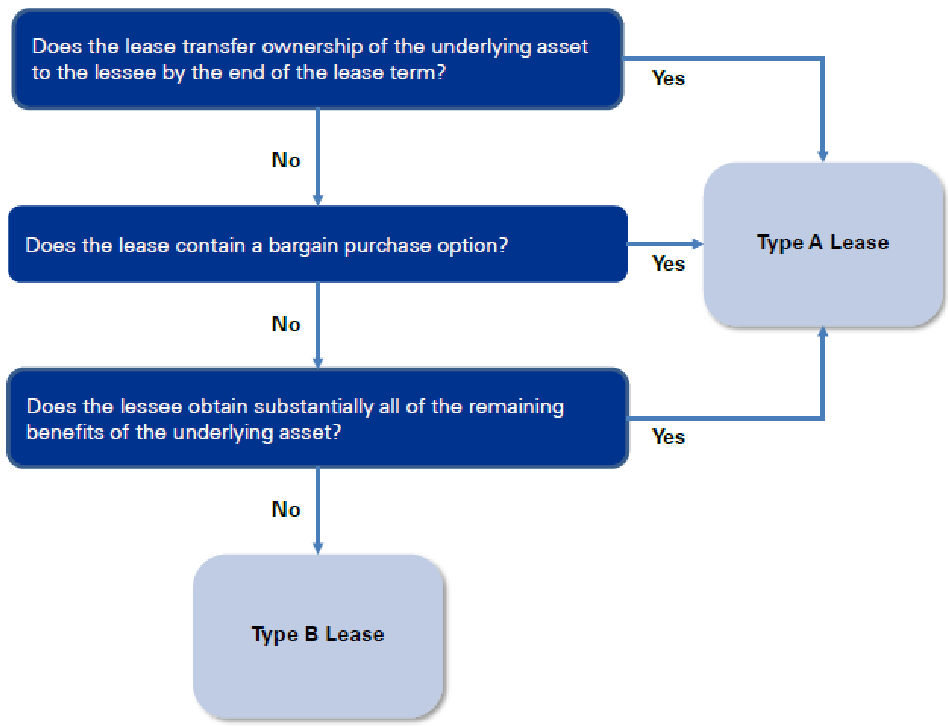
Factors that may indicate the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include:

- 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.

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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

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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.

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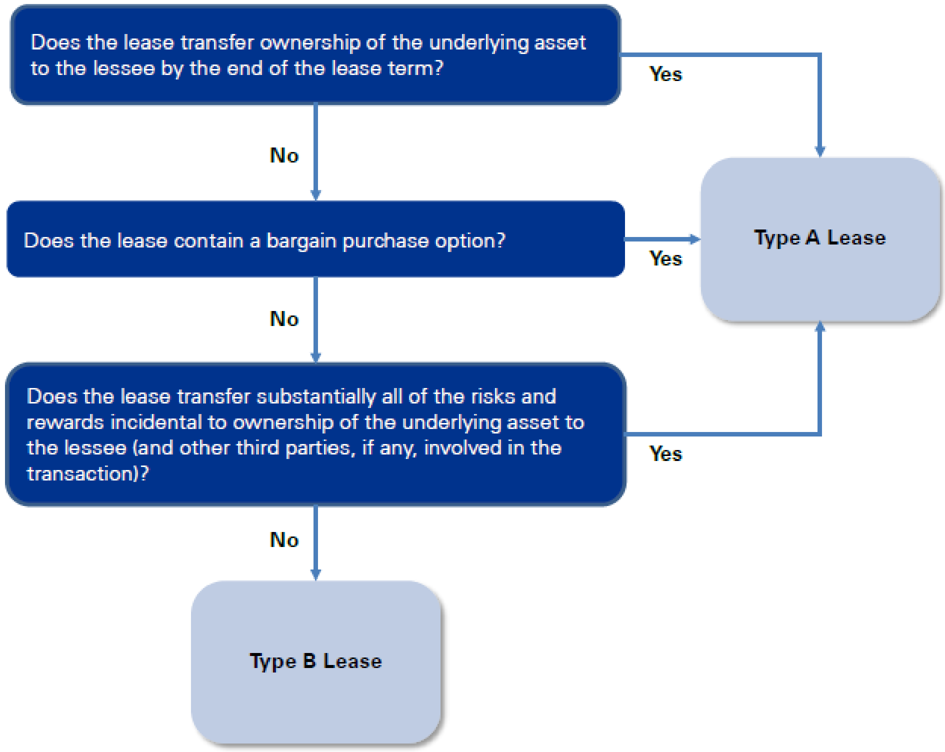

Leases that include a land element would require separate classification of the land element unless it is clearly immaterial. Leases not classified as Type B leases would be classified as Type A leases. Under this approach, a lessor would account for the vast majority of existing finance leases as Type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

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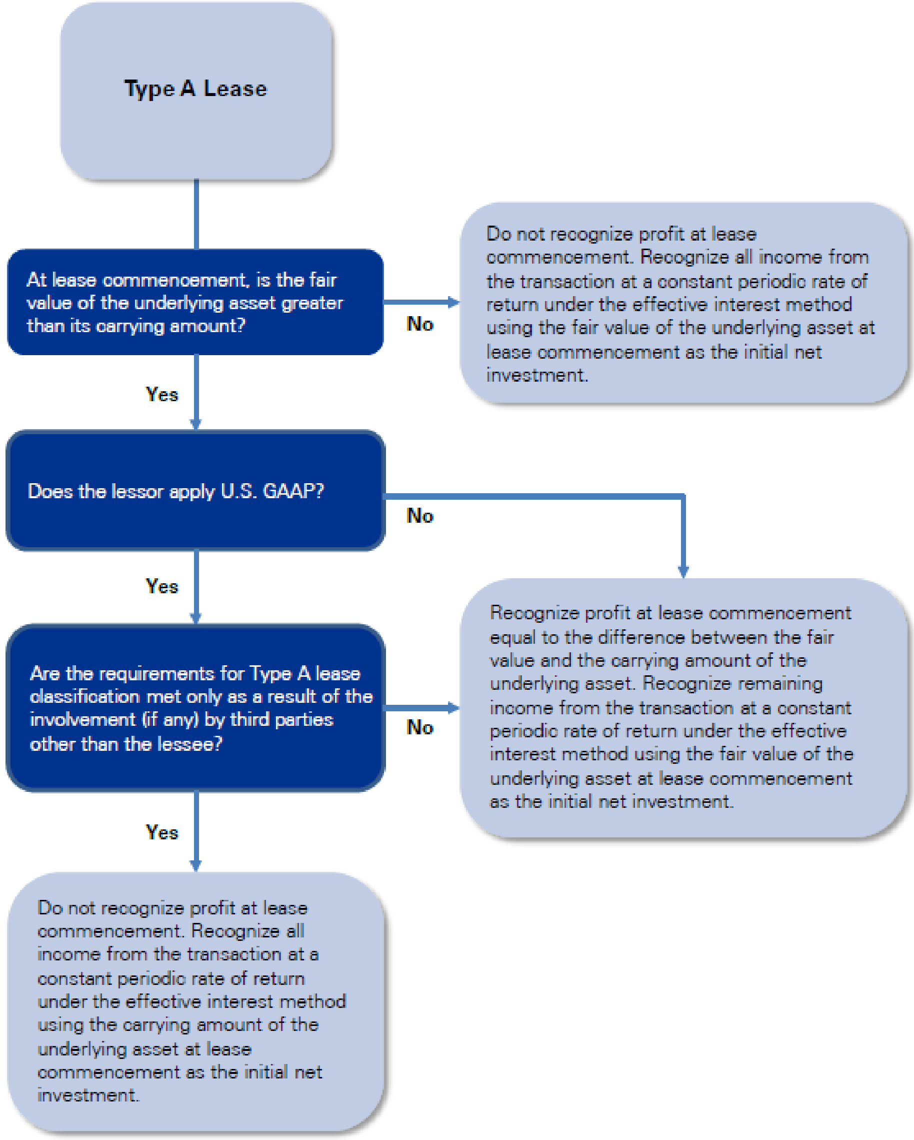

KPMG Observations

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.

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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.

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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

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- 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.

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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

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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.

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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,

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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**

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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.

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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.

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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.

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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

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- 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%).

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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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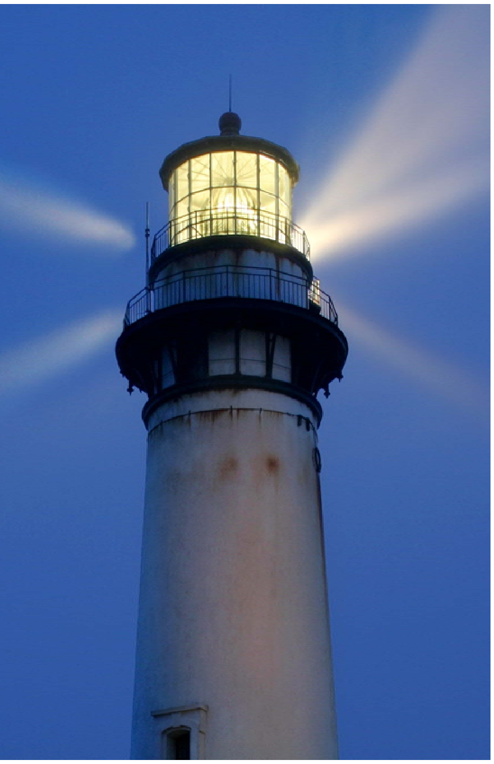

FASB and IASB Enter Home Stretch in Redeliberations on Lease Accounting – but on Different Tracks

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.

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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.

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- 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**

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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.

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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

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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.

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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.

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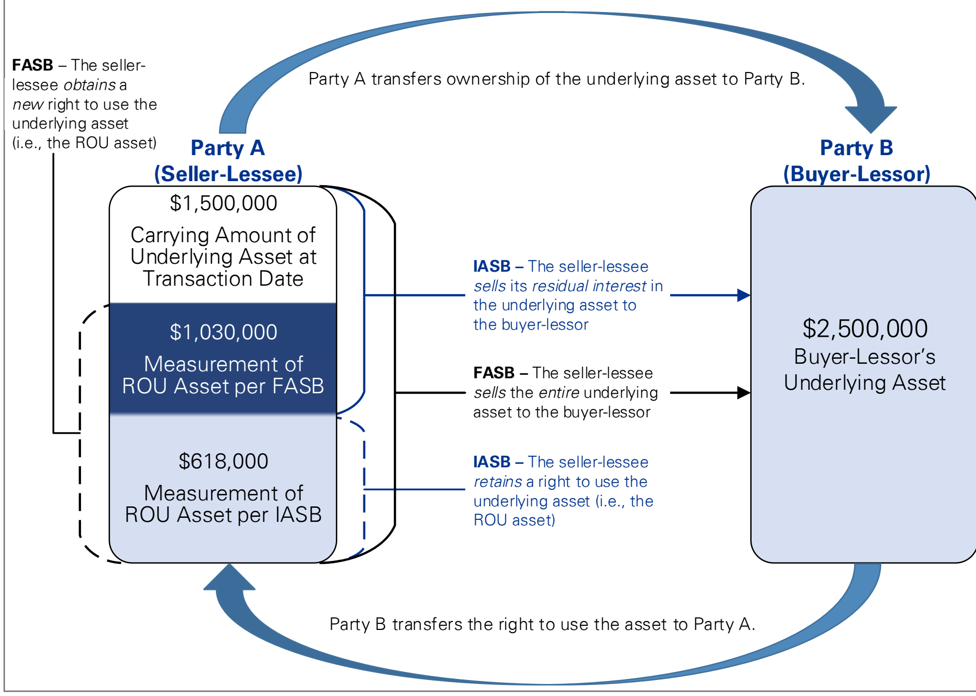
Example 1: Gain Recognized By a Seller-Lessee in a Sale-Leaseback Transaction

[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.

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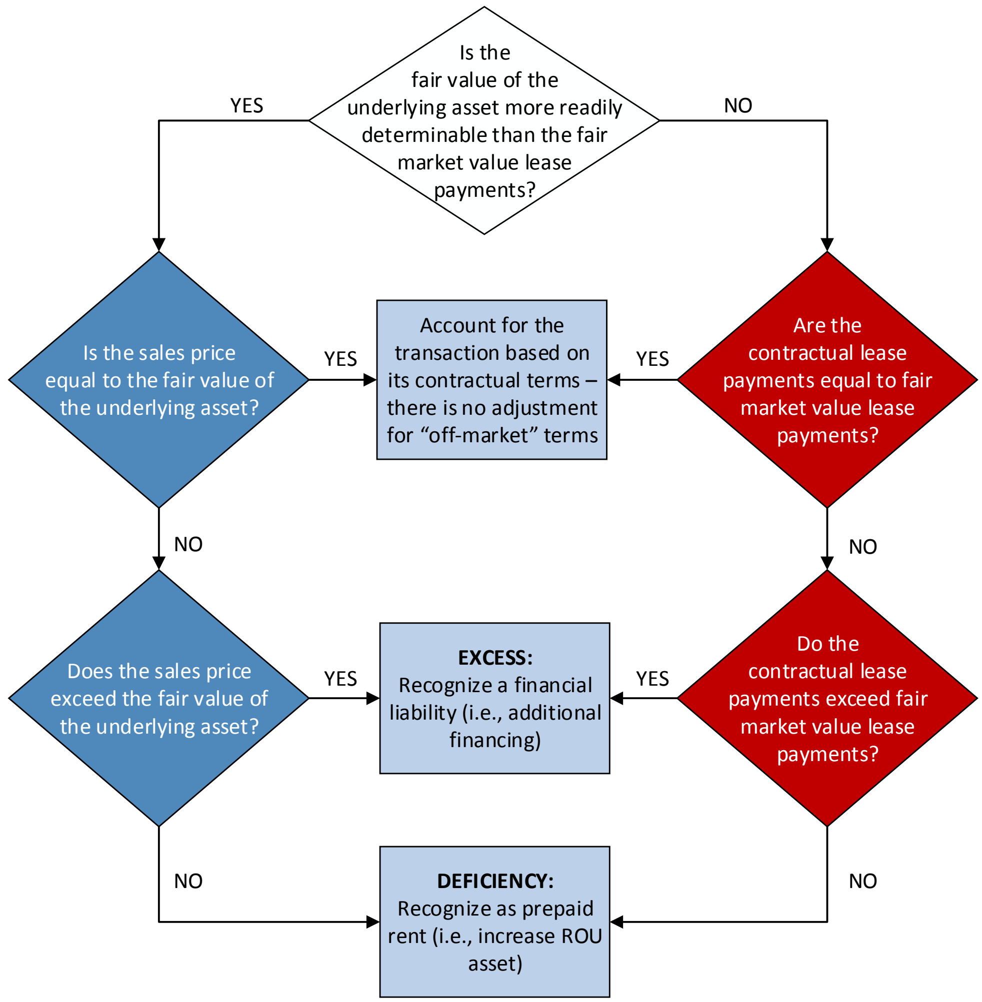
Accounting for "Off-Market" Terms



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.

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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)

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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.

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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.

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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

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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

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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.

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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.

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Summary of Decisions Reached in Redeliberations

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<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.

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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 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</td><td>– There would be no restriction on recognizing selling profit on commencement of Type A leases</td></tr>
<tr><td>• Existing leveraged leases would 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">• 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</td></tr>
<tr><td>Initial Direct Costs</td><td colspan="2">• 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</td></tr>
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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

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<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>

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<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.

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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="6">Sale-Leaseback Transactions</td><td colspan="2">Determining Whether a Sale has Occurred
• A sale 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>

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<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 would 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 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>

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Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
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[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
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	
Lessor Disclosures	*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	

[8] IAS 7, Statement of Cash Flows.

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<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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cutting through complexity

IFRS AND U.S. GAAP

Issues In-Depth

Revenue from Contracts with Customers

September 2014

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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.

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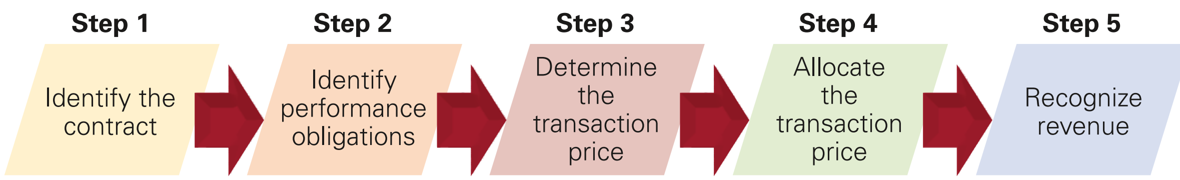
1 Key facts

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.

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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.

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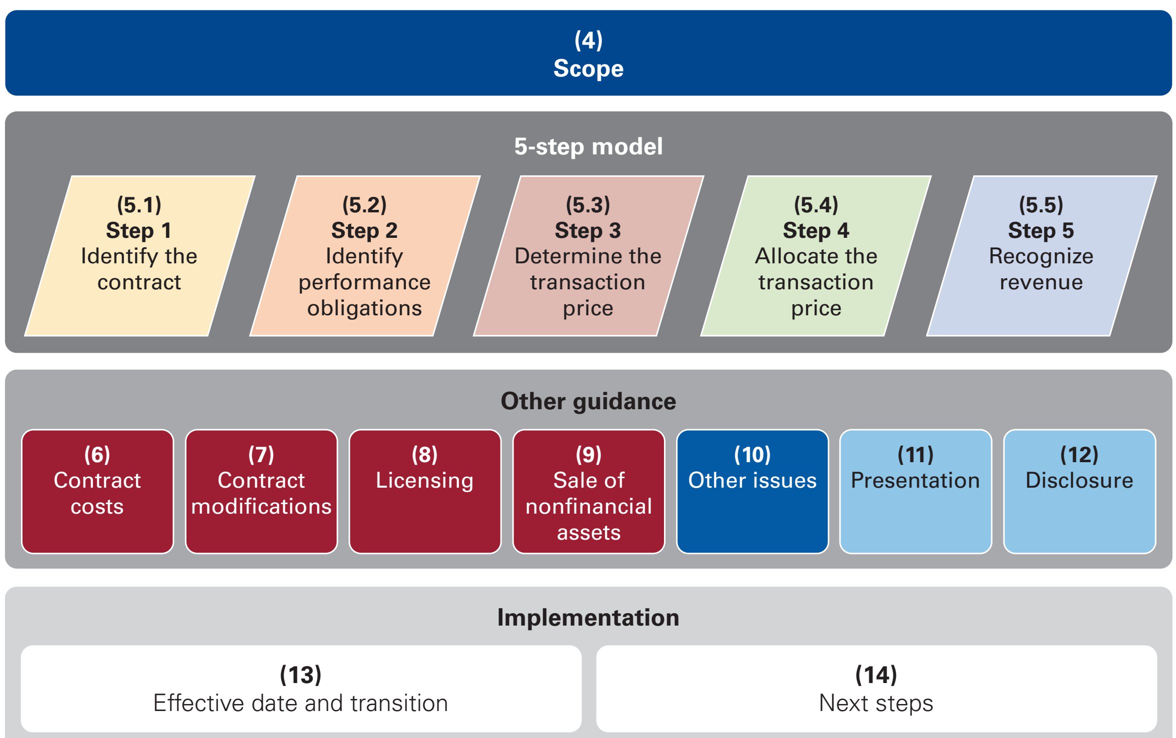
3 Putting the new standard into context

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

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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.

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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

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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.

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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.

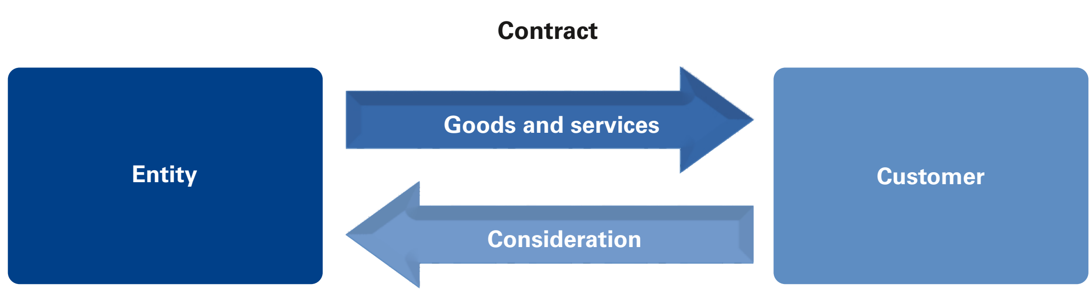
In some cases, the new standard will be applied to part of a contract or, in certain circumstances, to a portfolio of contracts. The new standard provides guidance on when it should or may be applied to these circumstances and how it is applied.

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.

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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.

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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.

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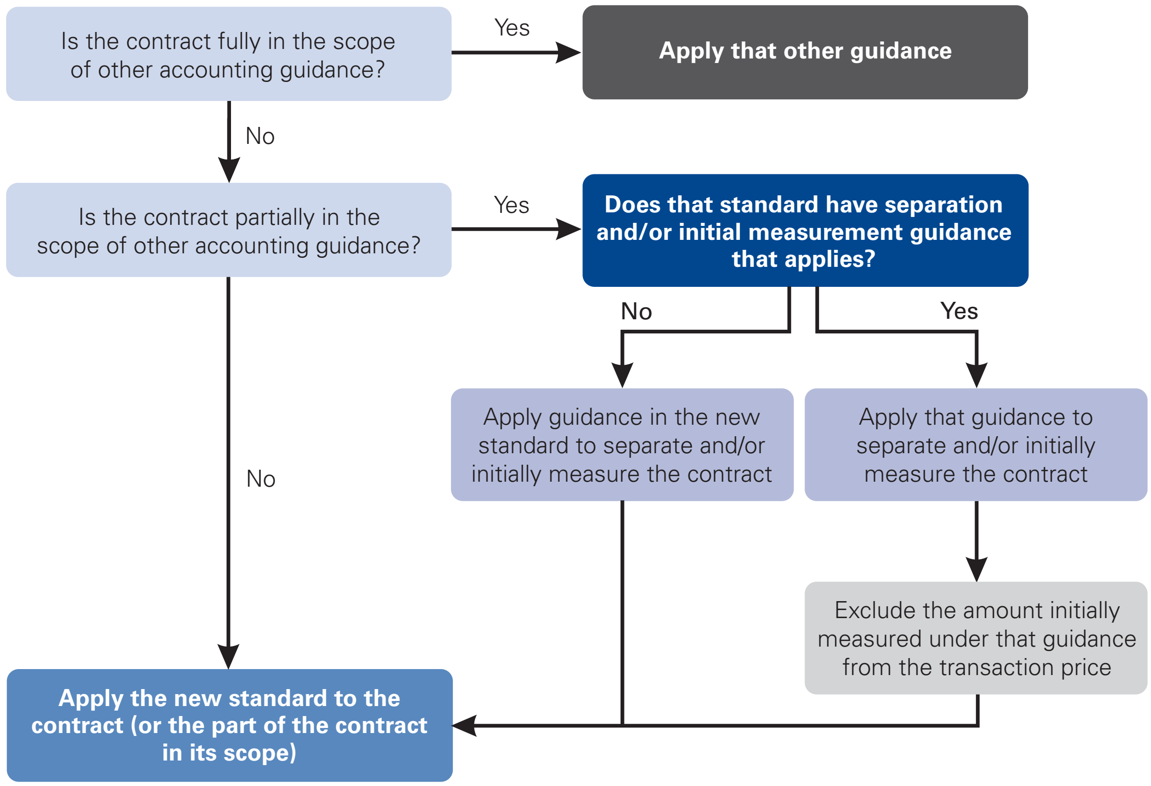

606-10-15-3; Topic 808
[IFRS 15.6]

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.

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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.

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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.

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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.

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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.

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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.

