NAREIT Alert (January 9, 2017)

NAREIT Alert Important Industry Updates from NAREIT

Executive Summary

On Jan. 5, the Financial Accounting Standards Board (FASB or Board) issued a final standard (the Standard) that clarifies the definition of a business. The Standard's objective is to add further guidance that assists preparers in evaluating whether a transaction will be accounted for as an acquisition of an asset or a business.

The Standard is of particular interest to NAREIT members, as the Standard revisits the definition of a business that was developed in Statement of Financial Accounting Standards (FAS) 141(R), *Business Combinations*. Under existing GAAP, the definition of a business is interpreted so broadly that even the acquisition of a single investment property meets the definition of a business. Under today's accounting, transaction costs associated with business combinations are expensed as incurred.

NAREIT believes that most acquisitions of investment property would qualify as asset acquisitions (as opposed to business combinations) under the clarified definition of a business in the Standard. Therefore, transaction costs associated with asset acquisitions will be capitalized, while these costs associated with business combinations will continue to be expensed as incurred.

Many REITs that are required to expense acquisition transaction costs under current GAAP, eliminate this expense in their calculation of a secondary FFO measure (*e.g.*, core FFO, adjusted FFO, normalized FFO.) Because NAREIT believes that the great majority of investment property acquisitions will qualify as asset acquisitions rather than acquisitions of businesses, this adjustment to NAREIT FFO will no longer be necessary.

The Standard will be applied on a prospective basis to transactions occurring as early as 10/1/16 (see further discussion below).

Some Important Details

Under current implementation guidance in GAAP, there are three components of a business: inputs, processes, and outputs. While an integrated set of assets and activities (set) that is a business usually has outputs, outputs are not required to be present for a transaction to be treated as a business. Additionally, all of the inputs and processes that a seller uses in operating a set are not required if a market participant can acquire the set and continue to produce outputs while integrating the acquired set with their own existing inputs and processes.

The "Substantially All" Fair Value Screen

If the "substantially all" screen is not met, the Standard requires that to be considered a business, a set must include (at a minimum) an input and a substantive process that together significantly contribute to the ability to create an output.

If the transaction does not include outputs (*e.g.*, real estate under development that has not generated revenues), the set will have an input (*e.g.*, real estate) and a substantive process only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output (*e.g.*, rental revenue). The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process. In performing this evaluation, a company would need to evaluate whether the acquired workforce is performing a substantive process. According to the Standard, a process is not critical if it is considered ancillary or minor in the context of all the processes required to create outputs.

If the transaction includes outputs, the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs when any of the following are present:

- Employees that form an organized workforce that has the necessary skills, knowledge or experience to perform an acquired process that when applied to an acquired input is critical to the ability to continue producing outputs.
- An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process is critical to the ability to continue producing outputs.
- The acquired process when applied to an acquired input significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.
- The acquired process when applied to an acquired input significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

Real Estate Examples Illustrating Whether an Acquired Process is "Critical"

The Standard includes Real Estate examples that contrast transactions involving the acquisition of cleaning, security, and maintenance personnel (Case A, Scenario 2) with the acquisition of employees responsible for leasing, tenant management, and managing and supervising all operational processes (Case A, Scenario 3).

In Scenario 2, the transaction qualifies as an asset acquisition because the cleaning and security processes were not considered critical in the context of all the processes required to create outputs. Additionally, the cleaning and security processes could be easily replaced with little cost, effort, or delay in the ability to continue producing outputs. Further, the cleaning and security contracts are not considered unique or scarce (*i.e.*, these arrangements are readily available in the marketplace).

In Scenario 3, the transaction qualifies as a business combination because the set includes an organized workforce that performs processes that when applied to the acquired inputs (*e.g.*, land, building and in-place leases) are critical to the ability to continue producing outputs. Thus, leasing, tenant management, and operational processes are critical to the creation of outputs.

Effective Date

For public companies, the Standard is effective for annual periods beginning after Dec. 15, 2017, including interim periods within those periods. All other companies would apply the Standard to annual periods beginning after Dec. 15, 2018 and interim periods within annual periods beginning after Dec. 15, 2019.

The Standard should be applied prospectively on or after the effective date. No disclosures are required at transition.

The Board provided companies with the option to early adopt the Standard. Companies can early adopt the Standard as of the beginning of a reporting period for which financial statements have not yet been issued. For example, if a REIT has not issued its 12/31/16 Form 10-K, the REIT could adopt the Standard for transactions that occurred after 10/1/16. Note that adoption in this fashion would result in similar transactions being accounted for differently within 2016 financial statements. From discussions with FASB Staff, NAREIT understands that REITs would be permitted to early adopt the Standard as of 1/1/17.

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