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 single 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