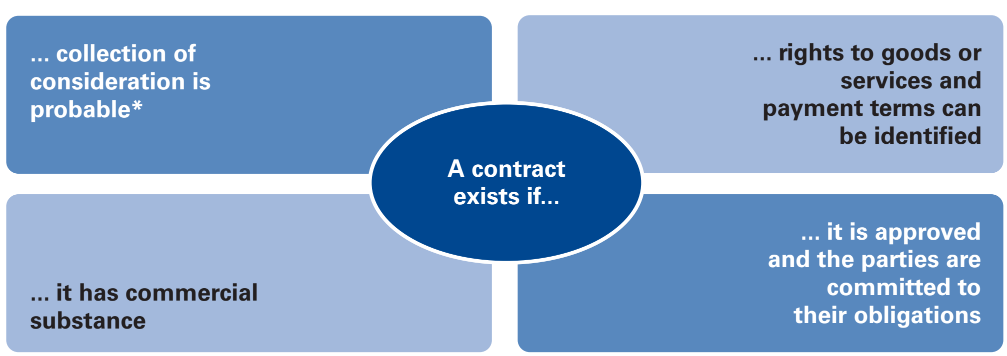
5.1.1 Criteria to determine whether a contract exists

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).

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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).

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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.

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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

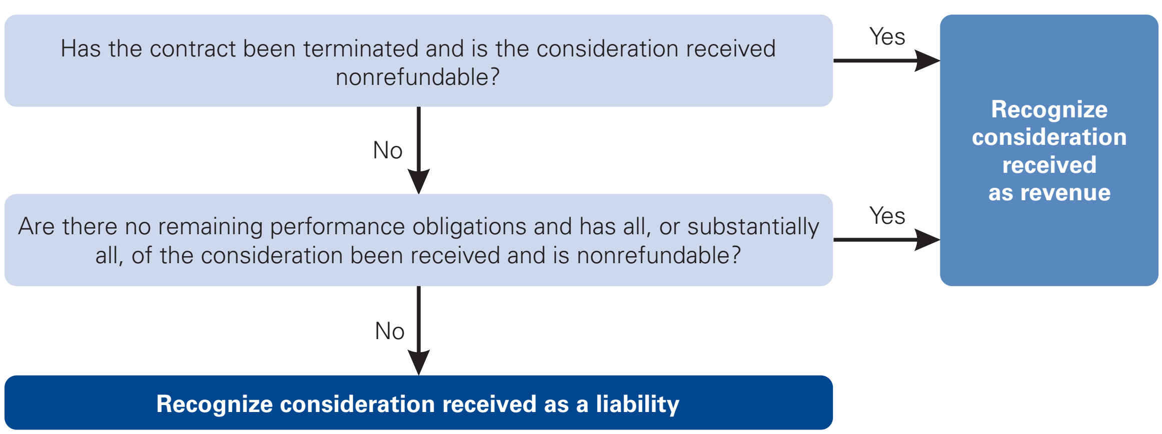
Under current SEC guidance and U.S. GAAP for software entities, consideration in a contract has to be fixed or determinable in order for the entity to recognize revenue. Under the new standard, the payment terms need to be identified for a contract to exist under the model, but do not need to be fixed 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.

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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

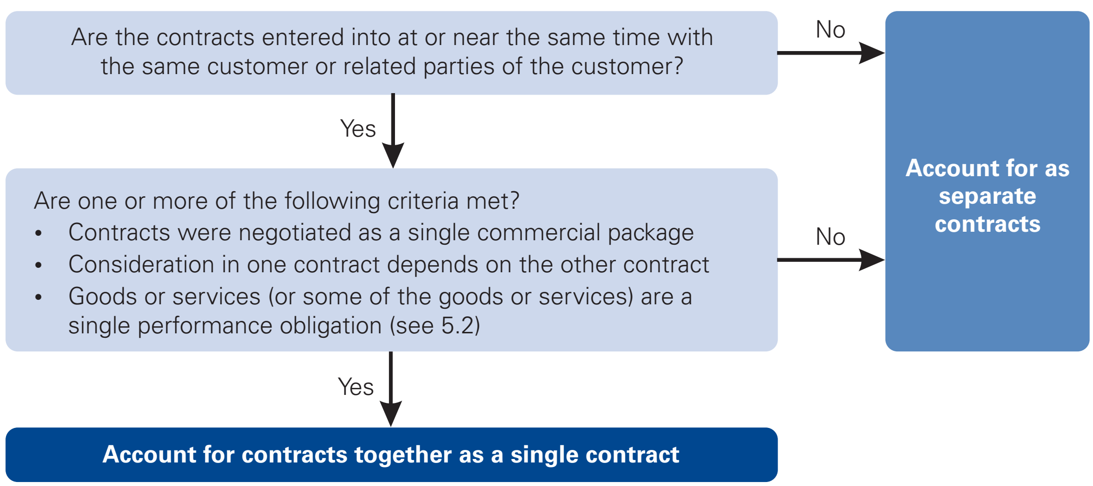
If an entity cannot conclude that a legally enforceable contract exists, it may be difficult to evaluate when all or substantially all of the promised consideration has been received and is nonrefundable. In some cases, an entity may have a deposit recognized for a significant period of time until it 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.

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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.

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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).

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5.2.1 Distinct goods or services

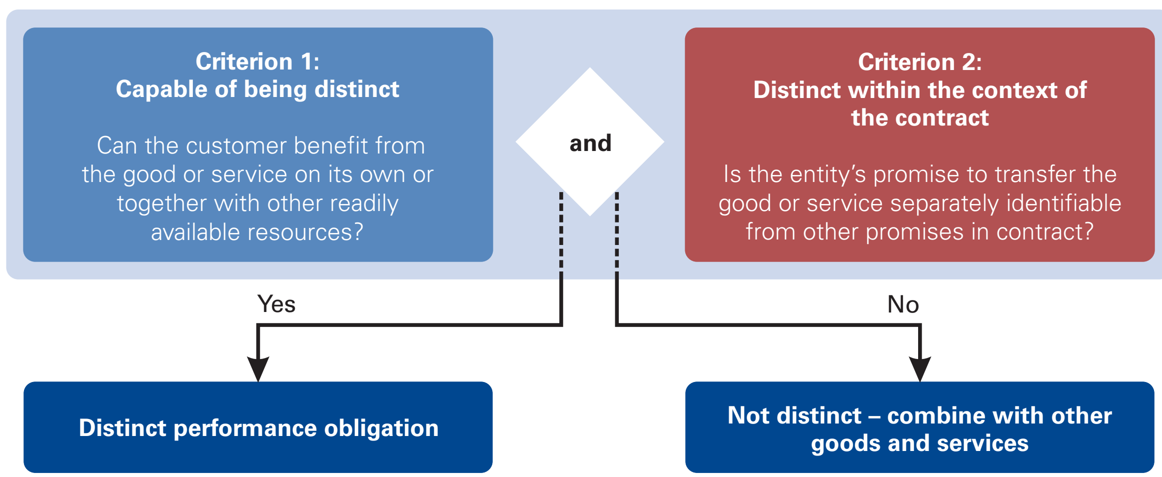
Requirements of the new standard

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.

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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.

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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.

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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.

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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).

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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.

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SEC SAB Topic 13; ASU 2014-09 BC89 to BC90

No perfunctory or inconsequential concept

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.

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- 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.

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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**

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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.

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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.

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In determining the transaction price, an entity considers the following components.

606-10-32-3
[IFRS 15.48]

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

Transaction price

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.

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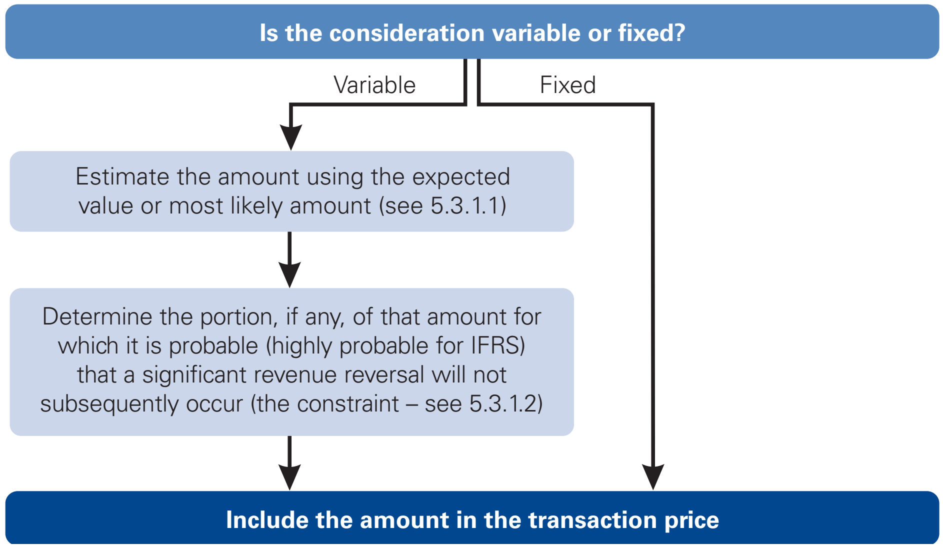

606-10-32-10
[IFRS 15.55]

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.

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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.

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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.

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- 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.

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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.

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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

[IAS 18.14(c)]

Estimation uncertainty limits rather than precludes revenue recognition

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

SEC SAB Topic 13

Applying the constraint

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.

985-605-25-36

Sell-in versus sell-through

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.

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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.

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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.

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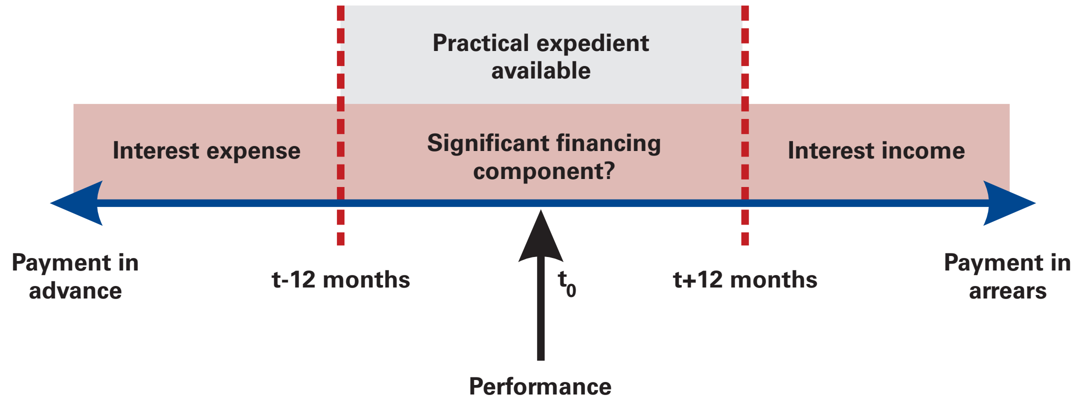

606-10-32-20
[IFRS 15.65]

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.

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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.

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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.

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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.

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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.

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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.

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5.3.4 Consideration payable to a customer

Requirements of the new standard

606-10-32-25
[IFRS 15.70]

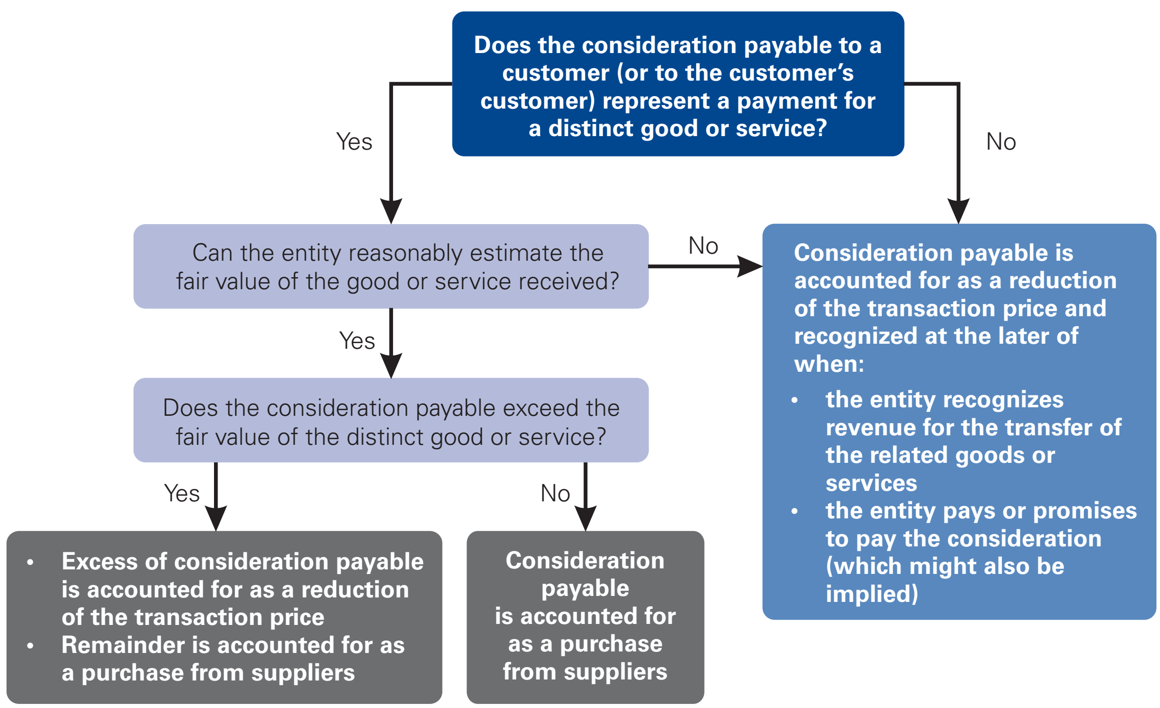
Consideration payable to a customer includes cash amounts that an entity pays or expects to pay to the customer, or to other parties that purchase the entity's goods or services from the customer. Consideration payable to a customer also includes credits or other items – e.g., a coupon or voucher – that 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.

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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.

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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)**

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5.4.1 Determine stand-alone selling prices

Requirements of the new standard

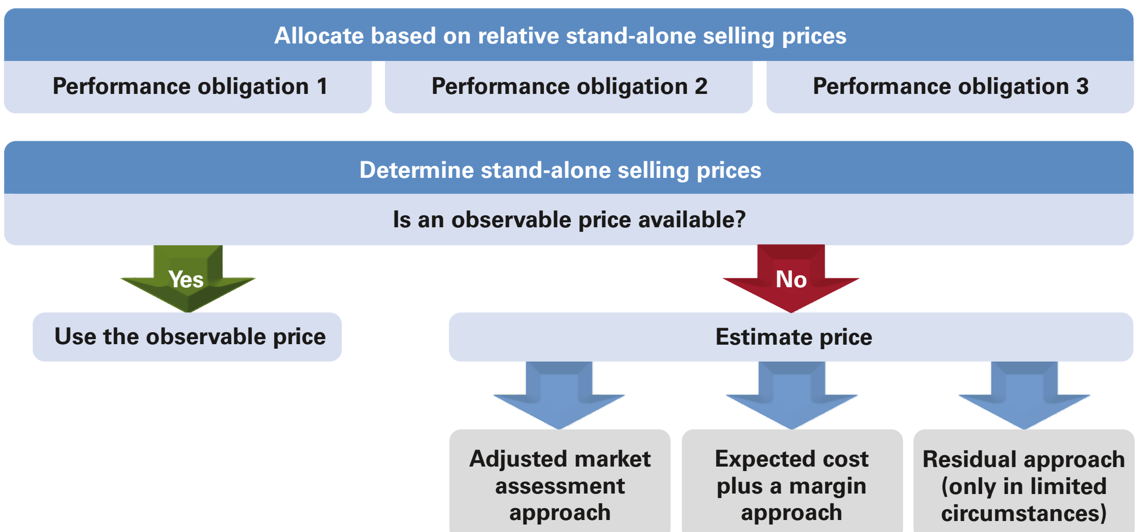
606-10-32-32 *[IFRS 15.77]*

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.

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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.

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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.

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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.

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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.

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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.

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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;

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- 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).

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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.

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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.

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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.

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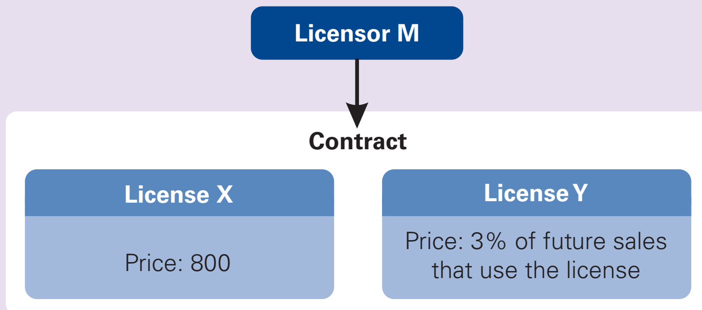
Example 21

606-10-55-271 to 55-274

[IFRS 15.IE179 to IE182]

Variable consideration allocated entirely to one performance obligation in the contract



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.

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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.

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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.

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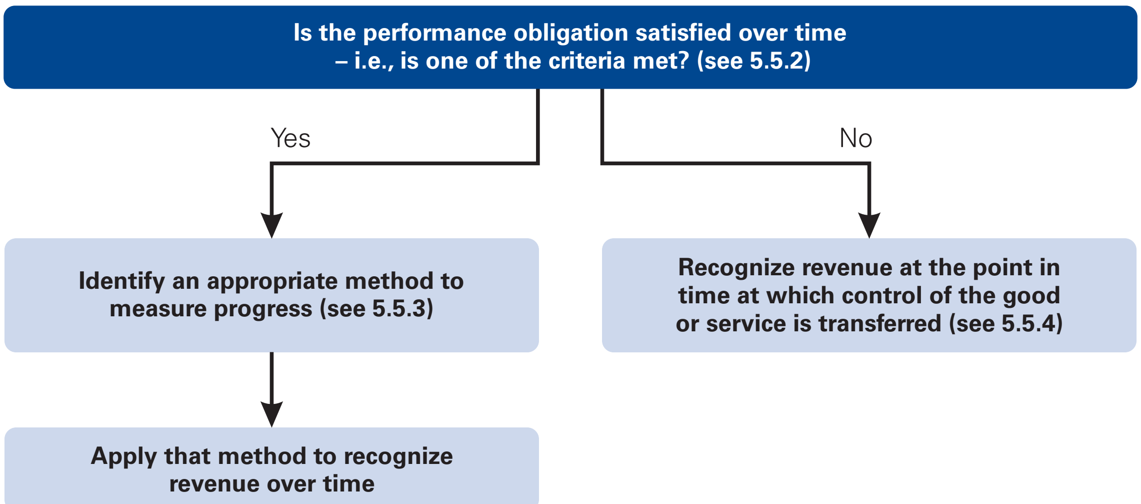
Requirements of the new standard

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.

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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.

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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.

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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).

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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.

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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.

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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.

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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.

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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.

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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.

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- 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.

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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.

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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).

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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.

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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.

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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.

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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).

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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.

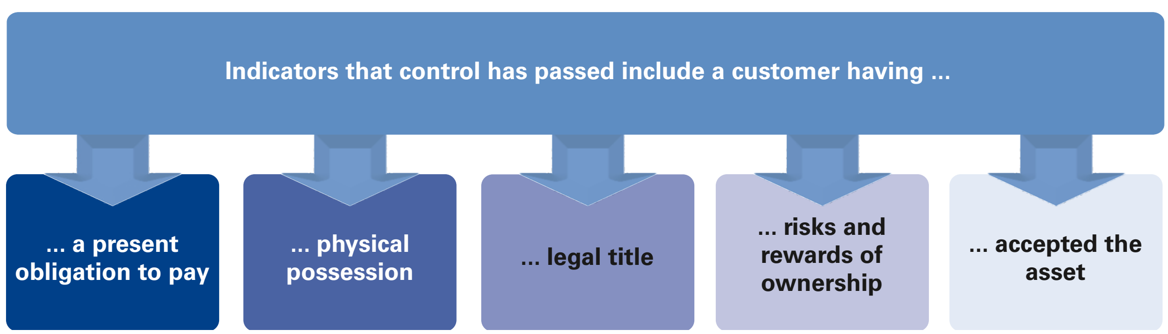
This requirement is consistent with the new standard's guidance that revenue is recognized only to the extent of costs incurred – i.e., at a zero percent profit margin – until the entity can reasonably measure its progress, although this situation does not arise frequently in our experience. However, 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).

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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.

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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

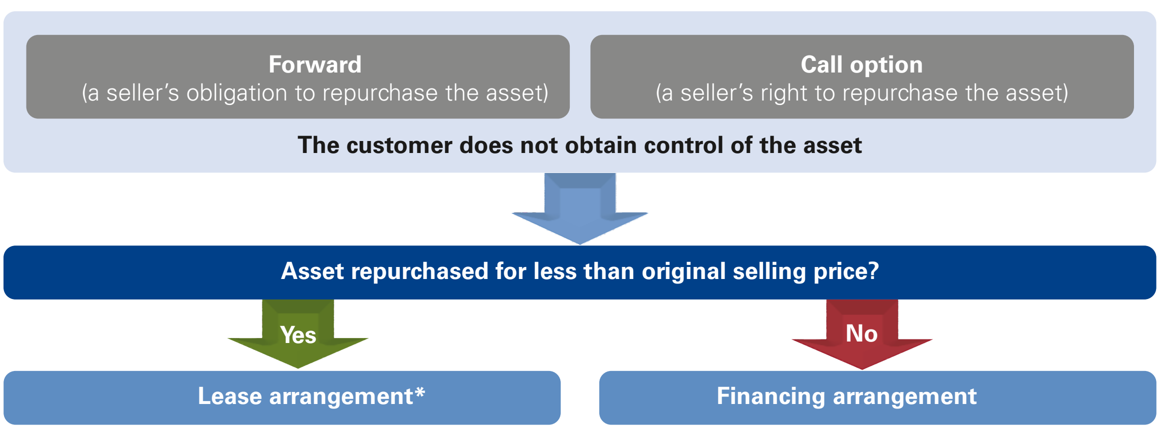
A forward or a call option

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.

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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]

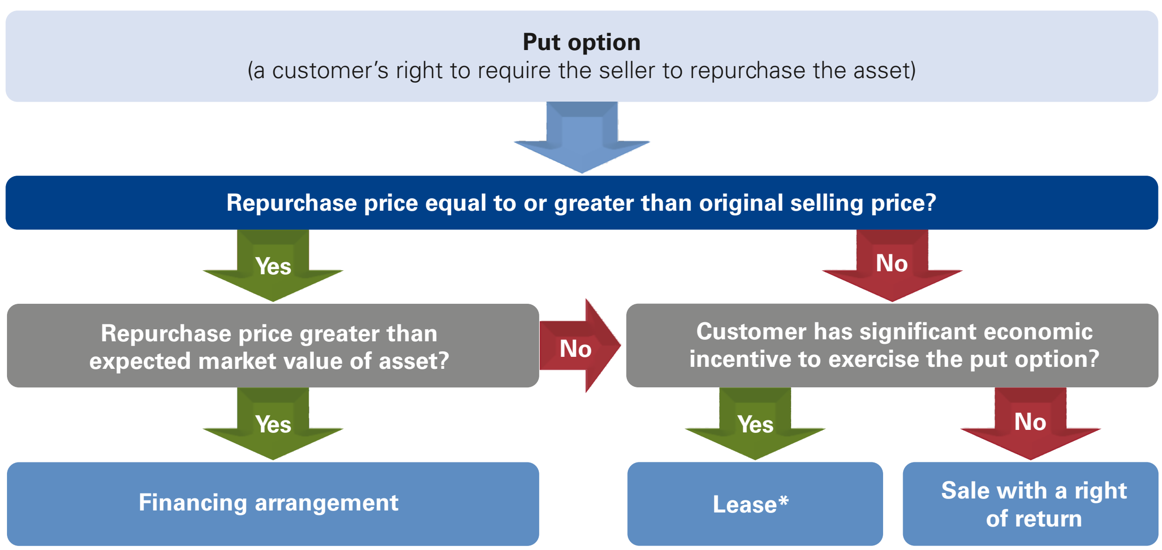
If the customer has a significant economic incentive to exercise the put option, the entity accounts for the agreement as a lease. Conversely, if the customer does not have a significant economic incentive, the entity accounts for the agreement as the sale of a product with a right of return (see 10.1).

