NAREIT Alert (February 24, 2017)

NAREIT Alert Important Industry Updates from NAREIT

On Feb. 22, the Financial Accounting Standards Board (FASB or Board) issued a final standard (the Final Standard) that clarifies the scope of recently issued guidance on sales of *in substance nonfinancial assets* (*e.g.*, real estate held in a legal entity) that was finalized in conjunction with the *Revenue from Contracts with Customers* Standard (the Revenue Standard). Additionally, the Final Standard addresses the accounting treatment for partial sales of nonfinancial assets (*e.g.*, real estate).

Executive Summary

NAREIT believes that the Final Standard will be of particular interest to equity REITs that contribute a controlling interest in a real estate property to a joint venture. When a REIT transfers control of a property and maintains a retained interest in the property transferred, the Final Standard requires that the REIT report a full gain or loss as if it sold 100% of the property transferred and measure its retained interest at fair value. *This represents a fundamental change from existing U.S. GAAP.* Under current U.S. GAAP, gain or loss is recognized only on the interest transferred and the retained interest is measured at its carry-over basis.

Partial Sales

The Final Standard acknowledges that a partial sale of a nonfinancial asset or in substance nonfinancial asset can be structured in different fashions. A transaction can be structured such that an entity transfers a nonfinancial asset to a counterparty in exchange for a non-controlling interest in the legal entity to which the nonfinancial asset was transferred. A parent could also transfer ownership interests in a consolidated subsidiary that includes nonfinancial assets and retain a non-controlling interest in the former subsidiary.

The Final Standard clarifies that partial sales transactions within the scope of ASC 610-20 include contributions of nonfinancial assets to a joint venture or other noncontrolled investee. The Final Standard requires a company to recognize a full gain or loss on transfers of nonfinancial assets within the scope of ASC 610-20 to equity method investees.

The Final Standard requires a company to derecognize a distinct nonfinancial asset or distinct in substance nonfinancial asset in a partial sale transaction when it:

- Does not have a controlling financial interest in the legal entity that holds the asset in accordance with Topic 810, *Consolidation*; and,
- Transfers control of the asset in accordance with Topic 606, *Revenue from Contracts with Customers*.

Once a company transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset, it is required to measure any non-controlling interest it receives or retains at fair value. The company is required to recognize a full gain or loss on the transaction.

If a company transfers ownership interests in a consolidated subsidiary and continues to hold a controlling financial interest, it does not derecognize the assets or liabilities, and accounts for the transaction as an equity transaction. Therefore, no gain or loss is recognized.

Scope

The Final Standard applies to all sales of nonfinancial assets and in substance nonfinancial assets, unless it meets one of the scope exceptions identified in par. 610-20-15-4, a through l.

Definition of In Substance Nonfinancial Asset

The Revenue Standard did not include a definition of an in substance nonfinancial asset. Therefore, the FASB included a definition in the Final Standard:

"An in substance nonfinancial asset is a financial asset promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets" (*e.g.*, real estate).

The Final Standard includes the following illustrative example that is relevant to the real estate industry (Example 1):

> Seller enters into a contract to transfer real estate, the related operating leases, and accounts receivable to Buyer. Seller

> guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for two years after the sale. In the event that the cash flows are not sufficient, Seller is required to make a payment in the amount of the shortfall.
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> Seller concludes that the assets promised in the contract are not a business within the scope of Topic 810 on consolidation and are not an output of Seller's ordinary activities within the scope of Topic 606 on revenue from contracts with customers. In addition, assume that Seller concludes that substantially all of the fair value of the assets promised in the contract is concentrated in nonfinancial assets (that is, substantially all of the fair value is concentrated in the real estate and in-place lease intangible assets). Therefore, the accounts receivable promised in the contract are in substance nonfinancial assets. In accordance with the guidance in this Subtopic, all of the assets in the contract, including the accounts receivable, are within the scope of this Subtopic.
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> Seller concludes that the guarantee, which is a liability of Seller, is within the scope of Topic 460 on guarantees. Therefore, Seller would apply the guidance in paragraph 606-10-15-4 to separate and measure the guarantee as described in paragraph 610-20-15-9.
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> Seller's conclusions would be the same if it transferred the real estate, leases, and receivables by transferring ownership interests in a consolidated subsidiary. That is, Seller would still conclude that all of the assets in the subsidiary are nonfinancial assets and in substance nonfinancial assets within the scope of this Subtopic and the guarantee is within the scope of Topic 460.

When determining whether substantially all of the fair value of the assets promised to counterparty in a contract is concentrated in nonfinancial assets, cash or cash equivalents promised to the counterparty should be excluded from the analysis. Further, any liabilities assumed or relieved by the counterparty should not factor into the determination of whether substantially all of the fair value of the assets transferred is concentrated in nonfinancial assets.

Effective Date

The Final Standard is effective at the same time as the new *Revenue from Contracts with Customers* Standard. Thus, the Final Standard is effective for annual periods beginning after Dec. 15, 2017 for public companies, including interim reporting periods within that reporting period. For all other entities, the Final Standard is effective for annual periods beginning after Dec. 15, 2018 and interim reporting periods within annual periods beginning after Dec. 15, 2019. All companies can early adopt the guidance for annual periods beginning after Dec. 15, 2016, including interim reporting periods within that reporting period.

Transition

Companies can elect to adopt the standard either:

- Retrospectively to each period presented in the financial statements; or,
- Retrospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

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