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.



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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.

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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.

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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.

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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.

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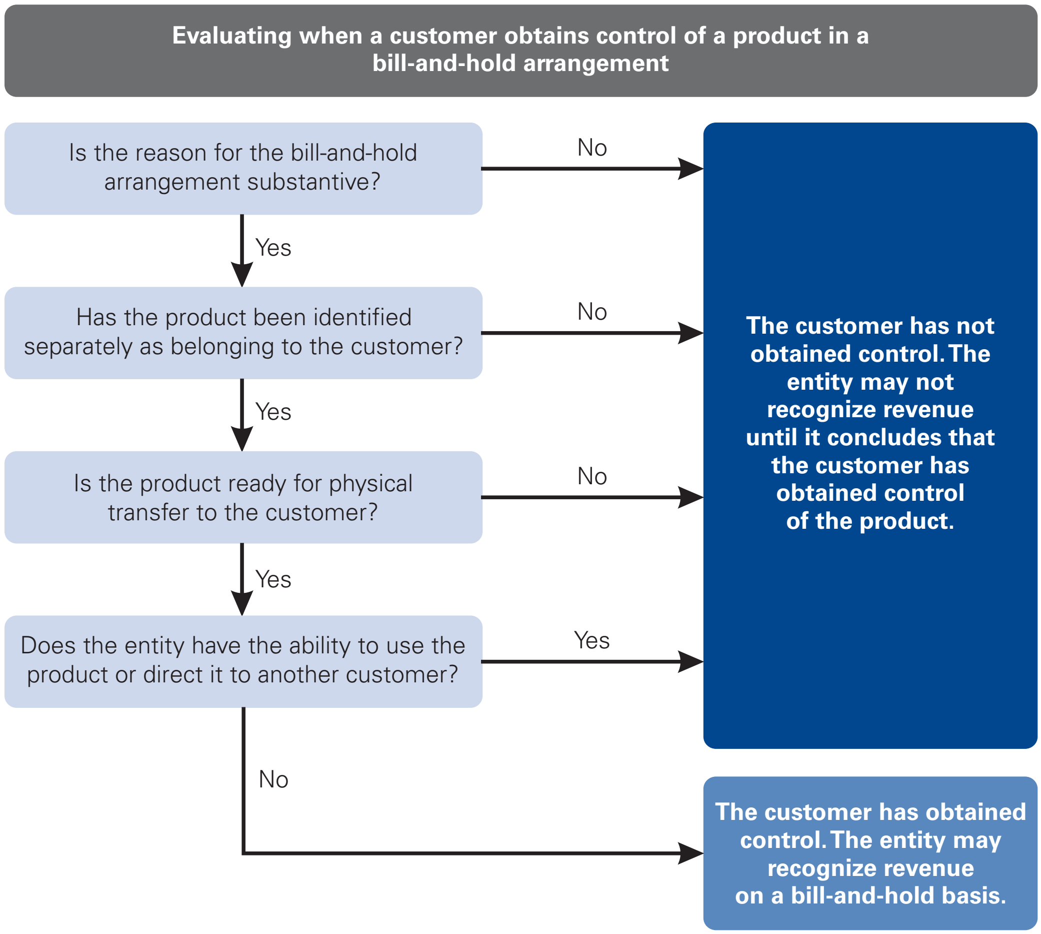

606-10-55-84
[IFRS 15.B82]

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.

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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.

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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.

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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.

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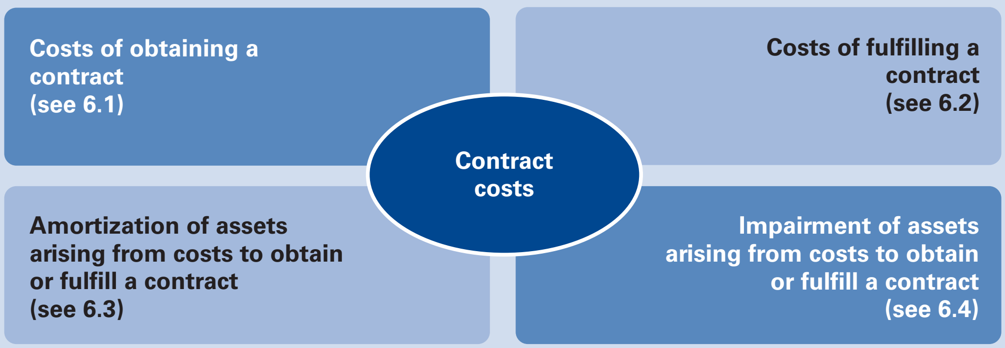
6 Contract costs

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).

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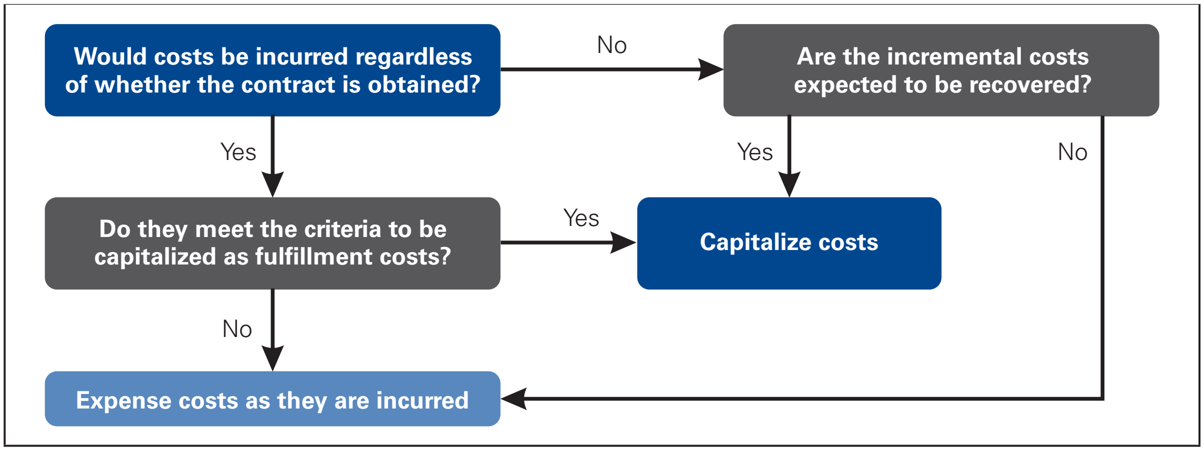

Example 29

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.

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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.

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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.

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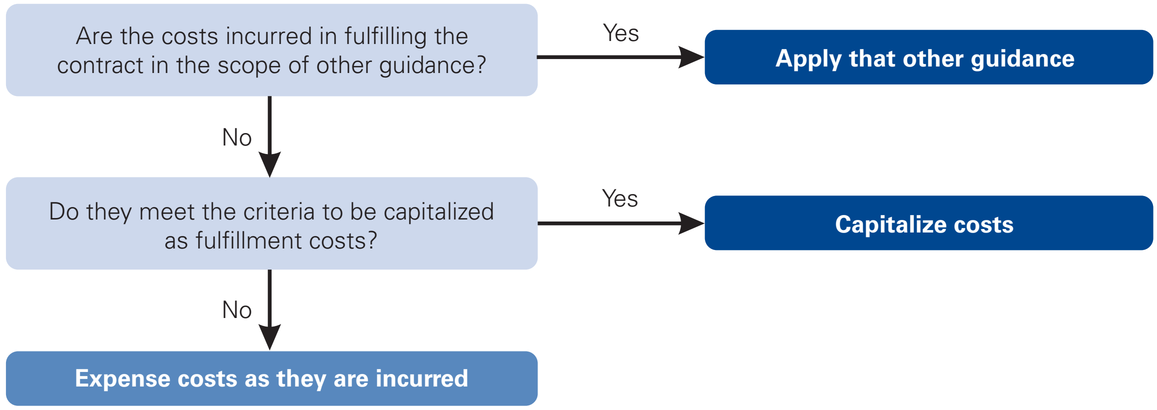

340-40-25-7 to 25-8
[IFRS 15.97 to 98]

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**

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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.

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[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.

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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.

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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.

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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.

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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.

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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.

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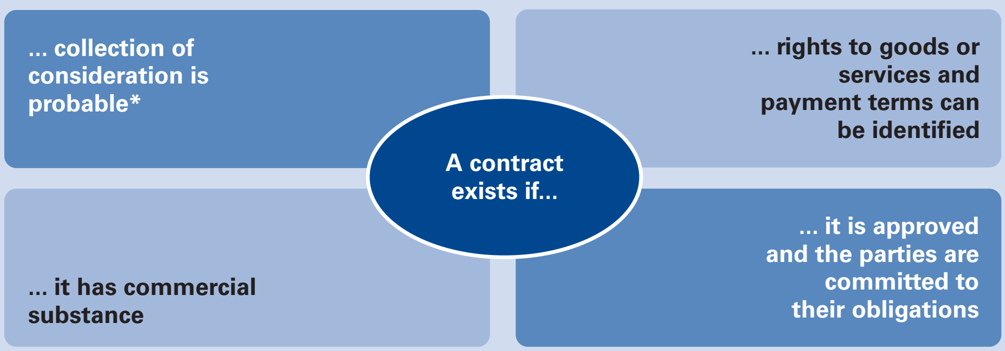
Assessment focuses on enforceability

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.

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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]	**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.
[IAS 11.13]	**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.

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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.

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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.

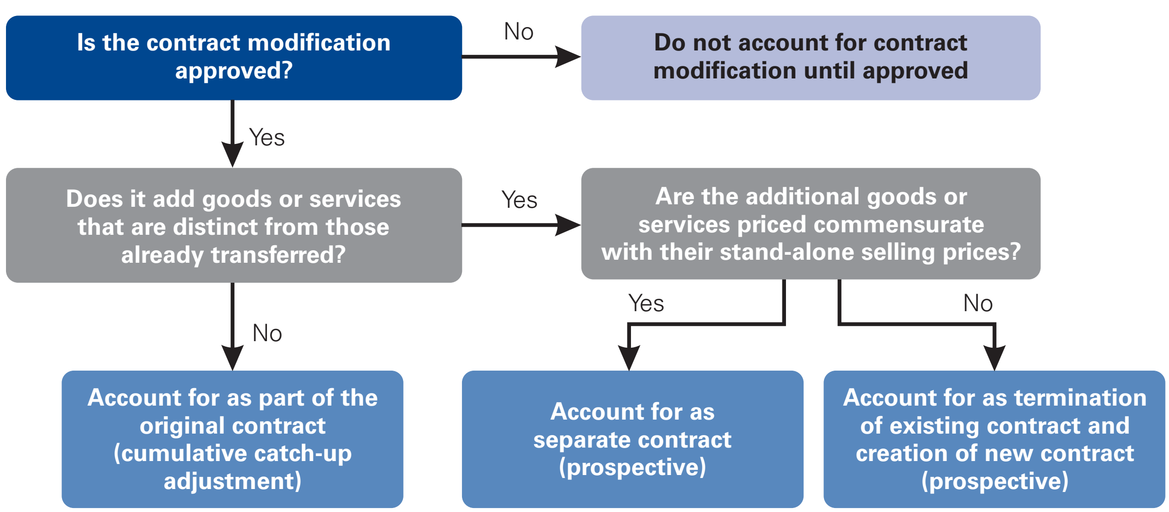
606-10-25-13
[IFRS 15.21]

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.



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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.

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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.

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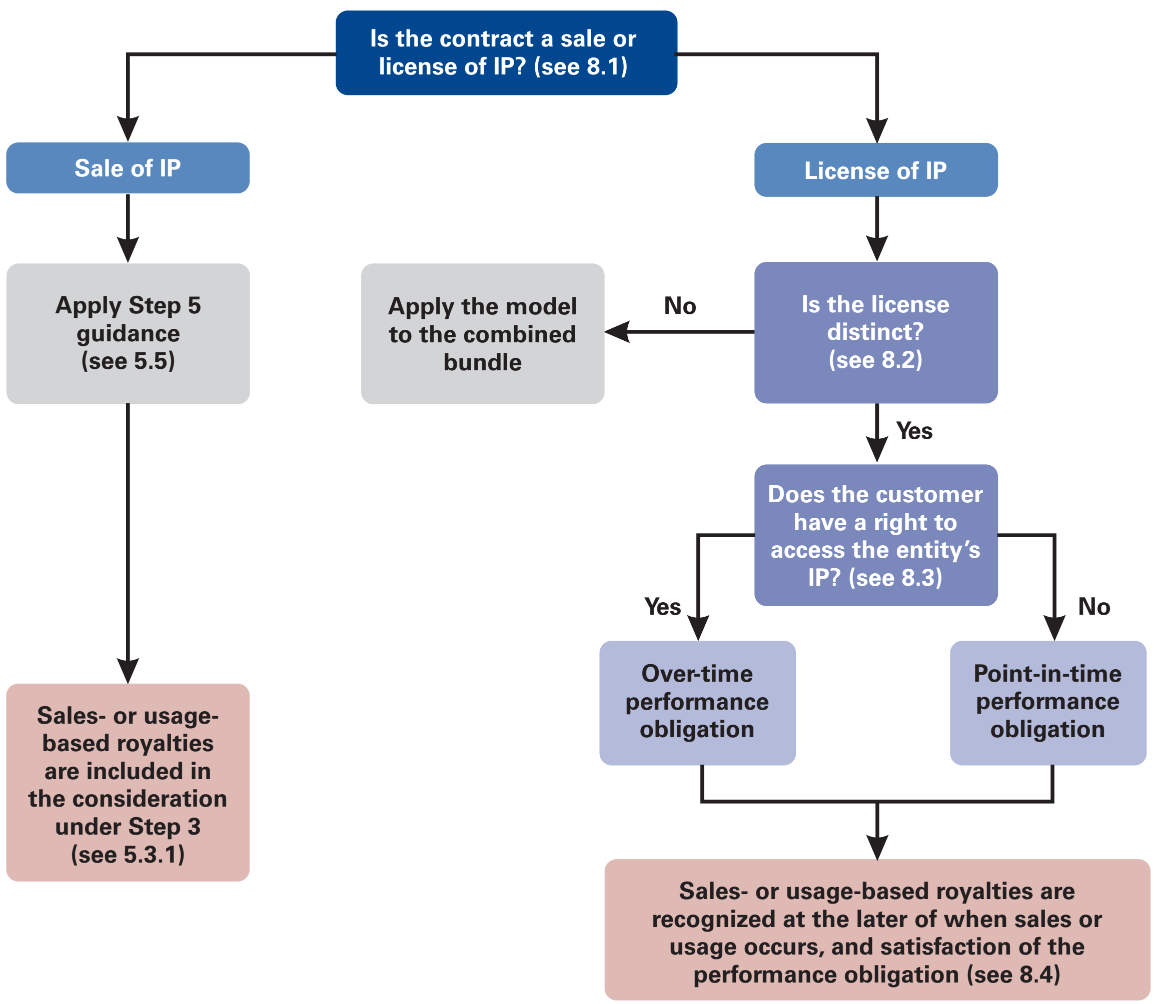
8 Licensing

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.



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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.

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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).

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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.

Reference	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

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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.

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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.

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8.3 Determining the nature of a distinct license

Requirements of the new standard

606-10-55-58 [IFRS 15.B56]

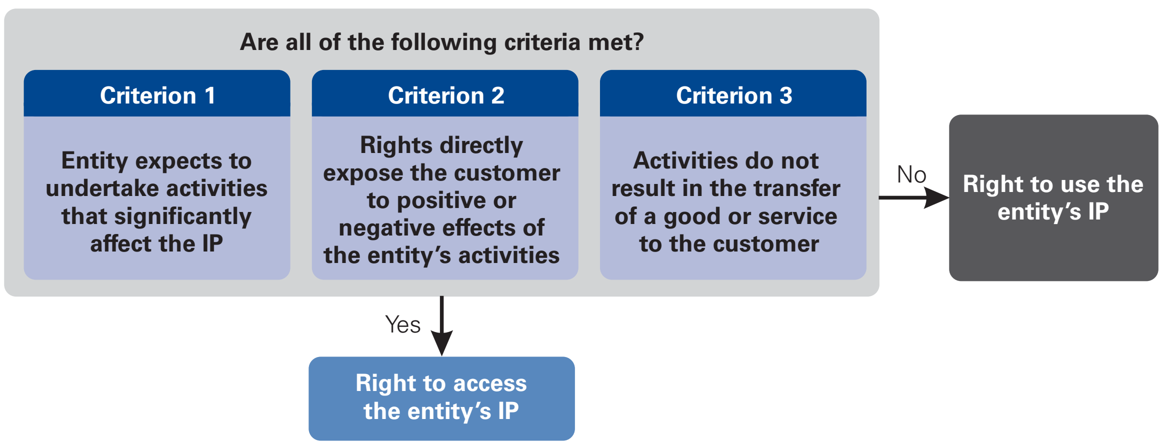
A distinct license of IP is treated as a separate performance obligation and an entity applies specific criteria to determine whether the license represents a right to:

- 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.

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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.

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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.

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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.

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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.

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8.4 Sales- or usage-based royalties

Requirements of the new standard

606-10-55-65
[IFRS 15.B63]

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.

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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.

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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.

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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.*

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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.

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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.

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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.

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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:

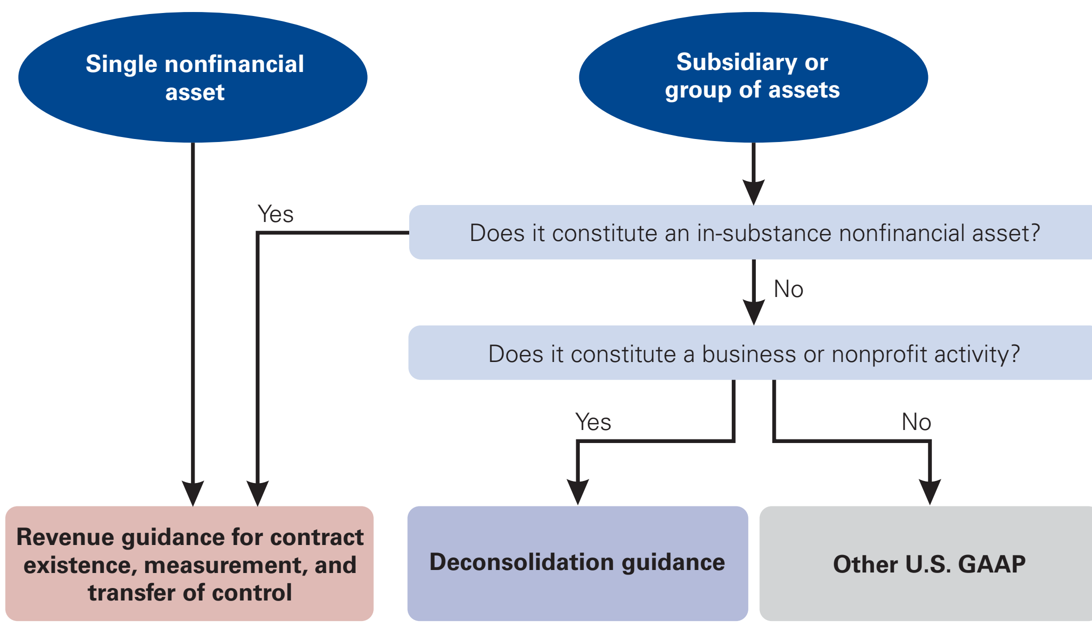
- the transfer of control and measurement guidance under the new standard; and
- the guidance in Step 1 of the model in the new standard to determine whether a contract exists (and, if not, the guidance on the accounting for consideration received in advance of having a contract – see 5.1.2).

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.



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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.

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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.

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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.

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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

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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).

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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.

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Requirements of the new standard

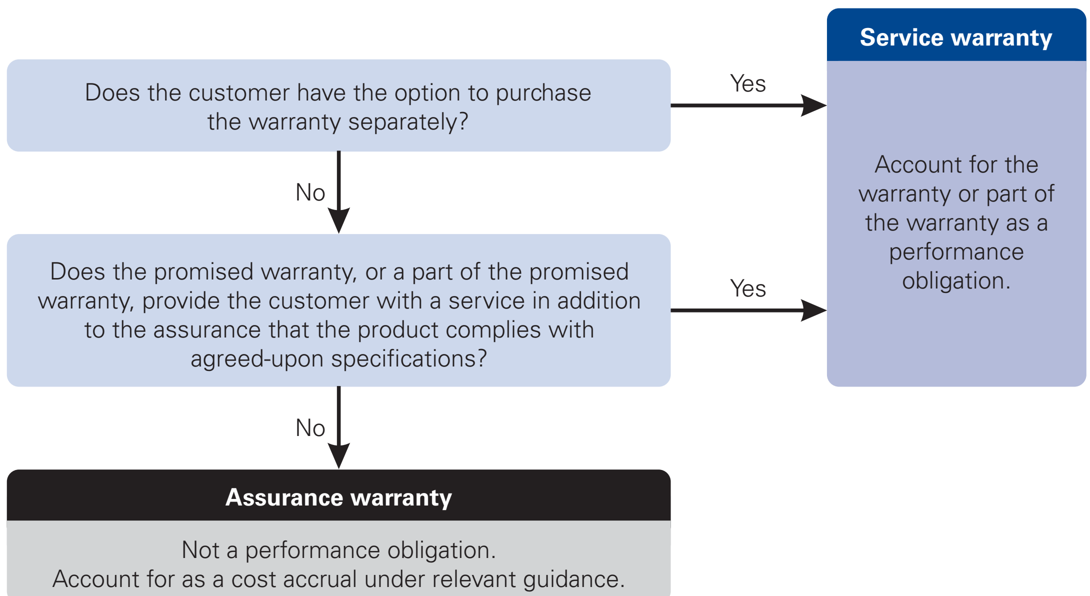
606-10-55-31
[IFRS 15.B29]

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.

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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

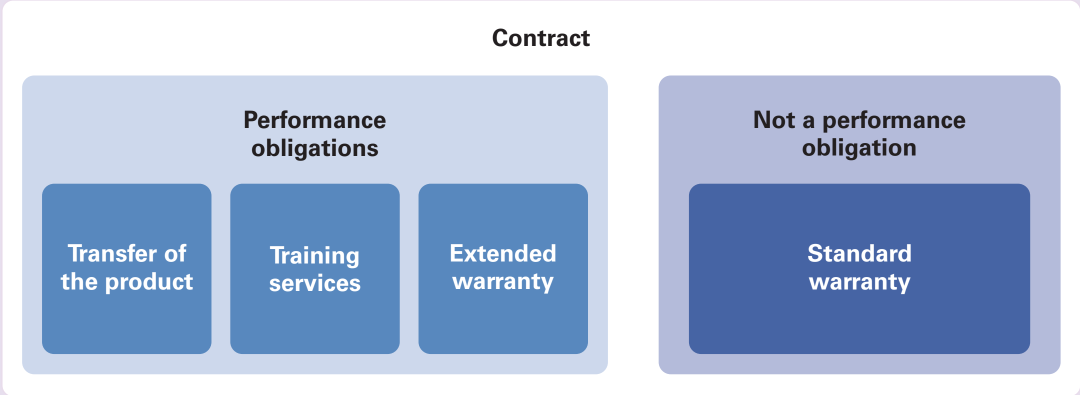
606-10-55-309 to 55-315
[IFRS 15.IE223 to IE229]

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.

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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.

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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]

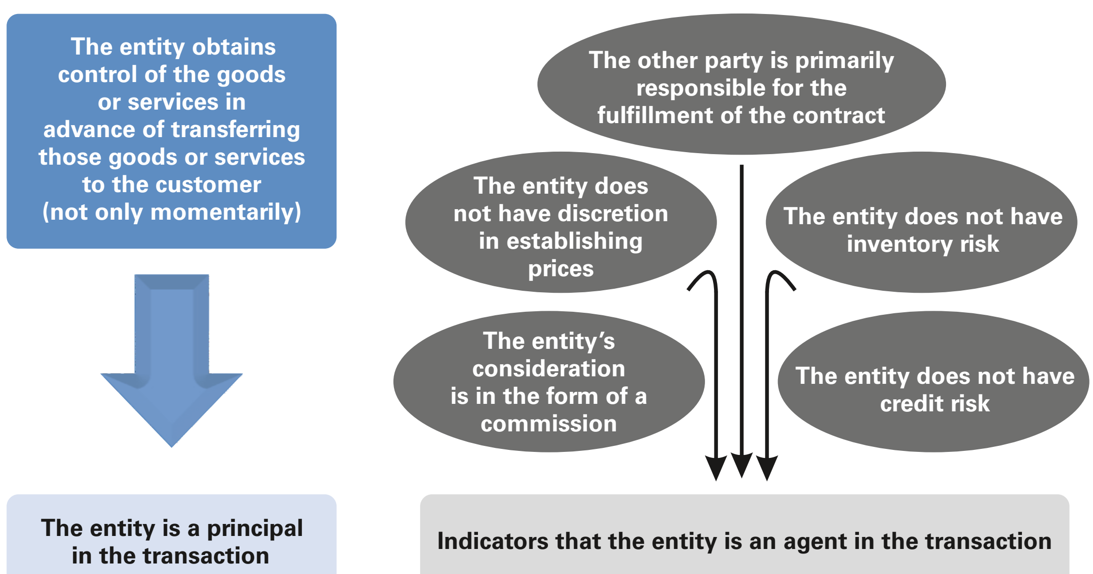
When other parties are involved in providing goods or services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself, or to arrange for another party to provide them – i.e., whether it is a principal 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.



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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.

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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.

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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.

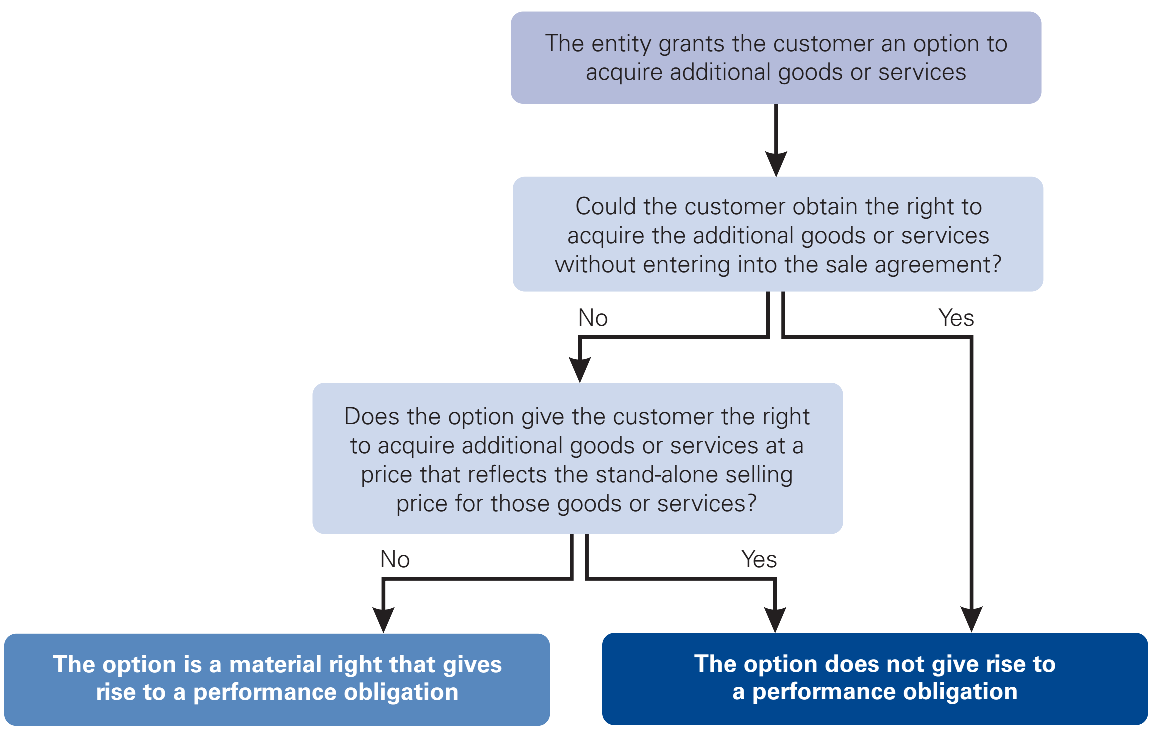
Requirements of the new standard

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.

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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.

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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.

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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'.

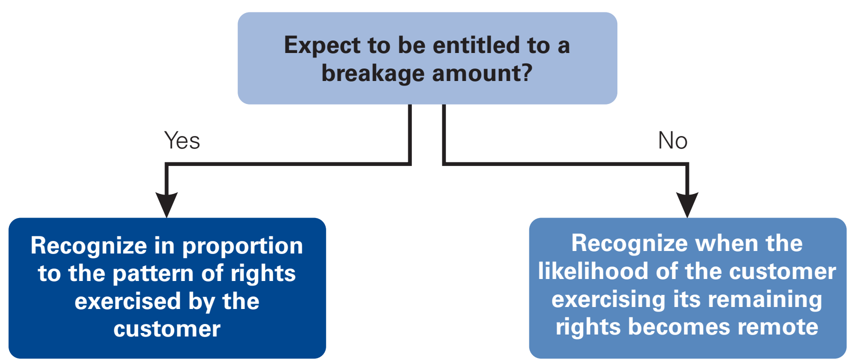
Requirements of the new standard

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.

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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.

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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.

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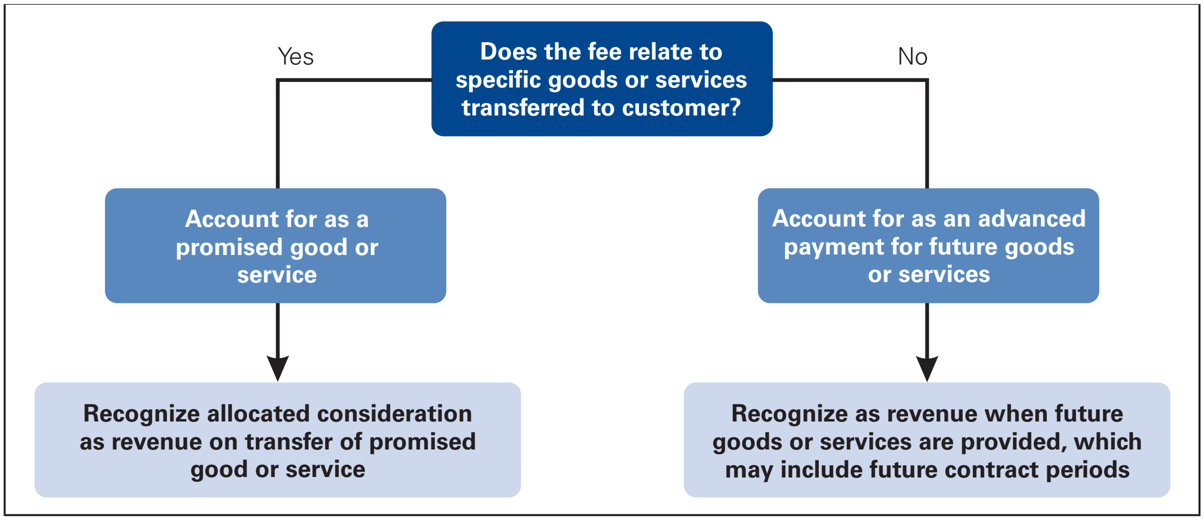

Example 41

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.

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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.

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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.

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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.

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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.

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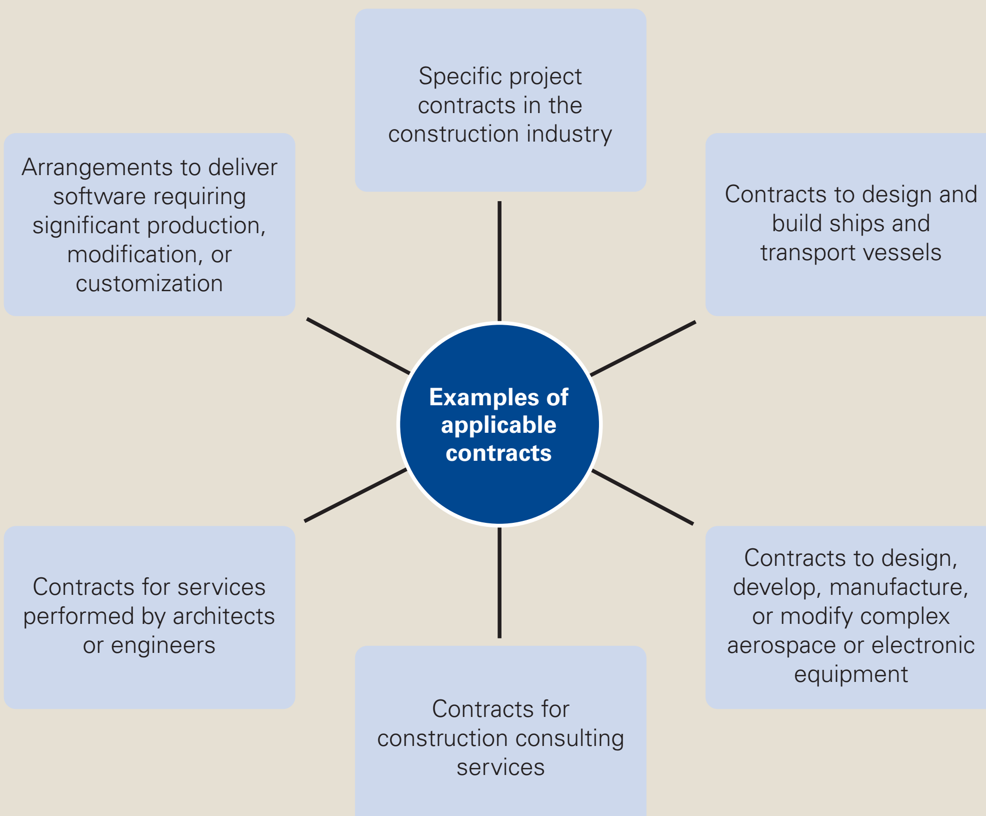
Current U.S. GAAP requires that costs of services performed for separately priced extended warranty and product maintenance contracts are expensed as incurred. Although the consequential amendments remove the cost guidance for separately priced extended warranties, the new standard will likely result 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).

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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.

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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.

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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.

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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.

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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.

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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.

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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]

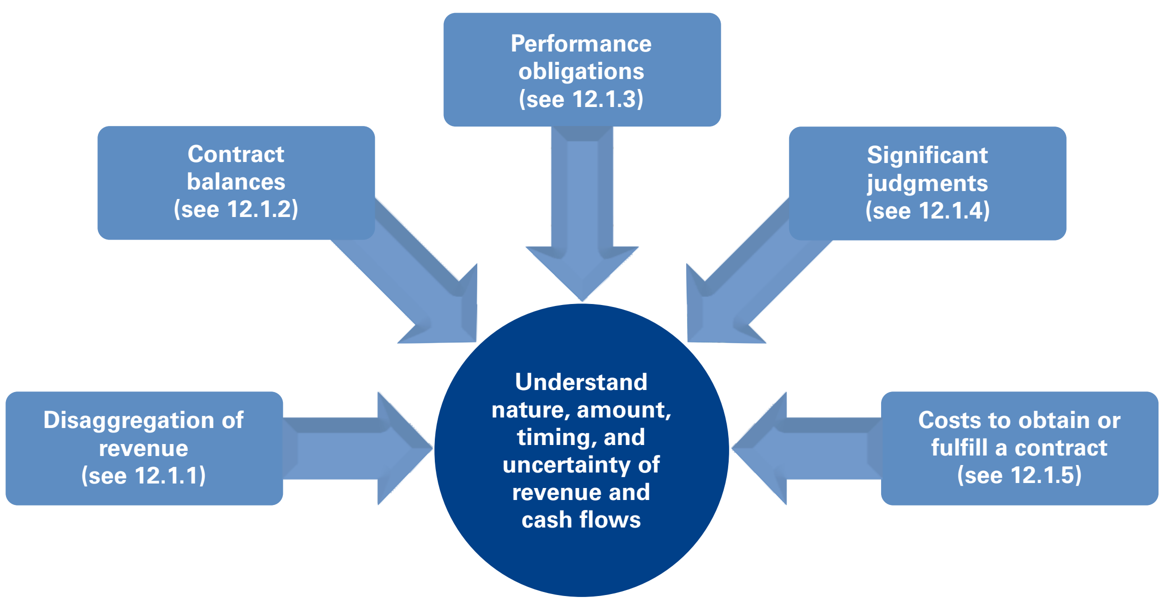
The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

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.



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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.

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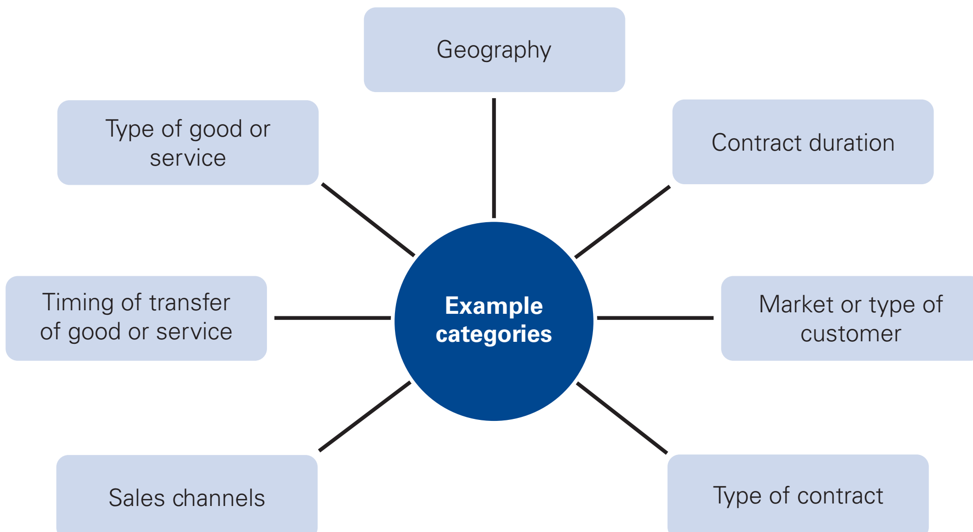
12.1.1 Disaggregation of revenue

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.

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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.

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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.

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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.

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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.

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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.

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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.

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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.

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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).

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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.

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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.

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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.

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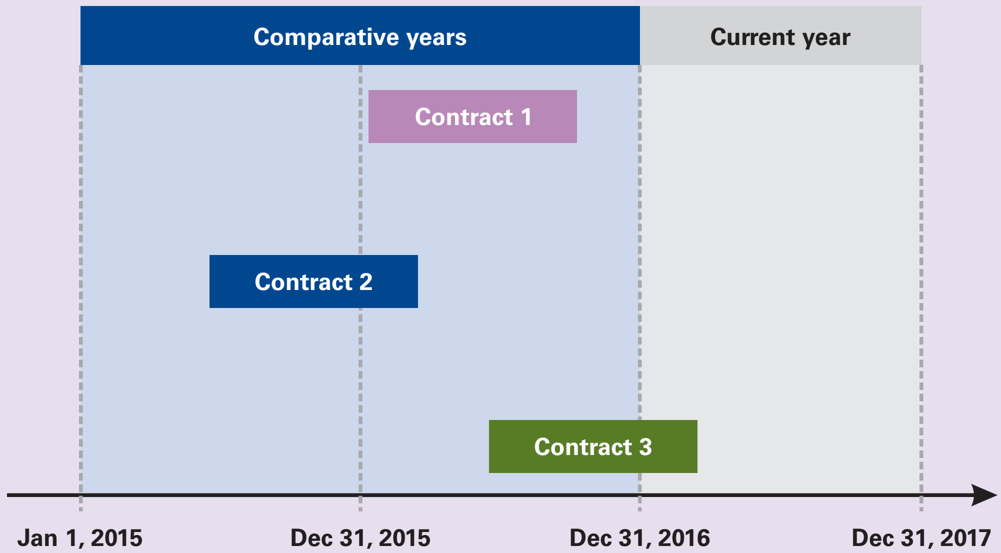
Contract timelines



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).

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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

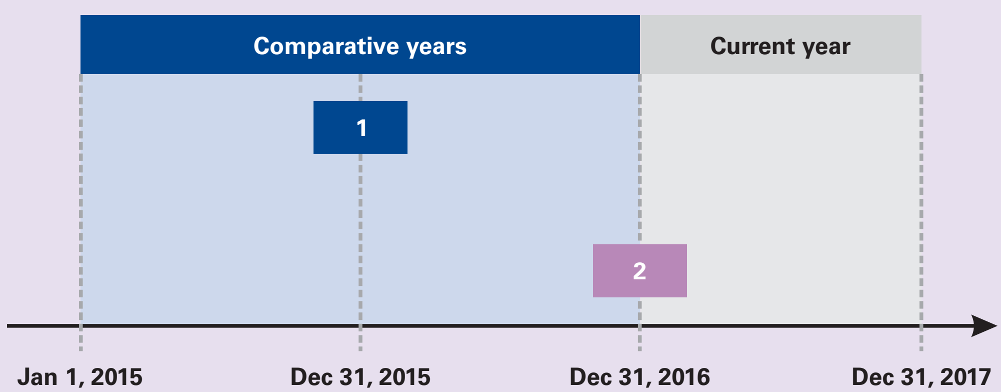
Manufacturer X enters into the following contracts.

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.

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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.

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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.

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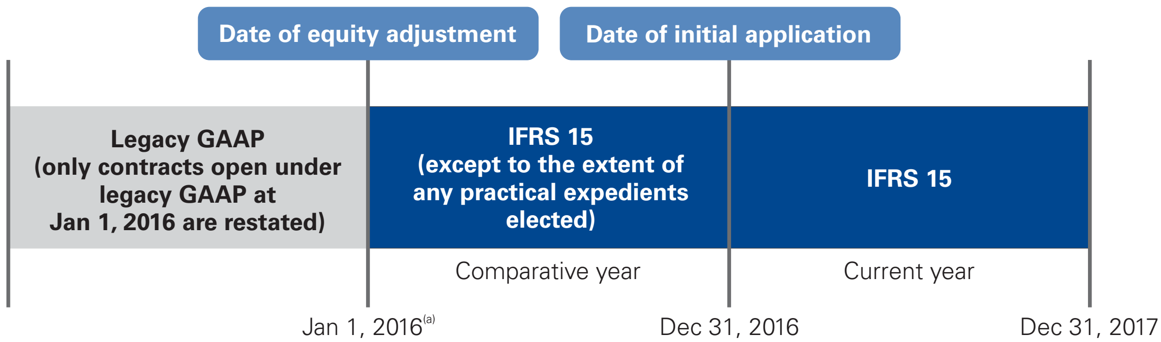
Timeline for a first-time adopter



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.

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- 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.

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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)

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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.

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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.

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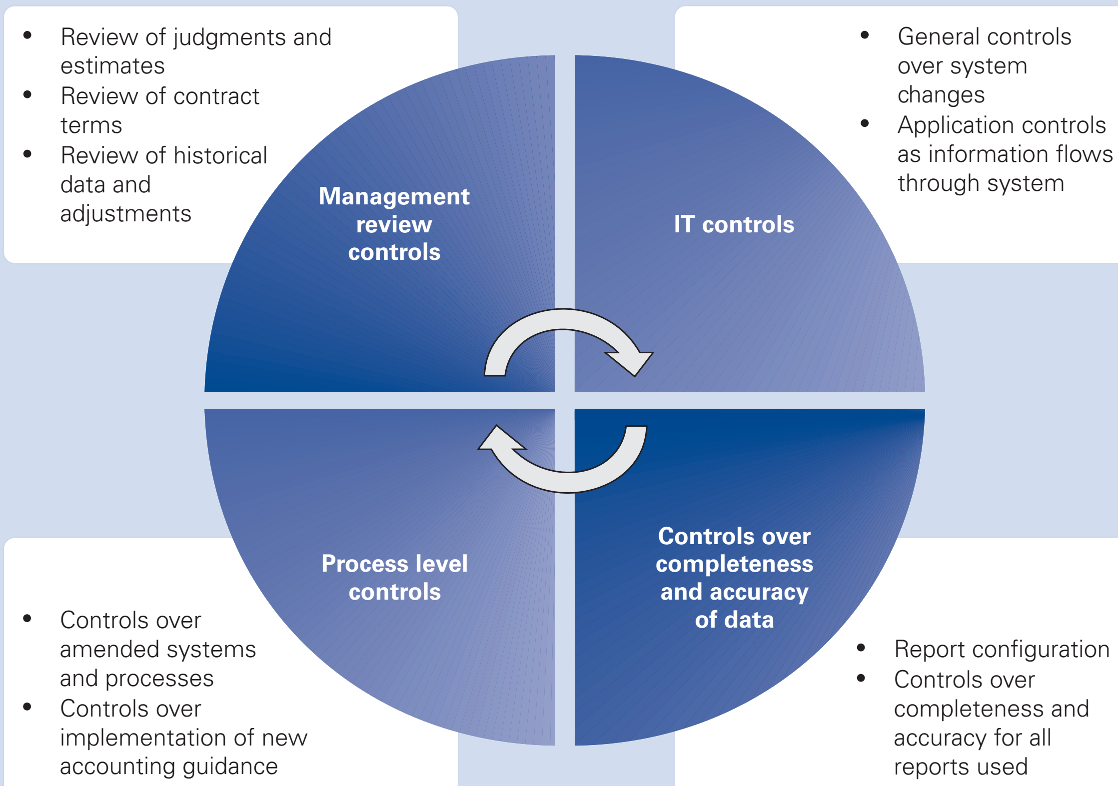
New risk points may arise from changes to IT systems and reports that provide data inputs used to support the new estimates and judgments. To the extent that data is needed in order to comply with the new standard, entities will need to consider the internal controls necessary to ensure the completeness 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.

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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

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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.

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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.

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Guidance referenced in this publication

IFRS guidance referenced in this publication	
The Conceptual Framework for Financial Reporting	
IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
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
IFRS 14	Regulatory Deferral Accounts
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FASB Statements of Financial Accounting Concepts	
Topic 250	Accounting Changes and Error Corrections
Topic 270	Interim Reporting
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Topic 310	Receivables
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Topic 340	Other Assets and Deferred Costs
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U.S. GAAP guidance referenced in this publication
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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Keeping you informed

More about U.S. GAAP

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.
Executive Education Sessions	Executive Education sessions are live, instructor-led continuing professional education (CPE) seminars and conferences in the United States that are targeted to corporate executives and accounting, finance, and business management professionals.

More about IFRS

Visit www.kpmg.com/ifrs to keep up to date with the latest developments in IFRS and browse our suite of publications. Whether you are new to IFRS or a current user of IFRS, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists. For a local perspective, follow the links to the IFRS resources available from KPMG member firms around the world.

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.

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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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Building a Bridge from Statement 66: Real Estate Sales Under the New Revenue Standard

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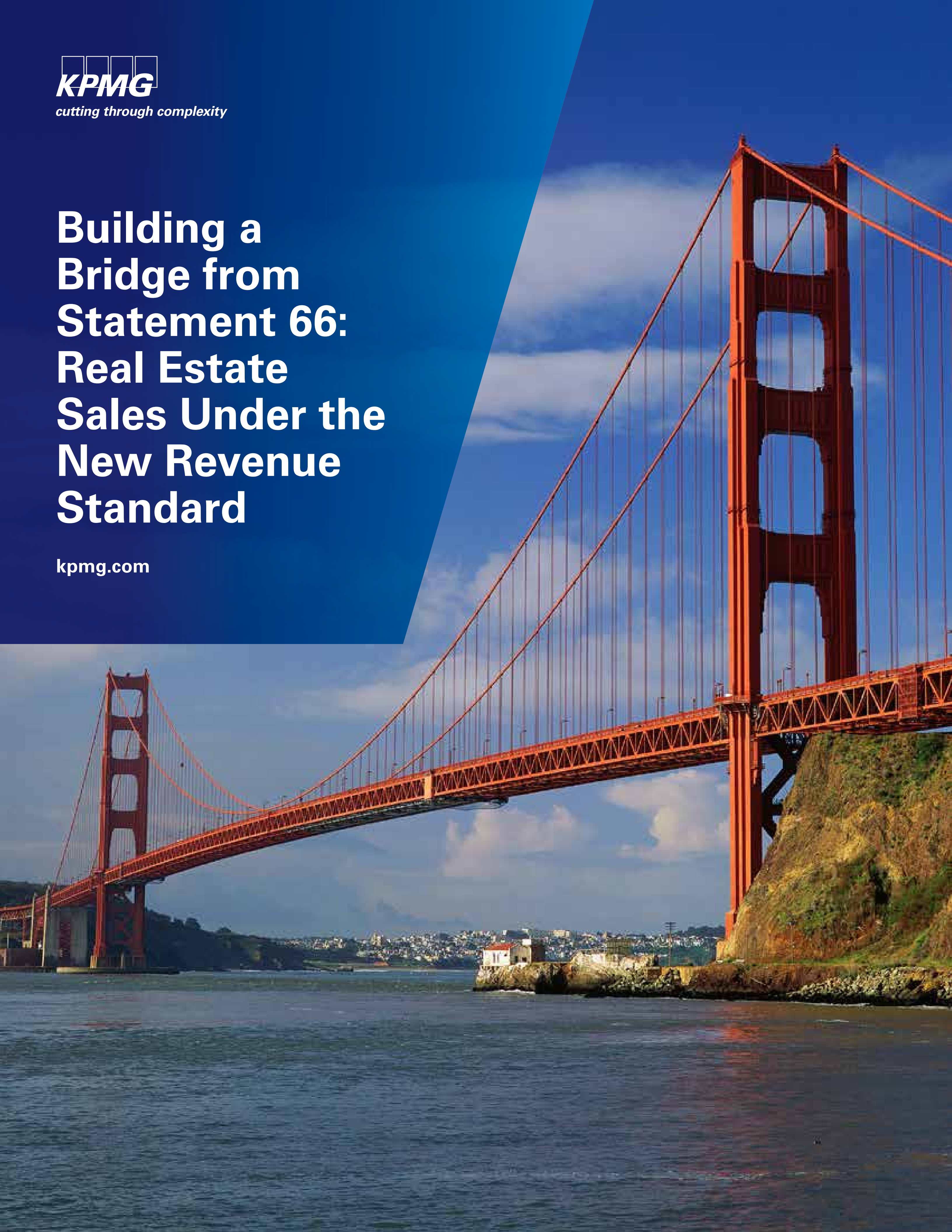

In May 2014, the IASB and the FASB published their new joint standard on revenue recognition. This replaces, among other things, most of the guidance on profit recognition for real estate sales that currently exists under U.S. GAAP. The 2017 effective date may seem a long way off (and the Boards are 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.

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[1] Issues In-Depth: Revenue from Contracts with Customers, available on KPMG's Financial Reporting Network at www.kpmg-institutes.com

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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.

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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).

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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.

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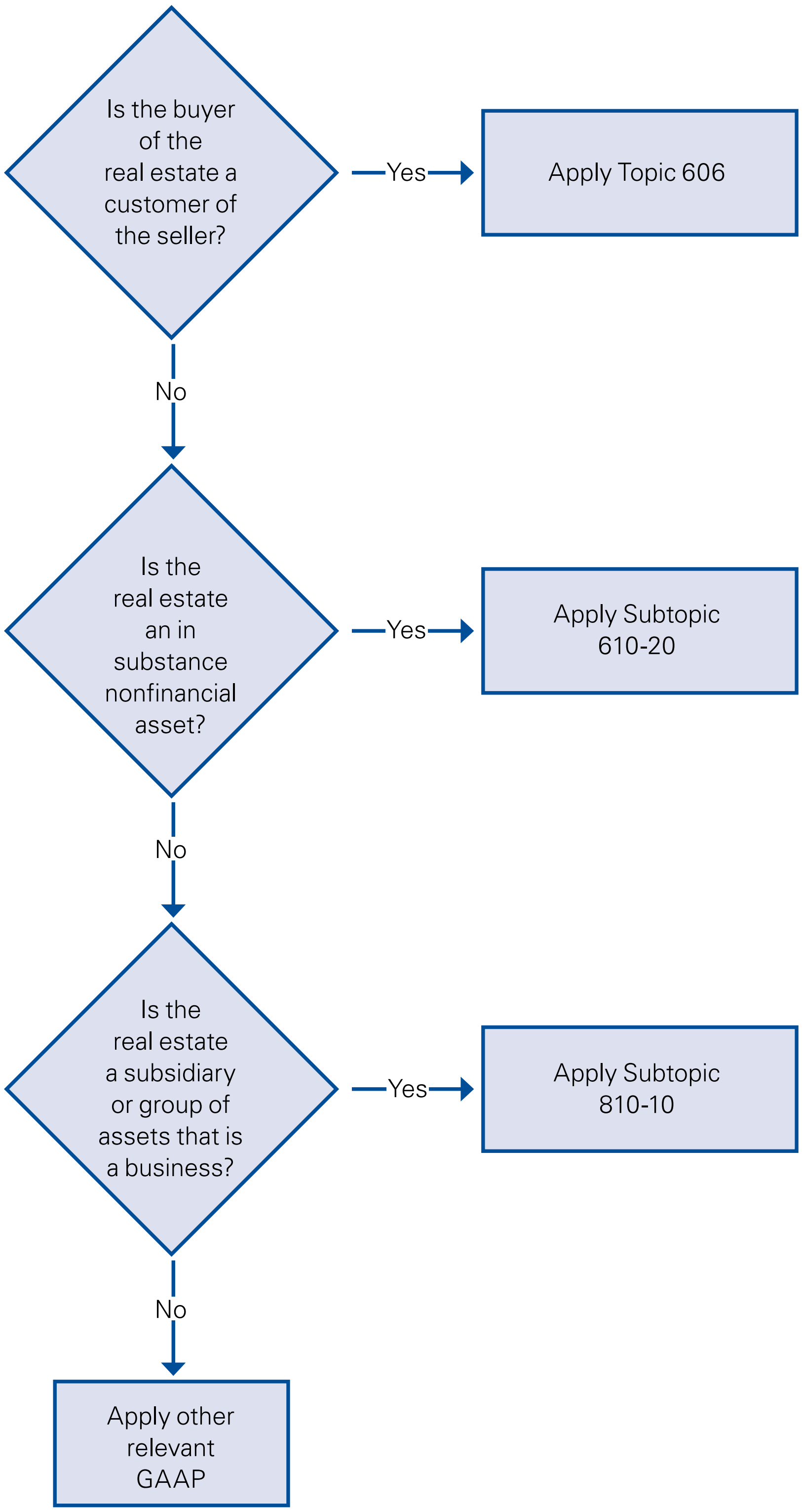
This flowchart depicts the decision sequence:



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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)).

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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.

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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).

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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.

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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).

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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.

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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).

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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.

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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.

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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.

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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.

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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.

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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).

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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.

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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.

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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**).

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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.

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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.

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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)).

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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.

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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.

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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.

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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).

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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.

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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.

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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.

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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).

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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).

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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.

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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.

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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

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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.

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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.

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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.

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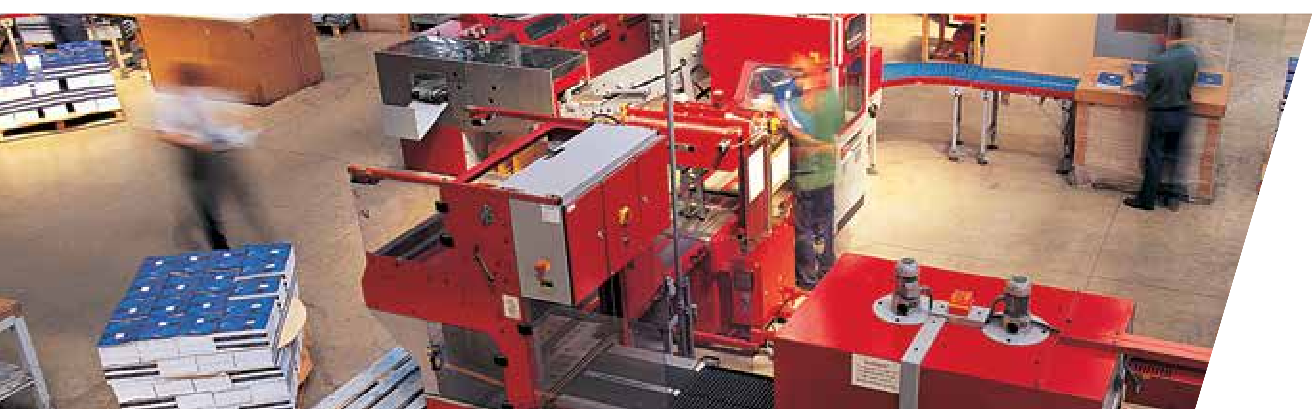
We believe in many standstill arrangements, all of the above criteria will be met, resulting in the conclusion that the lender would be deemed to have control even though the borrower maintains physical possession. In consideration of the last criterion, while the borrower continues to operate the property 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.



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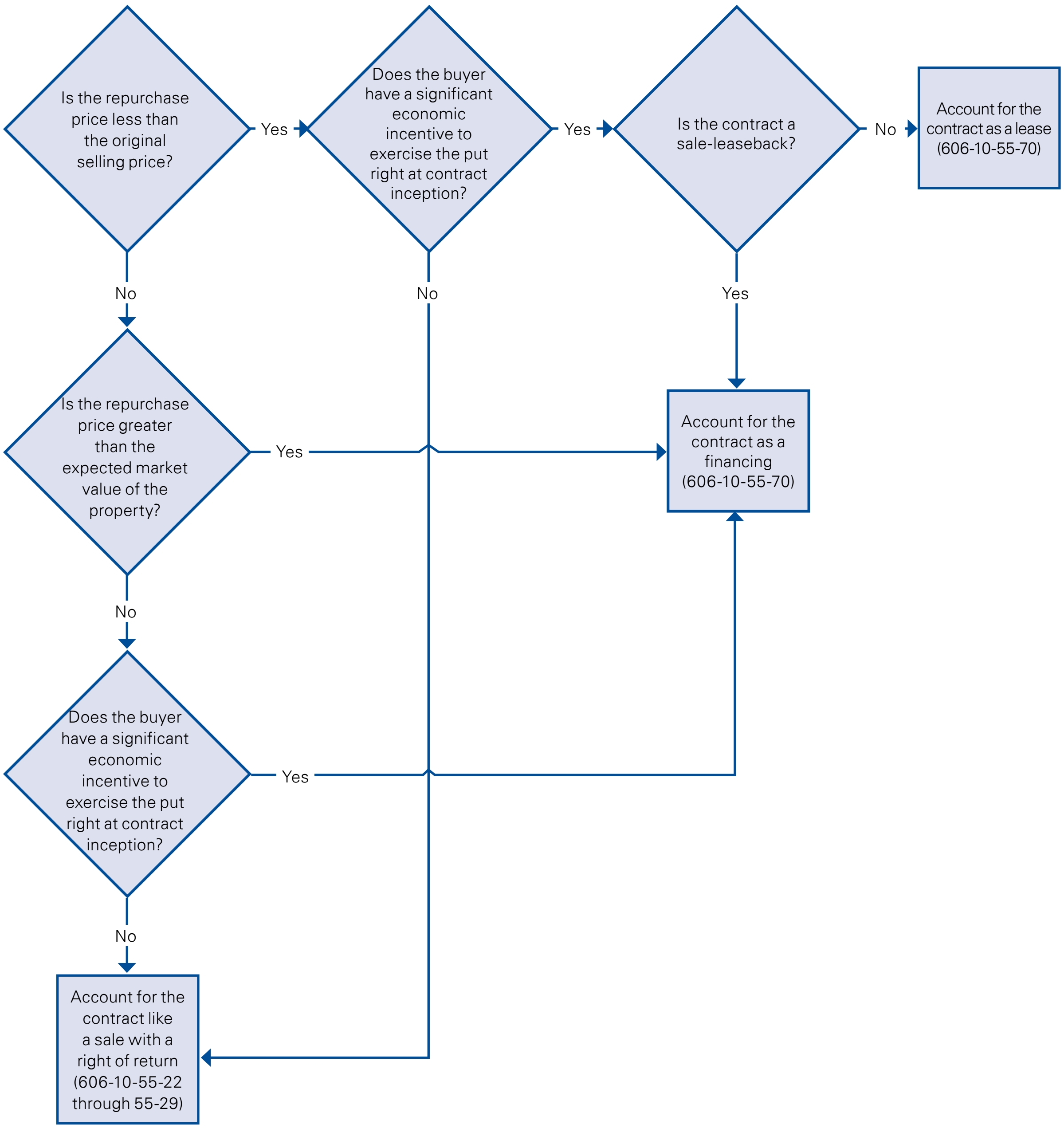
Question 5.6: Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller provides the buyer with an option to put the property back to the seller?

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:



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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.

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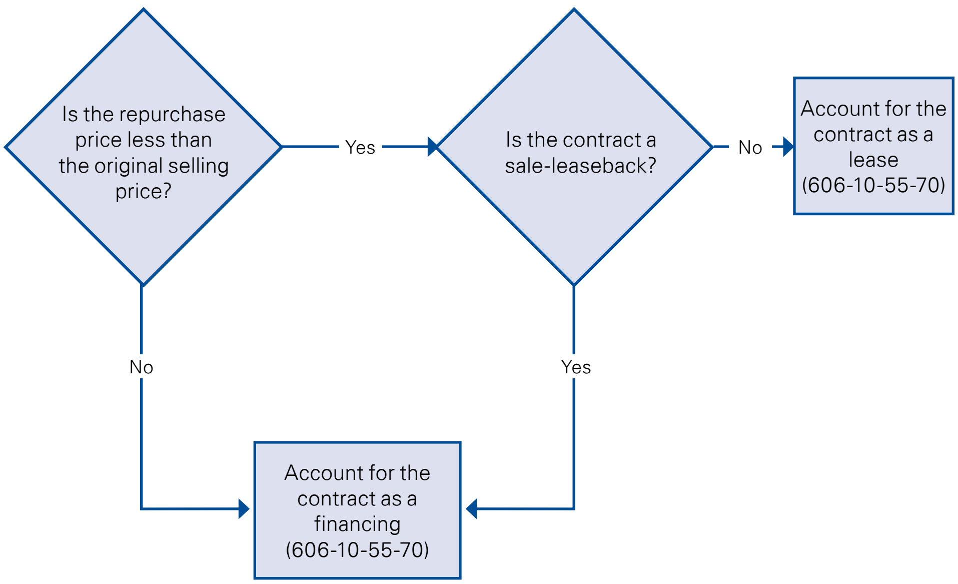
Question 5.7: Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller obtains the right to repurchase the property?

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

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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.

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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.

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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.

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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.

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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.

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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.

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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.

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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).

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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**.

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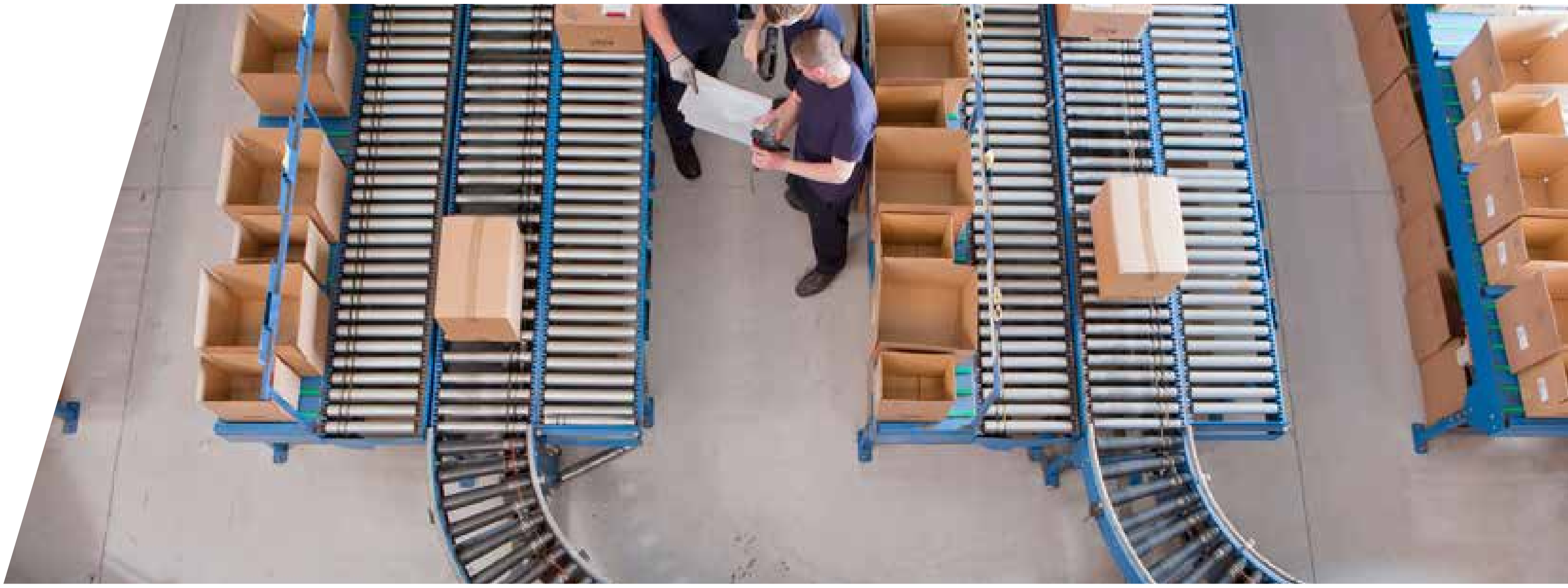
Question 5.12: What is the accounting consequence when a general partner in a limited partnership sells a property to the partnership for cash (contributed by the limited partners) and a significant receivable (i.e., a sale of a partial ownership interest in an entity that is considered in substance 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).



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Colony Financial, Inc.
Michael J. Schall
Essex Property Trust, Inc.
Doyle Simons
Weyerhaeuser
Wendy L. Simpson
LTC Properties, Inc.
James D. Taiclet, Jr.
American Tower Corporation
Amy L. Tait
Broadstone Net Lease, Inc.
Steven B. Tanger
Tanger Factory Outlet Centers, Inc.
Owen D. Thomas
Boston Properties, Inc.
Thomas W. Toomey
UDR, Inc.

July 25, 2014

Chairman Russell Golden
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Delivered Electronically

Subject: Lease Accounting Project, Accounting for Initial Direct Leasing Costs

Dear Chairman Golden:

The National Association of Real Estate Investment Trusts (NAREIT®) is submitting this unsolicited comment letter to provide the Financial Accounting Standards Board (FASB) its views on the financial reporting implications of the proposed accounting for initial direct leasing costs on companies that own, operate and lease portfolios of investment property.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $804 billion at May 31, 2014. Of these companies, 169 were equity REITs representing 91.2% of total U.S. listed REIT equity market capitalization (amounting to $733 billion)[1]. The remainder, as

[1] http://www.reit.com/sites/default/files/reitwatch/RW1406.pdf at page 21.

◆ ◆ ◆

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of May 31, 2014, was 40 publicly traded mortgage REITs with a combined equity market capitalization of $71 billion.

Implications of Recent Tentative Decision on "Initial Direct Costs"

At the joint meeting held on May 21, 2014, the Boards tentatively decided that "initial direct costs" should include only incremental costs that an entity would not have incurred if the lease had not been obtained (executed) (for example, commissions or payments made to existing tenants to obtain the lease). These costs could include external and certain internal costs but would not include allocations of internal costs, for example, regular salaries of employees engaged in arranging and negotiating leases.

The decision to allow the capitalization of *only* incremental costs represents a major change from existing U.S. GAAP and, in practice, IFRS. Currently, many companies capitalize all internal direct leasing costs provided that they are able to clearly identify those costs as directly attributable to obtaining successful lease agreements. The costs capitalized are not required to be incremental. Under the proposed accounting, significant internal costs of leasing may not be considered *incremental*. In our view, there is no conceptual basis for, in effect, accounting for direct *internal* leasing costs related to signed leases differently than direct *external* leasing costs.

The implication of no longer permitting the capitalization of a major portion of *direct* costs of internal efforts in securing tenant leases would have a significant detrimental impact on the operating results of NAREIT's member companies and potentially their share prices. This divergence of accounting for direct leasing costs between internal and external costs would clearly result in the lack of comparable operating results between companies having similar substantive leasing efforts despite similarity in economics. In the event that the Board continues in the direction of its May 21 decision, NAREIT is concerned that the proposed accounting standard would create structuring opportunities by encouraging companies to outsource their leasing function to third parties to achieve the most advantageous accounting result. Investors would be harmed if issuers undertake non-economic steps merely to achieve better financial statement results.

The Critical Nature of Leasing Investment Property

Leases generate rental revenue, which is the most important element in generating earnings, cash flow and in the valuation of an investment property. The cash flow from an investment property is the basis on which the property is valued and this property value directly impacts the share price of real estate investment trusts. See Exhibit I *REIT Valuation; The NAV-based Pricing Model* for a full discussion of the relationship between property cash flows (driven primarily by lease revenue), property values and the evaluation of share price.

Generally, a company will develop a leasing plan for each project. These plans identify spaces in each property that are or that will become vacant. With the help of market research, management assigns target rents for each space. Similarly, before making a decision to acquire or develop a property, management will evaluate the market and develop a leasing plan as a critical part of evaluating whether the project's cash flows will generate an adequate economic return.

These leasing plans are typically executed by the internal leasing staff; in some cases supplemented by external leasing resources. Achieving the leasing targets underlies the growth in operating performance of an investment property. Internal leasing staff is generally compensated at a base salary often plus bonuses based on achievement of overall leasing targets. These costs support the same business function as external leasing resources and are generally less costly and more effective than external leasing agents.

The critical nature of leasing in the effort to maximize returns from investment property is evidenced by the significant disclosures made by companies about the impact of leasing on future operating performance. These disclosures are contained in a REIT's Management's Discussion and Analysis, as well as in the company's supplemental reporting materials. See Exhibit II, *Duke Realty Supplemental Information* first quarter 2014, particularly the *Property Information* section, for an illustration of lease and tenant information generally included in a REIT's supplemental materials.

Because of the critical nature of leasing, most of NAREIT's member companies maintain internal leasing staff. They are an integral part of the management team and not simply hired guns with no long-term stake in the company's success. It would be a step backward in reporting the economics of investment property operating performance if the direct costs of this critical internal leasing staff were accounted for differently from the costs of external leasing resources, which, may not be aligned with the company's long-term success.

Further, it would be a very unfortunate result if the proposed accounting forced companies to abandon the most effective leasing structure (internal leasing staff) for a structure external to the management of the company or to dramatically change their compensation arrangements with their leasing staff in order to achieve a desired accounting outcome with limited change in overall economics. There seems to be three possible alternatives for structuring the leasing function under the FASB's most recent decision:

- Maintain current internal structure and expense a significant portion of the cost of internal leasing staff, even when direct efforts result in signed lease agreements;

- Maintain an internal structure but modify the compensation structure to pay staff based on a minimal base salary plus a commission for signed leases (we assume this arrangement would meet the *incremental* criteria for capitalizing leasing costs); or,

- Engage external leasing services, which our industry firmly believes may be less effective and more expensive, and therefore an economic drag on operating results.

NAREIT believes strongly that the proposed Leases standard, which was not intended to change the general model for lessor accounting, should not provide impetus for restructuring a REIT's leasing function to be able to properly capitalize all direct leasing costs.

Current Accounting for Internal Leasing Costs

While practice is mixed in some IFRS jurisdictions, most investment property companies in North America have developed systems to capture the cost of internal leasing effort *directly* related to signed leases. These costs are capitalized and amortized over the term of the related lease in accordance with the guidance in Topic 840 of the U.S. GAAP Accounting Standards Codification (ASC) and, as applied in practice, paragraph 38 of IAS 17, *Leases*.

ASC 840-20-25-18 states "The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease."

IAS 17 paragraph 38 states that "(I)nitial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease."

In Agenda paper 11A of the March 22-23, 2011 meeting of the IASB/FASB, the staff recommendation was "that *initial direct costs* should be defined as: Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made." It was also noted that "(V)ery little feedback about the definition of initial direct costs was received. The staff thinks that the definition in the ED is appropriate and **consistent with current lease guidance under Topic 840 and IAS 17. The staff notes that the proposed definition is not intended to change current practice for how initial direct costs are defined"** [emphasis added].

Absent the Board overturning its May 21, 2014 decision, it appears that the Boards will change current practice despite the intentions previously expressed by both the Boards and their respective staff. To emphasize, the current accounting practice that reflects the direct relationship between rental revenues and the cost to generate that revenue has been applied for decades and results in the most relevant measurement of operating performance of real estate companies and should be able to be continued.

The Boards' Due Process

NAREIT respectfully, but strongly, objects to the way in which the accounting for initial direct leasing costs was handled in the *Leases* project exposure drafts. The language used in the May 2013 Revised Exposure Draft (the Revised ED) was quite similar to the guidance in Topic 840, particularly when considering the implementation guidance. While Topic 840 did not use the word "incremental" to qualify leasing costs for capitalization, the definition of incremental was similar to the language in Topic 840, which allowed the capitalization of all direct internal costs related to signed leases.

In addition, some constituents were confused based on their view that the definition of initial direct costs in the Revised ED appeared to be inconsistent with the examples provided in the Implementation Guidance.

As a result, NAREIT believes that many constituents concluded that the standard would not change current accounting practice for initial direct leasing costs, and therefore, did not object to this guidance in the Revised ED. It seems as though the Boards have based a major decision on short-circuited constituent input.

IFRIC's Review of this Matter

NAREIT understands that the IFRS Interpretations Committee (IFRIC) discussed this matter in November 2013 and April 2014 and concluded, for a number of reasons, not to add the topic of accounting for *incremental costs* to its agenda. NAREIT is aware of two comment letters that discuss the practice of maintaining internal leasing staff and the basis for capitalizing the costs of all direct internal, as well as external, leasing resources. These letters are attached as Exhibit III (*i.e.*, Real Property Association of Canada (REALpac)) and Exhibit IV (*i.e.*, EY).

NAREIT's Recommendation: Develop a Comprehensive and Consistent Accounting Standard for Costs (both Direct and Indirect).

NAREIT understands that the accounting treatment for costs is an area that varies widely within U.S. GAAP. Costs come in varying types and definitions (*e.g.*, commitment fees, credit card fees and costs, loan syndication fees, loan origination fees and direct loan origination costs, interest costs, insurance acquisition costs, costs of acquiring non-financial assets, etc.) and U.S. GAAP permits capitalization of costs in certain circumstances.

Given the wide diversity of accounting treatment for cost within U.S. GAAP, NAREIT recommends that the FASB forgo further evaluation of accounting for initial direct cost within the *Leases* project. In our view, a robust and comprehensive analysis of cost accounting treatment that would cut across all GAAP literature should be added to the FASB's agenda. We believe that this project would provide a comprehensive cost accounting model and eliminate inconsistencies as a result of dealing with costs on a piece-meal basis in future standard setting.

We offer the following citations as examples of the spectrum of accounting models for capitalizing and expensing costs:

Costs that are Fully Capitalized

The following excerpt is taken from ASC *Property, Plant and Equipment*.

> ASC 360-10-30-1 Paragraph 835-20-05-1 states that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. As indicated in that paragraph, if an asset requires a period of time in which to carry out the activities

> necessary to bring it to that condition and location, **the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset** [emphasis added].

The following excerpt is taken from the *Financial Instruments – Recognition and Measurement* 2013 Proposal. NAREIT observes that there is no proposed change from current GAAP for loan origination costs. We also note that it appears that the Boards are treating direct finance leases in a different manner when they are economically similar to a loan.

> Direct Loan Origination Costs
>
> Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:
>
> a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
>
> b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
>
> 1. Evaluating the prospective borrower's financial condition
> 2. Evaluating and recording guarantees, collateral, and other security arrangements
> 3. Negotiating loan terms
> 4. Preparing and processing loan documents
> 5. Closing the transaction.
>
> The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

The following excerpt is taken from the *Insurance Contracts* Proposal.

> ASC 944-30-25-1 An insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:
>
> a. Incremental direct costs of contract acquisition

b. The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

1. Underwriting

2. Policy issuance and processing

3. Medical and inspection

4. Sales force contract selling.

c. Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.

d. Advertising costs that meet the capitalization criteria in paragraph 340-20-25-4.

Costs that are Partially Capitalized

The following excerpt is taken from ASC *Receivables*.

ASC 310-20-25-6 **Bonuses based on successful production of loans that are paid to employees involved in loan origination activities are partially deferrable as direct loan origination costs** under the definition of that term. Bonuses are part of an employee's total compensation. The portion of the employee's total compensation that may be deferred as direct loan origination costs is the portion that is directly related to time spent on the activities contemplated in the definition of that term and results in the origination of a loan [emphasis added].

The following excerpts are taken from the recently issued *Revenue from Contracts with Customers* Standard.

ASC 340-40-55-1 Example 1 illustrates the guidance in paragraphs 340-40-25-1 through 25-4 on incremental costs of obtaining a contract, paragraphs 340-40- 25-5 through 25-8 on costs to fulfill a contract, and paragraphs 340-40-35-1 through 35-6 on amortization and impairment of contract costs.

> > > Example 1—Incremental Costs of Obtaining a Contract
340-40-55-2 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$50,000

> 340-40-55-3 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.
>
> 340-40-55-4 The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

Costs that are Fully Expensed

The following excerpt is taken from ASC *Business Combinations*.

> ASC 805-10-25-23 Acquisition-related costs are costs the acquirer incurs to effect a business combination. These costs include finder's fees; advisory, legal, accounting, valuation, and other professional and consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. **The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received**, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP [emphasis added].

Conclusion

NAREIT objects to the Board's conclusion with respect to initial direct leasing costs, and respectfully requests that the Board reverse the decision in order to preserve current practice. On numerous occasions, the Board has asserted that the intention was not to change current lessor accounting; however, the Board's decision with respect to leasing costs would change the accounting by many lessors of investment property. As we have said in our previous letters to the Boards, we do not believe that current lessor accounting model is broken, and fail to see the reason to create inconsistent accounting results between significant direct internal and external leasing costs that do not reflect the underlying economics of obtaining successful lease agreements.

NAREIT would like to meet with the Board to discuss our views in greater detail. Please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432 to arrange a time for this meeting. If you have questions regarding this letter, please contact George Yungmann or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

cc: Chairman Hans Hoogervorst
International Accounting Standards Board

Exhibit I

REIT Valuation
The NAV-based Pricing Model

Green Street Advisors

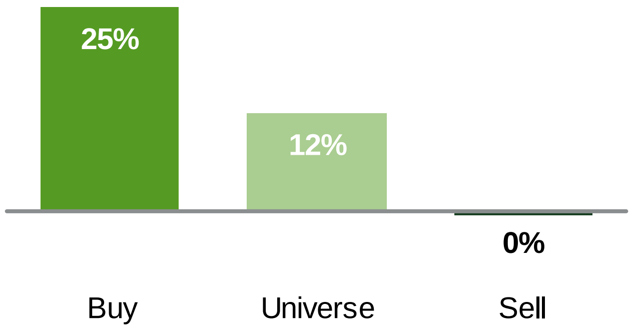
It's All Relative

Our NAV-based Pricing Model has served as the backbone of our stock selection process for over twenty years. The model is designed to assess relative valuations; i.e., it identifies the REITs that are most/least attractively valued.

The model combines NAV – a great starting point and high quality estimates are essential – with the factors that impact the premiums at which REITs should trade: franchise value, balance sheet risk, corporate governance, and overhead. The compartmentalized nature of the model forces discipline to consider all relevant valuation issues.

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

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This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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Executive Summary

Overview

- Our NAV-based pricing model has been a driver of our stock recomendations for over twenty years
- It has played an instrumental role in our successful recommendation track record
- The compartmentalized nature of the model forces discipline to consider all relevant valuation issues

The Basics

- NAV is the starting point - the value of a REIT is a function of the value of the assets it owns
- Warranted share price = NAV plus or minus a premium for future value added by management
- Franchise value, balance sheet risk, corporate governance and G&A impact the size of the premium
- It is a relative valuation model: roughly equal number of Buys and Sells at all times
- Relative approach anchors around average sector premiums at which REITs trade

The Components

- Franchise values are inherently subjective, but objective inputs help
  - Management Value Added (MVA) shines a bright light on performance attributable to mgm't
  - Total returns relative to peers are also important
  - Balance sheet acumen scores give credit for broad financing menus and low debt costs
- Balance sheets are important; less leverage is better
  - REITs with less leverage have delivered far better returns
  - Investors usually ascribe higher NAV premiums to REITs with low leverage
- Corporate Governance scoring system ranks REITs in a systematic fashion
- The impact of G&A is readily quantified and is dealt with apart from the other factors
  - Differences in G&A are large; they warrant large differences in unlevered asset value premiums

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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

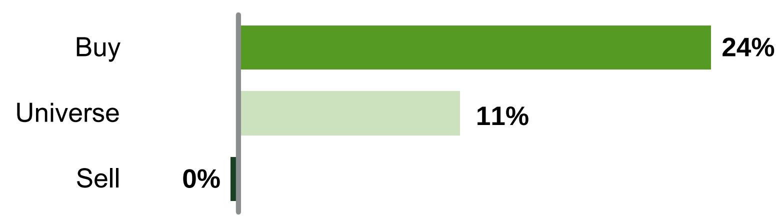
NAV-Based Pricing Model

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

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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."

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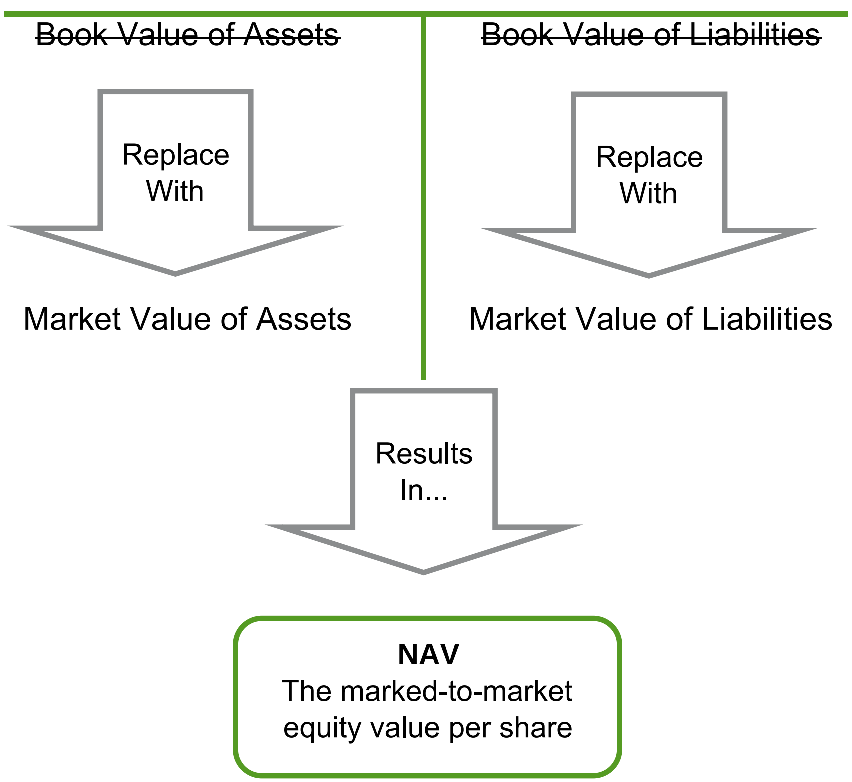
Overview: What is NAV?

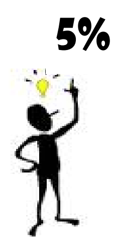
Mark It to Market: An NAV-based valuation methodology is only as good as the underlying estimate of NAV. High-quality estimates of marked-to-market asset value require a great deal of effort and resources, but the estimate can be reasonably precise when done properly. It is also important to mark-to-market 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.

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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.

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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.

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This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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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

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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.

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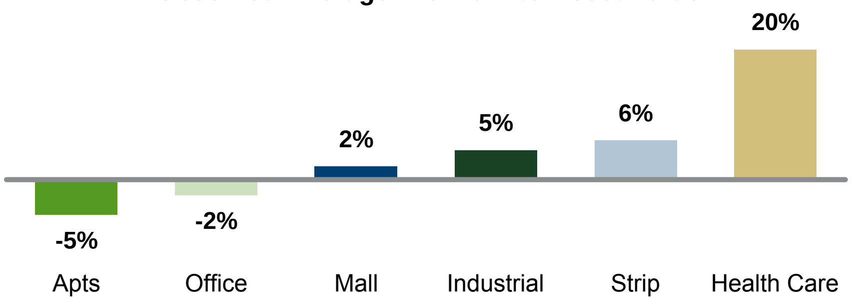
Overview: The Influence of Property Sectors

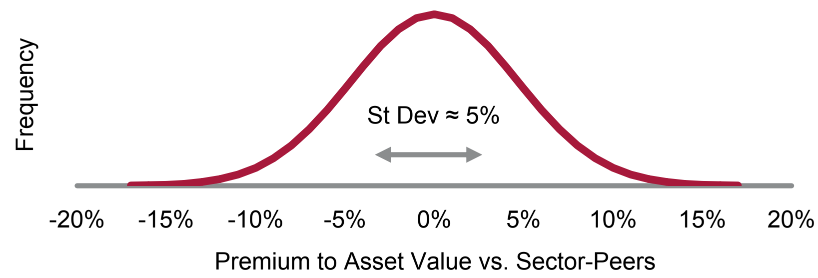
A Normal World: The starting point in calculating the warranted premium for any REIT is the sector-average premium ascribed by the market at current share prices. An assumption is made that the dispersion of observed premiums for the entirety of our coverage universe serves as a good indicator of how 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

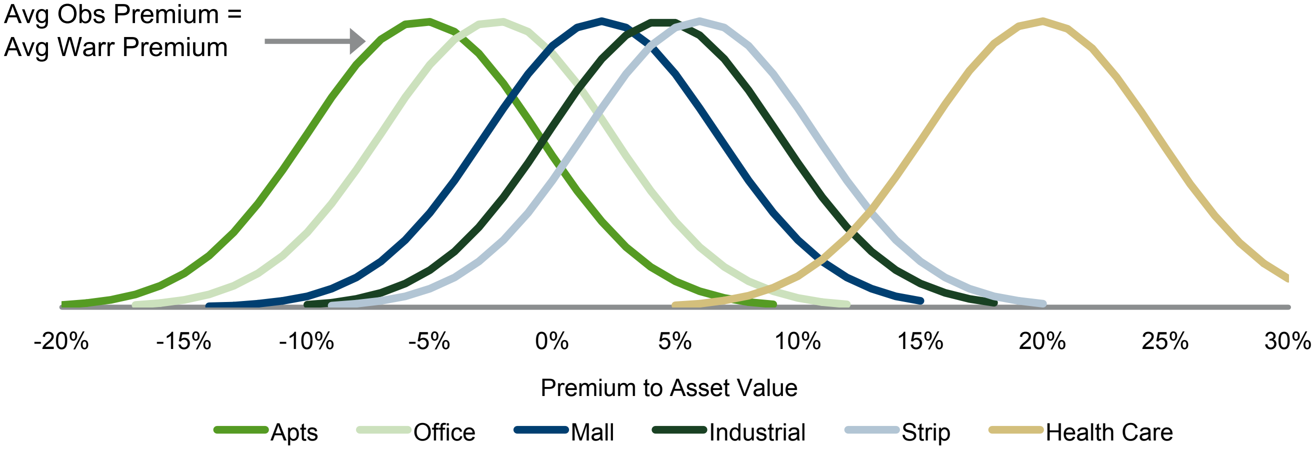


Dispersion of Observed Premiums - All REITs



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.

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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

Management Value Added (MVA)

Total Returns to Shareholders

Balance Sheet Management

Balance Sheet Acumen Score

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.

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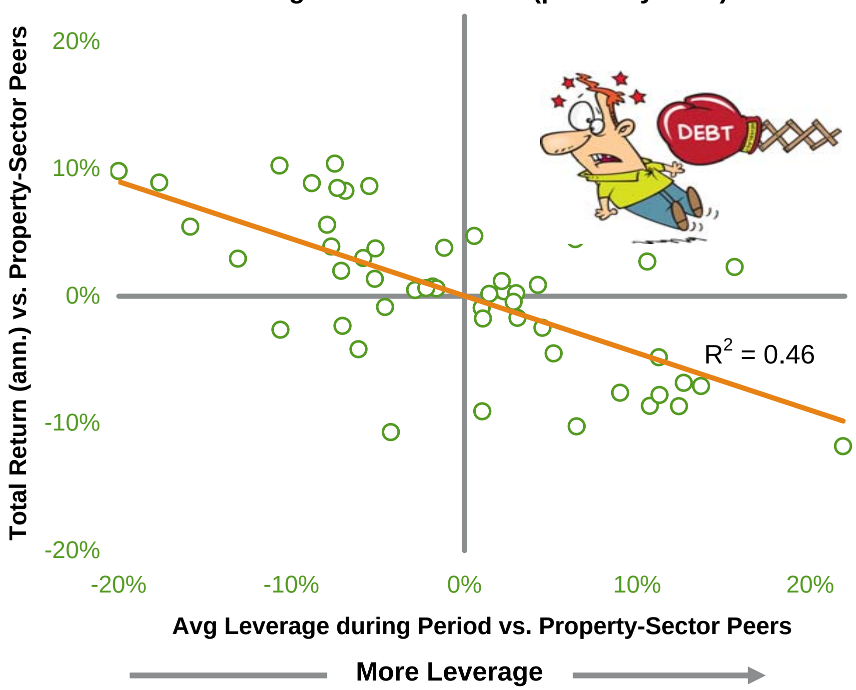
This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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.

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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.

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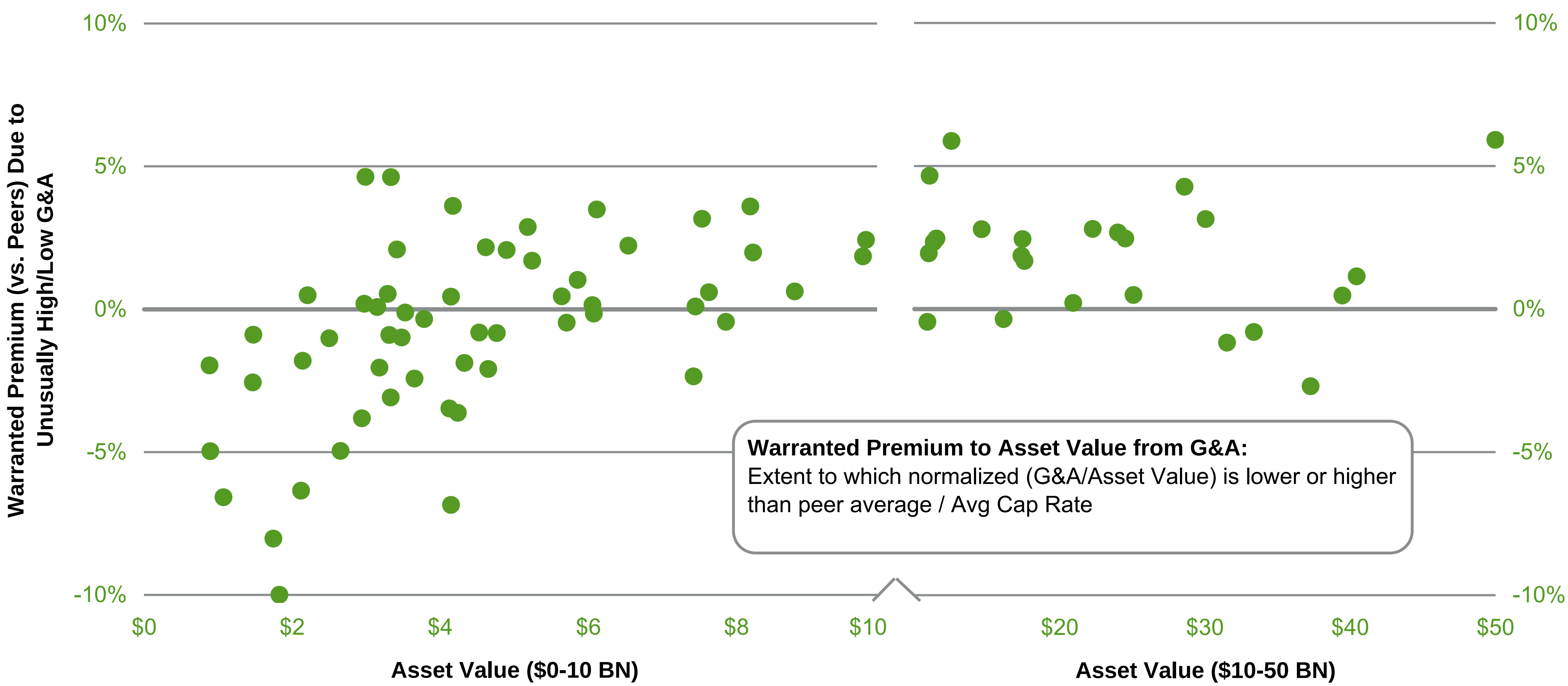
Overhead: A Strong Connection with Size

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



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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.

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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.

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Frequently Asked Questions (continued)

Q. NAV is a backward looking metric.

A. Real estate markets are active and liquid, and when buyers and sellers agree on deal terms (e.g., cap rates, price/square foot, etc.), those terms reflect their views of future prospects. When prevailing cap rates are applied to a REIT's forward-looking NOI estimate, the result is an estimate of value that is as forward looking as any other approach toward valuing stocks.

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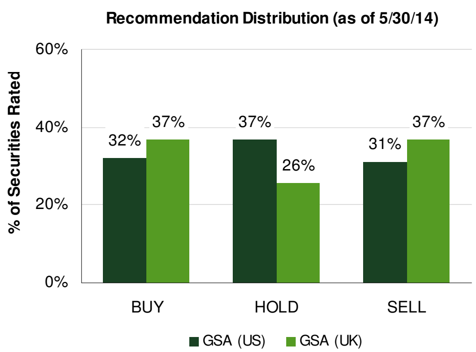
- Unless otherwise indicated, Green Street reviews all investment recommendations on at least a monthly basis.
- The research recommendation contained in this report was first released for distribution on the date identified on the cover of this report.
- Green Street will furnish upon request available 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

Exhibit II

SUPPLEMENTAL INFORMATION

FIRST QUARTER 2014

Duke REALTY

RELIABLE. ANSWERS.

Exhibit II

Duke REALTY

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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.

Exhibit II

Summary of Unsecured Public Debt Covenants

Covenant	Threshold	First Quarter '14	Fourth Quarter '13	Third Quarter '13	Second Quarter '13
Total Debt to Undepreciated Assets	<60%	48%	47%	49%	48%
Debt Service Coverage	>1.5x	2.5	2.5	2.4	2.3
Secured Debt to Undepreciated Assets	<40%	14%	14%	14%	15%
Undepreciated Unencumbered Assets to Unsecured Debt	>150%	217%	221%	215%	216%

Note: The ratios are based upon the results of Duke Realty Limited Partnership, the partnership through which Duke Realty conducts its operations, using calculations that are defined in the trust indenture.

	Three Months Ended		
Unencumbered Consolidated Assets	**March 31, 2014**		**March 31, 2013**
Number of properties	468	(1)	460
Total square feet (in thousands)	85,796	(1)	78,495
Gross book value (in thousands)	$6,091,021	(1)	$5,624,287
Annual stabilized NOI (in thousands)	$538,407	(1)	$517,895

(1) Excludes 23 wholly owned properties under development at March 31, 2014 which will be unencumbered upon completion. These properties totaled approximately 5.8 million square feet with total anticipated stabilized project costs of more than $568.3 million and anticipated stabilized NOI of more than $43.5 million.

Exhibit II

Owned Property Occupancy Analysis

(*SF in thousands*)

	March 31, 2013			June 30, 2013			September 30, 2013			December 31, 2013			March 31, 2014		
	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased
Stabilized or In Service Geater Than One Year:															
Bulk Distribution	481	110,458	94.0%	494	117,155	95.2%	495	118,909	95.4%	495	120,150	95.8%	487	120,539	95.2%
Suburban Office	176	20,131	84.5%	177	20,508	86.5%	177	20,507	87.2%	165	19,073	87.8%	165	19,172	88.1%
Medical Office	69	5,417	91.3%	72	5,563	93.0%	73	5,578	93.9%	63	5,298	93.7%	64	5,312	93.7%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	732	137,334	92.4%	748	144,163	93.8%	750	145,931	94.2%	728	145,458	94.6%	721	145,959	94.2%
Unstabilized and In Service Less Than One Year: (1)															
Bulk Distribution	1	421	0.0%	2	1,021	0.0%	2	1,021	0.0%	2	1,021	33.6%	1	600	57.2%
Suburban Office	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Medical Office	1	52	52.0%	1	52	61.0%	1	52	58.1%	-	-	-	-	-	-
Retail	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	2	473	5.7%	3	1,073	3.0%	3	1,073	2.8%	2	1,021	33.6%	1	600	57.2%
Total In-Service Portfolio:															
Bulk Distribution	482	110,879	93.6%	496	118,176	94.4%	497	119,930	94.6%	497	121,171	95.3%	488	121,139	95.0%
Suburban Office	176	20,131	84.5%	177	20,508	86.5%	177	20,507	87.2%	165	19,073	87.8%	165	19,172	88.1%
Medical Office	70	5,469	90.9%	73	5,615	92.7%	74	5,630	93.6%	63	5,298	93.7%	64	5,312	93.7%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	734	137,807	92.1%	751	145,237	93.2%	753	147,004	93.5%	730	146,479	94.2%	722	146,559	94.0%
Properties Under Development:															
Bulk Distribution	7	3,396	75.3%	3	1,936	87.6%	3	826	70.9%	10	4,854	89.8%	15	6,673	85.5%
Suburban Office	3	703	92.8%	2	406	75.8%	3	611	84.6%	3	652	81.5%	2	452	83.2%
Medical Office	13	1,021	100.0%	13	988	100.0%	12	817	100.0%	11	590	93.0%	8	397	89.6%
Retail	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	23	5,120	82.6%	18	3,331	89.8%	18	2,253	85.2%	24	6,095	89.2%	25	7,522	85.6%
Total Portfolio:															
Bulk Distribution	489	114,275	93.1%	499	120,112	94.3%	500	120,756	94.5%	507	126,025	95.0%	503	127,812	94.5%
Suburban Office	179	20,835	84.8%	179	20,915	86.3%	180	21,117	87.2%	168	19,724	87.6%	167	19,624	88.0%
Medical Office	83	6,491	92.4%	86	6,604	93.8%	86	6,447	94.4%	74	5,888	93.6%	72	5,709	93.4%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	757	142,928	91.8%	769	148,567	93.1%	771	149,257	93.4%	754	152,574	94.0%	747	154,081	93.6%

Note: Percentage leased numbers are shown on a lease-up basis. Lease-up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Joint Ventures are included at 100%.

(1) Includes development projects placed in-service less than 1 year that have not reached 90% occupancy.

Exhibit II

Historical Occupancy Summary

(SF in thousands)

	Properties in Service (1)		Under Development		Total Portfolio	
	Total Square Feet	Percent Leased	Total Square Feet	Percent Leased	Total Square Feet	Percent Leased
December 31, 2002	105,196	87.1%	3,058	79.5%	108,254	86.8%
December 31, 2003	106,220	89.3%	2,813	72.6%	109,033	88.9%
December 31, 2004	109,987	90.9%	4,228	59.2%	114,215	89.7%
December 31, 2005	98,671	92.5%	9,005	41.7%	107,676	88.3%
December 31, 2006	110,629	92.9%	10,585	33.8%	121,214	87.7%
December 31, 2007	116,323	92.0%	16,578	50.7%	132,901	86.9%
December 31, 2008	131,049	88.8%	4,021	46.4%	135,070	87.6%
December 31, 2009	133,829	87.4%	1,620	70.0%	135,449	87.2%
December 31, 2010	136,735	89.1%	2,741	88.5%	139,476	89.1%
December 31, 2011	135,590	90.7%	913	89.1%	136,503	90.7%
December 31, 2012	141,196	93.0%	4,446	73.5%	145,642	92.4%
December 31, 2013	146,479	94.2%	6,095	89.2%	152,574	94.0%
March 31, 2014	146,559	94.0%	7,522	85.6%	154,081	93.6%

Note: Percentage leased numbers are shown on a lease-up basis. Lease-up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Joint Ventures are included at 100%.

(1) Includes unstabilized developments that have reached shell completion.

Exhibit II

FFO and NOI Reconciliation

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Core Funds from Operations - Diluted (page 9)	**$93,183**	$83,197
Add back: Interest expense, continuing operations	**55,257**	57,181
Add back: Interest expense, discontinued operations	**382**	4,260
Add back: Dividends on preferred shares	**7,037**	9,550
Less: Company share of joint venture depreciation, amortization and other	**(6,396)**	(7,629)
Add back: Noncontrolling interest in consolidated joint ventures	**84**	206
Core EBITDA, Prior to Adjustments for Joint Ventures (page 11)	**$149,547**	$146,765
Less: General contractor and service fee revenue, net of related expenses	**(8,549)**	(9,063)
Add back: General and administrative expenses	**14,694**	13,145
Add back: Undeveloped land carrying costs	**2,124**	2,198
Add back: Other operating expenses	**92**	68
Add back: Gains (losses) on depreciable property sales - Company's share of JV	**(165)**	48,814
Less: Equity in earnings	**(2,321)**	(49,378)
Less: Interest and other income	**(351)**	(153)
Less: Revenues not allocable to operating segments	**(979)**	(1,197)
Add back: Rental expenses and real estate taxes not allocable to operating segments	**1,671**	886
Wholly Owned Property Level NOI	**$155,763**	$152,085
Less: Revenues from discontinued operations	**(1,368)**	(16,404)
Add back: Rental expenses and real estate taxes from discontinued operations	**913**	5,986
Wholly Owned Property Level NOI from Continuing Operations	**$155,308**	$141,667
Adjustments to rental revenues (1)	**(5,549)**	(3,332)
Sold assets not in discontinued operations	**96**	(2,767)
Wholly Owned Property Level NOI - Cash Basis (page 17)	**$149,855**	$135,568
Proforma property level NOI adjustments - wholly owned properties (2)	**1,140**	388
Property level NOI - cash basis (share of JV properties)	**12,342**	11,256
Total Proforma Property Level NOI - Cash Basis (Page 17)	**$163,337**	$147,212

(1) Represents adjustments for straight line rental income and expense, amortization of above and below market rents, amortization of lease concessions, intercompany rents and termination fees.

(2) NOI is adjusted to reflect a full quarter of operations for properties that were placed in service or acquired during the quarter.

Exhibit II

Net Operating Income by Product Type

(dollars and SF in thousands)

	Bulk Distribution	Suburban Office	Medical Office	Retail	Total	
Total Wholly Owned and Joint Venture In-Service Portfolio						
Rental revenues from continuing operations	$134,002	$66,972	$33,310	$2,087	$236,371	(1)
Adjustments to rental revenues	(3,874)	(1,636)	97	(136)	(5,549)	(2)
Sold assets not in discontinued operations	-	10	86	-	96	(3)
Adjusted rental revenues	130,128	65,346	33,493	1,951	230,918	
Rental and real estate tax expenses from continuing operations	(38,219)	(29,082)	(12,916)	(846)	(81,063)	(4)
Wholly owned property level NOI-cash basis (PNOI)	91,909	36,264	20,577	1,105	149,855	
Proforma property level NOI adjustments- wholly owned properties	44	185	911	-	1,140	(5)
Wholly owned pro-forma property level NOI-cash basis	$91,953	$36,449	$21,488	$1,105	$150,995	
Property level NOI- cash basis (share of JV properties)	4,767	5,362	1,222	991	12,342	(6)
Total pro-forma property level NOI- cash basis	$96,720	$41,811	$22,710	$2,096	$163,337	
NOI % by product type	59%	26%	14%	1%		
Number of properties	486	165	63	5	719	(7)
Total square footage at 100%	120,576	19,172	5,255	937	145,939	(7)
Total square footage at economic ownership %	109,472	15,976	4,732	718	130,897	(7)
Average commencement occupancy for the three months ended 3/31/14	92.9%	86.4%	90.2%	84.9%	91.9%	(8)
Ending lease up occupancy at 3/31/14	95.0%	88.1%	93.6%	87.6%	94.0%	(9)

Note: **NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31,2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.**

Note: **See page 19 for further detail regarding the composition of our in-service portfolio.**

Note: **Three properties are classified as held for sale, and treated as discontinued operations, at March 31, 2014 and, as such, are not included in the schedule above. These properties generated $729 of NOI during the three months ended March 31, 2014 and had a gross basis of $39,339 as of March 31, 2014.**

(1) Rental revenues from continuing operations as included in the segment reporting disclosures in the notes to our consolidated financial statements. Revenues not allocated to reportable segments, which are not included above, totaled $979 for the three months ended March 31, 2014.

(2) Represents adjustments for straight line rental income and expense, amortization of above and below market rents, amortization of lease concessions, intercompany rents and lease termination fees.

(3) Represents properties that were sold but not included in discontinued operations due primarily to ongoing property management agreements.

(4) Rental and real estate taxes as used in the computation of PNOI from the segment reporting disclosures in the notes to our consolidated financial statements. Rental expenses and real estate taxes not allocated to reportable segments, which are not included above, totaled $1,671 for the three months ended March 31,2014.

(5) NOI is adjusted to reflect a full quarter of operations for properties that were placed in service or acquired during the quarter.

(6) NOI for joint venture properties is presented at Duke's effective ownership percentage.

(7) Number of properties, total square footage at 100% and total square footage at economic ownership % exclude two industrial buildings (563,000 SF) and one medical office building (57,000 SF) that are held for sale and included in discontinued operations.

(8) Commencement occupancy represents the percentage of total square feet where the leases have commenced.

(9) Lease up occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Exhibit II

Net Operating Income

(dollars and SF in thousands)

	Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Stabilized Properties Generating Positive NOI (1)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ 97,928	$ 42,688	$ 22,710	$ 2,096	$ 165,421
Gross book value (4)	$4,868,181	$2,099,676	$ 1,233,091	$209,983	$8,410,931
Number of properties	465	154	63	5	687
Average age	11.8	14.9	6.1	8.0	11.9
Total square footage at 100%	116,096	18,110	5,254	937	140,396
Total square footage at economic ownership %	105,309	14,949	4,732	718	125,708
Average commencement occupancy for the three months ended 3/31/14	95.4%	88.3%	90.2%	84.9%	94.2%
Lease up occupancy at 3/31/14	96.6%	90.1%	93.6%	87.6%	95.6%
Stabilized Properties with Negative NOI (2)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ (1,185)	$ (877)	N/A	N/A	$ (2,063)
Gross book value (4)	$ 187,812	$ 113,590	N/A	N/A	$ 301,402
Number of properties	20	11	N/A	N/A	31
Average age	8.7	20.0	N/A	N/A	11.2
Total square footage at 100%	3,880	1,063	N/A	N/A	4,943
Total square footage at economic ownership %	3,863	1,026	N/A	N/A	4,890
Average commencement occupancy for the three months ended 3/31/14	23.8%	53.1%	N/A	N/A	30.1%
Lease up occupancy at 3/31/14	52.3%	54.0%	N/A	N/A	52.7%
Unstabilized Properties (3)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ (21)	N/A	N/A	N/A	$ (21)
Gross book value (4)	$ 9,543	N/A	N/A	N/A	$ 9,543
Number of properties	1	N/A	N/A	N/A	1
Average age	0.8	N/A	N/A	N/A	0.8
Total square footage at 100%	600	N/A	N/A	N/A	600
Total square footage at economic ownership %	300	N/A	N/A	N/A	300
Average commencement occupancy for the three months ended 3/31/14	57.2%	N/A	N/A	N/A	57.2%
Lease up occupancy at 3/31/14	57.2%	N/A	N/A	N/A	57.2%

Note: NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31, 2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.

Note: This schedule provides supplemental information for the same population of properties presented on page 17 and 18.

Note: Three properties are classified as held for sale and treated as discontinued operations, at March 31, 2014 and, as such, are not included in the schedule above. These properties generated $729 of NOI during the three months ended March 31, 2014 and had a gross basis of $39,339 as of March 31, 2014.

(1) Represents buildings that have reached 90% occupancy and/or been in service for at least one year and that have positive NOI for the current reporting period.

(2) Represents buildings that have reached 90% lease-up occupancy and have negative NOI for the current reporting period.

(3) Represents buildings that have been in service for less than one year and have not reached 90% occupancy.

(4) Joint ventures are included at ownership percentage.

Exhibit II

Net Operating Income by Market

(dollars and SF in thousands)

Market	Net Operating Income: Bulk Distribution	Net Operating Income: Suburban Office	Net Operating Income: Medical Office	Net Operating Income: Retail	Net Operating Income: Total	Total Square Footage at Economic Ownership %: Bulk Distribution	Total Square Footage at Economic Ownership %: Suburban Office	Total Square Footage at Economic Ownership %: Medical Office	Total Square Footage at Economic Ownership %: Retail	Total Square Footage at Economic Ownership %: Total
Indianapolis	$ 11,174	$ 8,560	$ 2,165	$ 10	$ 21,909	14,917	2,812	402	38	18,170
Cincinnati	7,003	7,082	1,480	40	15,604	9,533	3,060	370	30	12,993
Dallas	8,873	539	4,184	-	13,596	10,663	200	816	-	11,678
Raleigh	3,612	7,285	1,578	52	12,527	2,801	2,297	357	20	5,475
Atlanta	6,078	1,937	4,104	-	12,119	8,370	724	891	-	9,986
South Florida	6,382	5,047	646	-	12,075	4,793	1,484	107	-	6,384
Chicago	10,528	98	976	-	11,602	10,773	20	161	-	10,954
Nashville	3,793	3,691	633	-	8,117	3,932	1,023	121	-	5,076
St. Louis	4,224	3,435	-	-	7,659	4,559	1,960	-	-	6,520
Central Florida	4,184	695	2,280	-	7,158	3,542	208	466	-	4,216
Columbus	6,684	97	-	-	6,781	8,332	51	-	-	8,383
Washington DC	612	3,626	576	-	4,814	272	728	101	-	1,101
Minneapolis	3,612	-	-	991	4,603	3,599	-	-	340	3,938
Houston	3,382	143	553	-	4,078	2,452	32	169	-	2,652
Pennsylvania	2,708	-	-	1,003	3,711	2,384	-	-	290	2,674
Savannah	3,606	-	-	-	3,606	5,318	-	-	-	5,318
Northern California	2,676	-	-	-	2,676	2,572	-	-	-	2,572
Southern California	2,557	-	-	-	2,557	1,796	-	-	-	1,796
Seattle	1,950	-	-	-	1,950	1,136	-	-	-	1,136
New Jersey	1,827	-	-	-	1,827	1,335	-	-	-	1,335
Phoenix	1,342	-	-	-	1,342	1,251	-	-	-	1,251
Baltimore	746	-	-	-	746	462	-	-	-	462
Other	375	452	3,534	-	4,362	517	350	772	-	1,638
Totals	$ 97,928	$ 42,688	$ 22,710	$ 2,096	$ 165,421	105,309	14,949	4,732	718	125,708

Note: NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31, 2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.

Note: This schedule provides supplemental information for the stabilized properties generating positive NOI shown on page 18.

Exhibit II

Geographic Highlights

In Service Properties as of March 31, 2014

Primary Market	Square Feet (1) Bulk Distribution	Suburban Office	Medical Office	Retail	Overall	Percent of Overall	Average Annual Rental Revenue (2)	Percent of Annual Net Effective Rent
Indianapolis	19,524,342	2,918,233	539,157	38,366	23,020,098	15.7%	$ 92,195,992	12.8%
Cincinnati	9,626,505	3,311,264	370,180	206,315	13,514,264	9.2%	68,998,199	9.5%
Dallas	14,758,823	199,800	1,200,905	-	16,159,528	11.0%	56,664,699	7.8%
South Florida	4,915,895	1,794,523	107,000	-	6,817,418	4.7%	55,906,910	7.7%
Atlanta	8,938,350	1,249,036	890,892	-	11,078,278	7.6%	55,629,900	7.7%
Raleigh	2,800,680	2,394,831	356,836	20,061	5,572,408	3.8%	52,094,943	7.2%
Chicago	11,447,070	98,304	161,443	-	11,706,817	8.0%	48,240,791	6.7%
St. Louis	4,678,255	2,264,278	-	-	6,942,533	4.7%	39,932,968	5.5%
Nashville	3,932,110	1,167,531	120,660	-	5,220,301	3.6%	34,149,832	4.7%
Central Florida	4,268,901	415,373	465,727	-	5,150,001	3.5%	27,997,605	3.9%
Columbus	9,246,217	253,705	-	-	9,499,922	6.5%	25,403,374	3.5%
Minneapolis	3,720,250	-	-	381,922	4,102,172	2.8%	23,789,932	3.3%
Savannah	6,935,446	-	-	-	6,935,446	4.7%	19,640,725	2.7%
Houston	2,691,611	318,231	168,850	-	3,178,692	2.2%	19,331,482	2.7%
Washington DC	748,362	2,366,239	100,952	-	3,215,553	2.2%	18,265,052	2.5%
Pennsylvania	2,384,240	-	-	289,855	2,674,095	1.8%	15,899,000	2.2%
Northern California	2,571,630	-	-	-	2,571,630	1.8%	10,953,257	1.5%
Southern California	2,339,379	-	-	-	2,339,379	1.6%	10,914,228	1.5%
Seattle	1,136,109	-	-	-	1,136,109	0.8%	10,256,153	1.4%
New Jersey	1,335,464	-	-	-	1,335,464	0.9%	7,016,296	1.0%
Phoenix	2,058,316	-	-	-	2,058,316	1.4%	5,241,798	0.7%
Baltimore	462,070	-	-	-	462,070	0.3%	2,696,875	0.4%
Other	618,944	420,869	829,044	-	1,868,857	1.3%	21,667,161	3.0% (3)
Total	121,138,969	19,172,217	5,311,646	936,519	146,559,351	100.0%	$ 722,887,174	100.0%
% of Square Feet	82.7%	13.1%	3.6%	0.6%	100.0%			

Primary Market	Occupancy % Bulk Distribution	Suburban Office	Medical Office	Retail	Overall
Indianapolis	97.3%	93.4%	97.1%	92.1%	96.8%
Cincinnati	97.5%	84.8%	98.4%	100.0%	94.4%
Dallas	97.1%	100.0%	95.7%	-	97.1%
South Florida	91.4%	92.2%	100.0%	-	91.7%
Atlanta	89.3%	92.3%	95.7%	-	90.2%
Raleigh	95.8%	95.2%	97.2%	71.7%	95.5%
Chicago	98.0%	100.0%	98.9%	-	98.0%
St. Louis	95.5%	80.6%	-	-	90.7%
Nashville	81.0%	94.4%	100.0%	-	84.4%
Central Florida	93.6%	92.1%	81.3%	-	92.4%
Columbus	99.2%	75.4%	-	-	98.5%
Minneapolis	95.3%	-	-	82.5%	94.1%
Savannah	87.7%	-	-	-	87.7%
Houston	100.0%	100.0%	85.0%	-	99.2%
Washington DC	93.4%	80.3%	100.0%	-	84.0%
Pennsylvania	100.0%	-	-	85.9%	98.5%
Northern California	100.0%	-	-	-	100.0%
Southern California	76.8%	-	-	-	76.8%
Seattle	100.0%	-	-	-	100.0%
New Jersey	100.0%	-	-	-	100.0%
Phoenix	96.3%	-	-	-	96.3%
Baltimore	100.0%	-	-	-	100.0%
Other **(3)**	82.0%	58.6%	87.8%	-	79.3%
Total	95.0%	88.1%	93.7%	87.6%	94.0%

(1) Includes all wholly owned and joint venture projects shown at 100% as of report date.

(2) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating expenses and real estate taxes, as well as percentage rents. Joint venture properties are included at the Company's economic ownership percentage.

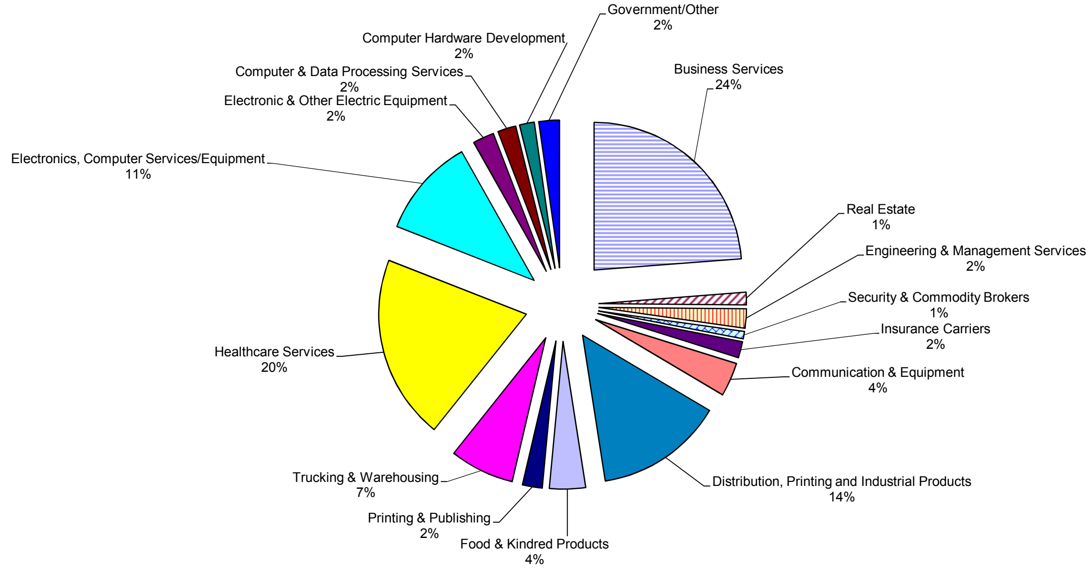
(3) Represents properties not located in the company's primary markets.

Exhibit II

Tenant Industry Profile and Largest Tenant Summary

March 31, 2014

Tenant Industry Profile as a Percentage of Annualized Gross Effective Rent (1)



Largest Tenants (In-Service Properties) Based Upon Annualized Gross Rent

Tenant	Primary Location	Primary Industry	Year of Lease Expiration	Average Annual Gross Effective Rent (1) (In Thousands)	Percentage of Annualized Gross Effective Rent
Baylor Scott & White Healthcare	Dallas	Healthcare Services	2014 - 2029	$20,201	2.5%
U.S. Government Agencies	South Florida	U.S. Government	2014 - 2034	17,126	2.2%
Amazon.com	Seattle	Retail	2017 - 2028	15,521	2.0%
Ascension Health	Other Midwest	Healthcare Services	2015 - 2029	10,226	1.3%
Lenovo Inc.	Raleigh	Computer Hardware Development	2020	9,558	1.2%
Crate and Barrel	New Jersey	Retail	2020 - 2022	8,236	1.0%
Mars, Incorporated	Columbus	Manufacturing/Agriculture	2014 - 2023	7,165	0.9%
Harbin Clinic	Atlanta	Healthcare Services	2027	7,093	0.9%
Home Depot	Northern California	Retail	2015 - 2024	6,377	0.8%
Interactive Intelligence	Indianapolis	Computer Software Services	2016 - 2019	6,194	0.8%
Northside Hospital Health Syst	Atlanta	Healthcare Services	2014 - 2023	6,169	0.8%
Tenet Healthcare Corp.	Dallas	Healthcare Services	2022 - 2030	5,846	0.7%
Schneider National	Savannah	Distribution/Warehousing	2014 - 2023	5,680	0.7%
Carolinas Healthcare System	Raleigh	Healthcare Services	2020	5,375	0.7%
Adventist Health	Central Florida	Healthcare Services	2014 - 2028	5,273	0.7%
Restoration Hardware	Columbus	Retail	2028	5,121	0.6%
Mercy	St. Louis	Healthcare Services	2014 - 2019	5,015	0.6%
Catholic Health Initiatives	Cincinnati	Healthcare Services	2021 - 2028	4,944	0.6%
Genco Distribution Systems	Indianapolis	Distribution/Warehousing	2014 - 2016	4,781	0.6%
CEVA Group PLC	Chicago	Distribution/Warehousing	2014 - 2020	4,728	0.6%
				$160,629	20.1%

(1) Represents average annual gross effective rents due from tenants in service as of March 31, 2014. Average annual gross effective rent equals the average annual rental property revenue over the terms of the respective leases including landlord operating expense allowance and excluding additional rent due as operating expense reimbursements and percentage rents.

Note: Joint ventures are included at the Company's economic ownership percentage.

Exhibit II

Same Property Performance

All Properties:	Three Months Ended March 31, 2014 and 2013 Bulk Distribution	Suburban Office	Medical Office	Retail	Total	Twelve Months Ended March 31, 2014 and 2013 Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Number of properties (3)	446	156	25	4	631	446	156	25	4	631
Square feet	89,210,870	14,467,633	2,048,239	688,193	106,414,934	89,210,870	14,467,633	2,048,239	688,193	106,414,934
Percent of in-service properties	81.1%	90.6%	42.8%	95.9%	80.9%	81.1%	90.6%	42.8%	95.9%	80.9%
2014 Average Commencement Occupancy (1)	93.9%	85.6%	89.1%	80.8%	92.6%	93.8%	84.1%	88.6%	79.2%	92.3%
Period over period percent change	0.4%	3.7%	0.9%	3.6%	0.8%	1.0%	2.8%	1.0%	0.6%	1.2%

	Three Months Ended March 31 2014	2013	% Change	Twelve Months Ended March 31 2014	2013	% Change
Bulk Distribution						
Total operating revenues	$ 112,037,791	$ 105,505,806	6.2%	$ 432,520,086	$ 416,584,839	3.8%
Total operating expenses	37,308,301	32,423,761	15.1%	130,431,514	122,735,346	6.3%
Net Operating Income (2)	$ 74,729,491	$ 73,082,045	2.3%	$ 302,088,572	$ 293,849,493	2.8%
Suburban Office						
Total operating revenues	$ 67,757,406	$ 63,971,543	5.9%	$ 263,216,223	$ 252,794,131	4.1%
Total operating expenses	30,602,054	27,764,196	10.2%	114,777,650	110,523,242	3.8%
Net Operating Income (2)	$ 37,155,352	$ 36,207,347	2.6%	$ 148,438,573	$ 142,270,889	4.3%
Medical Office						
Total operating revenues	$ 14,462,284	$ 13,435,853	7.6%	$ 55,758,912	$ 53,556,093	4.1%
Total operating expenses	6,298,683	5,580,943	12.9%	23,440,138	22,356,186	4.8%
Net Operating Income (2)	$ 8,163,601	$ 7,854,911	3.9%	$ 32,318,774	$ 31,199,907	3.6%
Retail						
Total operating revenues	$ 4,492,438	$ 4,342,731	3.4%	$ 17,080,577	$ 16,987,728	0.5%
Total operating expenses	2,615,477	2,242,168	16.6%	9,036,786	7,897,900	14.4%
Net Operating Income (2)	$ 1,876,960	$ 2,100,563	-10.6%	$ 8,043,791	$ 9,089,828	-11.5%
Total						
Total operating revenues	$ 198,749,919	$ 187,255,934	6.1%	$ 768,575,799	$ 739,922,791	3.9%
Total operating expenses	76,824,515	68,011,068	13.0%	277,686,088	263,512,674	5.4%
Net Operating Income (2)	**$ 121,925,405**	**$ 119,244,866**	**2.2%**	**$ 490,889,710**	**$ 476,410,116**	**3.0%**

Note: All information for joint venture properties is presented at Duke's effective ownership percentage.

(1) Commencement occupancy represents the percentage of total square feet where the leases have commenced.

(2) Net Operating Income (NOI) is equal to FFO excluding the effects of straight-line rent, concession amortization and market lease amortization.

(3) The population for determining same property performance includes both consolidated and joint venture properties. In order not to distort trends due to non-operating events, properties with termination fees over $250,000 have been excluded from both periods shown. The population, for both periods shown, consists of the 722 in-service properties that we own or jointly control, as of March 31, 2014, less (i) 47 in-service buildings that were acquired within the last 24 months, (ii) 26 in-service buildings we developed that were placed in service within the last 24 months, (iii) 15 in-service buildings that have recognized income from a lease termination fee of greater than $250,000 within the last 24 months and (iv) 3 in-service buildings that are under contract to sell at March 31, 2014 and are classified as held-for-sale for accounting purposes.

Exhibit II

Lease Expiration Comparison - Square Feet and Annualized Net Effective Rent

In-Service Properties as of March 31, 2014

(dollars and SF in thousands)

Wholly Owned Portfolio:	**Total Portfolio**			Bulk Distribution Portfolio		Suburban Office Portfolio		Medical Office Portfolio		Retail Portfolio	
Year of Expiration	Square Feet	Average Annual Rental Revenue (1)	%	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)
2014	7,554	$ 37,520	6%	6,460	$ 24,478	985	$ 11,253	105	$ 1,669	4	$ 120
2015	12,713	63,955	10%	10,985	41,362	1,663	21,265	57	1,152	8	176
2016	14,667	74,647	11%	12,645	46,587	1,794	23,453	209	4,250	19	357
2017	14,326	74,653	11%	12,663	49,986	1,407	19,102	183	3,842	73	1,723
2018	12,525	75,548	11%	10,188	39,124	1,872	25,145	388	9,807	77	1,472
2019	11,660	65,132	10%	9,860	38,354	1,531	20,088	257	6,406	12	284
2020	10,807	61,512	9%	9,354	37,659	986	14,576	457	9,020	10	257
2021	7,443	42,451	6%	6,280	24,984	912	11,613	238	5,582	13	272
2022	5,920	29,731	4%	5,333	18,230	246	4,339	319	6,715	22	447
2023	2,883	24,489	4%	2,101	10,518	465	7,366	311	6,456	6	149
2024 and Therafter	16,183	117,592	18%	13,385	59,253	1,003	14,751	1,743	42,946	52	642
	116,681	$ 667,230	100%	99,254	$ 390,535	12,864	$ 172,951	4,267	$ 97,845	296	$ 5,899
Total Portfolio Square Feet	124,146			104,590		14,628		4,580		348	
Percent Leased - Lease up Basis (2)	94.0%			94.9%		87.9%		93.2%		85.7%	
Joint Venture Portfolio:											
2014	1,483	$ 3,280	6%	1,334	$ 2,239	146	$ 973	-	$ -	3	$ 68
2015	1,981	7,743	14%	967	1,570	1,014	6,173	-	-	-	-
2016	2,256	5,341	10%	1,867	2,912	373	2,126	1	3	15	300
2017	1,330	3,387	6%	1,007	1,749	316	1,638	-	-	7	-
2018	3,313	6,957	12%	2,296	2,126	800	4,332	-	-	217	499
2019	3,667	4,379	8%	3,350	2,359	309	1,750	-	-	8	270
2020	542	3,068	6%	417	846	50	326	-	-	75	1,896
2021	2,596	3,959	7%	2,449	2,572	120	805	6	27	21	555
2022	707	3,117	6%	414	601	284	2,238	-	-	9	278
2023	233	1,034	2%	121	67	102	880	-	-	10	87
2024 and Therafter	2,987	13,392	23%	1,621	2,441	508	2,207	702	4,708	156	4,036
	21,095	$ 55,657	100%	15,843	$ 19,482	4,022	$ 23,448	709	$ 4,738	521	$ 7,989
Total Portfolio Square Feet	22,413			16,549		4,544		732		588	
Percent Leased - Lease up Basis (2)	94.1%			95.7%		88.5%		96.8%		88.6%	
Total:											
2014	9,037	$ 40,800	6%	7,794	$ 26,717	1,131	$ 12,226	105	$ 1,669	7	$ 188
2015	14,694	71,698	10%	11,952	42,932	2,677	27,438	57	1,152	8	176
2016	16,923	79,988	11%	14,512	49,499	2,167	25,579	210	4,253	34	657
2017	15,656	78,040	11%	13,670	51,735	1,723	20,740	183	3,842	80	1,723
2018	15,838	82,505	11%	12,484	41,250	2,672	29,477	388	9,807	294	1,971
2019	15,327	69,511	10%	13,210	40,713	1,840	21,838	257	6,406	20	554
2020	11,349	64,580	9%	9,771	38,505	1,036	14,902	457	9,020	85	2,153
2021	10,039	46,410	6%	8,729	27,556	1,032	12,418	244	5,609	34	827
2022	6,627	32,848	5%	5,747	18,831	530	6,577	319	6,715	31	725
2023	3,116	25,523	4%	2,222	10,585	567	8,246	311	6,456	16	236
2024 and Therafter	19,170	130,984	17%	15,006	61,694	1,511	16,958	2,445	47,654	208	4,678
	137,776	$ 722,887	100%	115,097	$ 410,017	16,886	$ 196,399	4,976	$ 102,583	817	$ 13,888
Total Portfolio Square Feet	146,559			121,139		19,172		5,312		936	
Percent Leased - Lease up Basis (2)	94.0%			95.0%		88.1%		93.7%		87.6%	

(1) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating expenses and real estate taxes, as well as percentage rents. Joint venture properties are included at the Company's economic ownership percentage.

(2) Lease up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Exhibit II

New Lease Analysis

Second Generation Deals as of March 31, 2014

Product Type	Number of New Leases	Square Feet of Second Generation Spaces	2nd Generation Weighted Average Capital Expenditures Per Sq. Ft.	Per Sq. Ft. / Per Year of Lease Term	Average Term in Years	Average Net Effective Rent
Year Ended 2013						
Bulk Distribution	126	6,752,474	$ 4.00	$ 0.73	5.48	$ 3.63
Suburban Office	161	1,305,293	25.75	3.80	6.78	12.49
Medical Office	11	40,711	16.37	2.94	5.56	17.97
	298	8,098,478	$ 7.57	$ 1.33	5.69	$ 5.13
1st Quarter 2014						
Bulk Distribution	28	2,381,949	$ 4.98	$ 0.66	7.49	$ 3.58
Suburban Office	26	220,592	19.15	4.19	4.57	12.79
Medical Office	4	14,090	29.36	4.89	6.01	16.69
	58	2,616,631	$ 6.30	$ 0.87	7.23	$ 4.43
Year to Date 2014						
Bulk Distribution	28	2,381,949	$ 4.98	$ 0.66	7.49	$ 3.58
Suburban Office	26	220,592	19.15	4.19	4.57	12.79
Medical Office	4	14,090	29.36	4.89	6.01	16.69
	58	2,616,631	$ 6.30	$ 0.87	7.23	$ 4.43

Note: **Activity noted above does not include first generation lease-up of new development and acquisitions as these amounts are included in our initial return calculations. Activity is based on leases signed during the period and excludes temporary leases of space.**

Note: **Joint ventures are shown at 100%**

Exhibit II

Renewal Analysis

As of March 31, 2014

	Leases up for Renewal		Leases Renewed					Average Capital Expenditures		
Product Type	Number	Square Feet	Number	Square Feet	Percent Renewed (1)	Average Term in Years	Average Net Effective Rent	Per Sq. Ft.	Per Sq. Ft. / Per Year of Lease Term	Growth in Net Eff. Rent (2)
Year Ended 2013										
Bulk Distribution	240	16,446,780	159	11,286,276	68.6%	4.22	$ 4.00	$ 1.66	$ 0.39	4.31%
Suburban Office	269	2,703,532	179	2,214,216	81.9%	4.66	14.52	10.52	2.26	1.38%
Medical Office	39	138,984	22	53,433	38.4%	3.83	19.13	6.86	1.79	5.96%
	548	19,289,296	360	13,553,925	70.3%	4.29	$ 5.78	$ 3.13	$ 0.73	3.11%
1st Quarter 2014										
Bulk Distribution	50	2,694,499	36	1,784,591	66.2%	3.80	$ 4.56	$ 0.87	$ 0.23	8.29%
Suburban Office	43	295,701	22	158,011	53.4%	3.90	13.43	7.95	2.04	4.47%
Medical Office	10	32,751	4	18,153	55.4%	5.00	21.00	4.00	0.80	20.76%
	103	3,022,951	62	1,960,755	64.9%	3.82	$ 5.43	$ 1.47	$ 0.38	7.90%
Year to Date 2014										
Bulk Distribution	50	2,694,499	36	1,784,591	66.2%	3.80	$ 4.56	$ 0.87	$ 0.23	8.29%
Suburban Office	43	295,701	22	158,011	53.4%	3.90	13.43	7.95	2.04	4.47%
Medical Office	10	32,751	4	18,153	55.4%	5.00	21.00	4.00	0.80	20.76%
	103	3,022,951	62	1,960,755	64.9%	3.82	$ 5.43	$ 1.47	$ 0.38	7.90%

(1) The percentage renewed is calculated by dividing the square feet of leases renewed by the square feet of leases up for renewal. The square feet of leases up for renewal is defined as the square feet of leases renewed plus the square feet of space vacated due to lease expirations. Excludes temporary leases of space. Joint venture properties are included at 100%.

(2) Represents the percentage change in net effective rent between the original leases and the renewal leases. Net effective rent represents average annual base rental payments, on a straight-line basis for the term of each lease excluding operating expense reimbursements.

Exhibit II

Space Vacated Analysis

As of March 31, 2014

	Total	Terminations	Lease Expirations (1)		Default / Bankruptcy		Buyouts (2)		Relocations (3)		Contractions (4)	
			Space Vacated for the Following Reasons									
Year Ended 2013												
Bulk Distribution	130	8,106,662	81	5,160,504	22	1,293,566	9	800,704	6	491,805	12	360,083
Suburban Office	145	855,736	90	489,316	13	68,233	15	92,115	7	27,181	20	178,891
Medical Office	22	106,118	17	85,551	2	10,312	-	-	1	2,355	2	7,900
	297	9,068,516	188	5,735,371	37	1,372,111	24	892,819	14	521,341	34	546,874
1st Quarter 2014												
Bulk Distribution	25	2,036,855	14	909,908	2	37,102	7	860,339	1	77,281	1	152,225
Suburban Office	35	249,503	21	137,690	6	75,415	2	11,376	4	9,544	2	15,478
Medical Office	7	18,715	6	14,598	-	-	1	4,117	-	-	-	-
	67	2,305,073	41	1,062,196	8	112,517	10	875,832	5	86,825	3	167,703
Year to Date 2014												
Bulk Distribution	25	2,036,855	14	909,908	2	37,102	7	860,339	1	77,281	1	152,225
Suburban Office	35	249,503	21	137,690	6	75,415	2	11,376	4	9,544	2	15,478
Medical Office	7	18,715	6	14,598	-	-	1	4,117	-	-	-	-
	67	2,305,073	41	1,062,196	8	112,517	10	875,832	5	86,825	3	167,703

Note: Excludes temporary leases of space.

Note: Joint Ventures are shown at 100%.

(1) Represents tenants who did not renew their leases upon expiration due to the closing of their local operations, relocation to another property not owned or built by the Company, or the exercising of a termination option.

(2) Represents space with termination fees required to allow the tenants to vacate their space prior to the normal expiration of their lease term.

(3) Represents tenants who vacated their space and relocated to another property owned or built by the Company or moved out to accommodate another Duke tenant expansion.

(4) Represents tenants who have downsized prior to expiration of their lease term.

Exhibit II

Debt Maturity & Preferred Stock Analysis

March 31, 2014

(in thousands)

	Mortgages (1)		Unsecured (1)		Credit		Weighted Average Effective Interest
Year	Amortization	Maturities	Amortization	Maturities	Facility (2)	Total (3)	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 stocl	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.

Exhibit II

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.

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March 17, 2014

International Financial Reporting Standards
Interpretations Committee
30 Cannon Street
London
EC4M 6XH

Subject: Tentative agenda decision – IAS 17 Leases – Meaning of incremental costs

Dear IFRS Interpretations Committee members,

This letter is submitted by the Real Property Association of Canada (REALpac) in response to the tentative agenda decision from the November 2013 discussion on IAS 17 Leases, Meaning of Incremental costs.

REALpac is Canada's senior national industry association for owners and managers of investment real estate. Our Members include publicly traded real estate companies, real estate investment trusts (REITs), private companies, pension funds, banks and life insurance companies. The association is further supported by large owner/occupiers and pension fund advisers as well as individually selected investment dealers and real estate brokerages. Members of REALpac currently own in excess of $180 Billion CAD in real estate assets located in the major centers across Canada

REALpac's Comments

The Interpretations Committee received a request for clarification about IAS 17 *Leases* related to the meaning of "incremental costs" within the context of IAS 17, and in particular, whether salary costs of permanent staff involved in negotiating and arranging new leases as a lessor qualify as "incremental costs".

We do not support the Interpretations Committee's tentative decision that internal salary costs do not qualify as incremental costs. In addition, we would assert that there is diversity in practice on this issue.

IAS 17 paragraph 38 states that "(I)nitial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They 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:

“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
Real Property Association of Canada
Association des biens immobiliers du Canada

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

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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.

Ernst & Young Global Limited is a company limited by guarantee registered in England and Wales No. 4328808.

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).

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

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Dennis H. Friedrich
Brookfield Office Properties
Lawrence L. Gellerstedt, III
Cousins Properties Incorporated
Michael P. Glimcher
Glimcher Realty Trust
Steven P. Grimes
RPAI
William P. Hankowsky
Liberty Property Trust
Andrew F. Jacobs
Capstead Mortgage Corporation
John B. Kilroy, Jr.
Kilroy Realty Corporation
Spencer F. Kirk
Extra Space Storage, Inc.
David J. LaRue
Forest City Enterprises, Inc.
Stephen D. Lebovitz
CBL & Associates Properties, Inc.
Peter S. Lowy
Westfield Group
Craig Macnab
National Retail Properties, Inc.
Joel S. Marcus
Alexandria Real Estate Equities, Inc.
Christopher P. Marr
CubeSmart L.P.
Lauralee E. Martin
HCP, Inc.
Sandeep Mathrani
General Growth Properties, Inc.
Richard K. Matros
Sabra Health Care REIT, Inc.
Donald A. Miller
Piedmont Office Realty Trust, Inc.
Marguerite Nader
Equity Lifestyle Properties, Inc.
Jeffrey S. Olson
Equity One, Inc.
Edward J. Pettinella
Home Properties, Inc.
Colin V. Reed
Ryman Hospitality Properties, Inc.
Joseph D. Russell, Jr.
PS Business Parks, Inc.
Richard B. Saltzman
Colony Financial, Inc.
Michael J. Schall
Essex Property Trust, Inc.
Doyle Simons
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Wendy L. Simpson
LTC Properties, Inc.
James D. Taiclet, Jr.
American Tower Corporation
Amy L. Tait
Broadstone Net Lease, Inc.
Steven B. Tanger
Tanger Factory Outlet Centers, Inc.
Owen D. Thomas
Boston Properties, Inc.
Thomas W. Toomey
UDR, Inc.

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

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Accounting Standard (IAS) 17 *Leases* should be used in making that distinction. Because IAS 17 is well understood by financial statement preparers that currently report under IFRS, as well as auditors and regulators, we do not believe the dual model approach would increase complexity in applying the standard. Those leases that transfer control over substantially all of the future economic benefits of an asset to the lessee would be classified as a Type A lease and accounted for effectively as a purchase. Leases that do not transfer substantially all of the future economic benefits of the leased asset would be accounted for as Type B leases.

We also believe that the IASB's reference to the lessee model as a "single model" is a misnomer. The IASB has previously agreed to a scope exception for "short term" leases, as well as a practicability exception for "small ticket" leases. In our view, this amounts to a lessee accounting model that has three alternatives. In essence, the IASB is trading existing IFRS (*i.e.*, finance leases and operating leases) for a new model that will now have three types of leases: finance-type leases (*i.e.*, Type A leases), "short term" leases, and "small ticket" leases. We fail to see the simplification that the IASB's current decisions would provide over existing IFRS.

For Type B leases, there is clearly a linkage between the rights to use the asset and the lessee's obligation to make payments under the lease. Considering this linkage, we believe that the lessee should allocate the total cost of the lease over the term of the lease. We believe that the Type B accounting approach adopted by the FASB recognizes the linkage between the rights to use the asset and the lessee's obligation to make payments under the lease and more appropriately accounts for the economic differences between arrangements that simply provide a right to use an asset and those that are in-substance purchases of assets.

Quantitative Considerations

As indicated above, we understand that certain constituents are of the view that the income statement impacts of the two approaches to accounting for leases results in only minimal differences in charges to net income of lessees. Our experience indicates that this may generally not be the case. For example, a large global retailer developed pro forma financial impacts on the company's 2013 operating results that would result from applying the accelerated expense recognition patterns consistent with the proposed Type A accounting approach to all of the company's leases. The resulting pro forma net income was $46 million, $0.16 per share, less than net income reported for 2013. Applying the company's multiple to the $0.16 decrease in net income would negatively impact the company's stock price by $2-3 or about 10%.

Simply put, we do not consider this 10% negative impact to be "minimal."

In addition to the negative impact on earnings of applying the Type A approach to all leases, we agree with the analyses and conclusions reached with respect to the impacts on the balance sheets of a number of large global companies described in the June 25, 2014 unsolicited comment letter submitted to the Boards by the Equipment Leasing and Finance Association[1].

[1]http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828960081&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content Disposition&blobheadervalue2=831047&blobheadervalue1=filename%3DLEASES-14.UNS.0009.ELFA_WILLIAM_G._SUTTON.pdf&blobcol=urldata&blobtable=MungoBlobs

Usefulness of Reported Financial Information

The Boards have consistently indicated that financial standards should primarily serve the needs of investors and other financial statement users. NAREIT strongly agrees with this principle and believes that the presentation of financial information must provide relevant information to financial statement users. If information is not relevant, there is no need to debate the conceptual merits of the accounting.

An important standing committee of NAREIT is its Best Financial Practices Council. This Council reviews all financial reporting proposals that may impact the real estate industry's financial reporting, including proposals from the FASB, IASB and Securities and Exchange Commission (SEC). The Council currently includes 27 members representing a broad cross section of NAREIT's membership, including six investors/sell-side analysts. These financial statement users (and other investors and analysts who are NAREIT members) have been very clear in their position that, to be relevant, payments made by lessees pursuant to a lease of property should be reported as rent expense and not bifurcated as interest and amortization. Further, investors/sell-side analysts on the Council have consistently stated that, should the new Leases standard result in the elimination of rent expense, they would then ask companies to assist them in unwinding the proposed accounting. This would lead to analysts making capital allocation decisions based on unaudited/non-GAAP financial information, which in our view would not provide users with the most reliable decision-useful information.

If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432 or gyungmann@nareit.com, or Christopher Drula, NAREIT's Vice President, Financial Standards, at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

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Senior Vice President, Financial Standards

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.