REIT Wise® 2017

NAREIT's Law, Accounting & Finance Conference

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FASB Update

Presenters

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Moderator

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Standard Disclaimer

The views expressed herein are those of the presenters and do not necessarily reflect the views of their respective organizations.

ASU 2017-01

Overview

- Adds the ‘substantially all’ threshold
- Requires that a business include at least one substantive process
- Eliminates the evaluation of a market participant’s ability to replace the missing elements
- Aligns the definition of outputs with goods and services to customers

ASU 2017-01

‘Substantially all’ threshold

If *substantially all of the fair value* of the gross assets acquired is concentrated in a <u>single</u> identifiable tangible or intangible asset (or group of similar identifiable tangible or intangible assets), the set is not a business	- Single assets include:
	  - Tangible assets that are attached to and cannot be physically removed from other tangible assets without significant cost or diminution in utility or value (or an intangible asset representing the right to use a tangible asset that cannot be used separately from the tangible asset such as leased land and a building)
	  - In-place lease intangible assets (and liabilities) and related leased assets
	- Similar assets do not include:
	  - Assets in different major asset classes
	  - Assets that have significantly different risk characteristics

ASU 2017-01

Example – ‘Substantially all’ threshold

- RE Co. purchases a fully leased office building for $100 million and incurs $4 million of transaction costs. The assets and their fair values include land ($20m), building ($65m) and lease intangibles ($15m).
  - **Legacy guidance**: Business combination – the continuation of outputs indicates processes are embedded in the set. RE Co. would expense the transaction costs and record each asset at fair value.
  - **ASU 2017-01**: Asset acquisition – the set meets the ‘substantially all’ threshold (as all assets in set are considered a single asset). RE Co. would capitalize the transaction costs and allocate the consideration transferred on a relative fair value basis.

ASU 2017-01

Polling question

- What percentage of your acquisitions do you anticipate meeting the ‘substantially all’ threshold?
  - All (100%)
  - Most (75-99%)
  - Some (50-74%)
  - Less than 50%
  - Unknown

ASU 2017-01

Substantive process

To be a business, the set of acquired activities and assets must include inputs and *one or more substantive processes* that <u>together</u> contribute to the ability to create outputs	- For a set generating outputs, a process is substantive if it includes ***any*** of the following: - Employees that form an organized workforce ***or*** an acquired contract that provides access to an organized workforce that are critical - A process that cannot be replaced without significant cost, effort or delay - A process that is considered unique or scarce - For a set not generating outputs, a process is substantive if it includes employees that form an organized workforce that is critical - Existence of continuing revenues (i.e., an in-place lease) would not indicate on its own a substantive process was acquired

ASU 2017-01

Example – Substantive process

- RE Co. purchased a portfolio of fully leased properties and the ‘substantially all’ threshold was not met. RE Co. assumes the existing outsourced cleaning, security and maintenance contracts in the acquisition.
  - **Legacy guidance**: Business combination – RE Co. determines the continuation of outputs indicates processes are embedded in the acquisition.
  - **ASU 2017-01**: Asset acquisition – RE Co. evaluates the processes acquired and determines they are not substantive processes. The processes are not unique, critical or scarce and could be replaced with little cost, effort or delay in set’s ability to generate outputs.

ASU 2017-01

Transition

- When is it effective?
  - 2018 for calendar-year public business entities
  - 2019 for all other calendar-year end entities
  - Early adoption permitted, including for interim or annual periods in which financial statements have not been issued or made available for issuance
- What are the transition provisions?
  - Applied prospectively as of the beginning of the period of adoption to all acquisitions and dispositions
  - No disclosures are required at transition

ASU 2017-01

10-K disclosures: REITs adopting the new definition of a business

Early Adopted Q4 2016	Early Adopted Q1 2017	Early Adopting in 2017	Not Early Adopting	Didn't Clarify Timing of Adoption
26	42	3	5	81
17%	27%	2%	3%	52%

10-K reports filed as of March 1, 2017

ASU 2017-01

10-K disclosures: REITs adopting the new definition of a business – by Industry

	Early Adopted Q4 2016	Early Adopted Q1 2017	Early Adopting in 2017	Not Early Adopting	Didn't Clarify Timing of Adoption
Retail	3	8	0	1	11
Residential	1	8	1	0	12
Lodging	3	3	0	2	12
Health Care	4	7	0	1	4
Net Lease	0	4	0	0	10
Diversified	2	3	2	0	6
Office	4	5	0	0	3
Industrial	2	0	0	1	6
Specialty/other	4	3	0	0	12

ASU 2017-01

How It May Change Business Practices

Eliminating Market Participants Ability to Replace Missing Elements and Substantive Processes → Greater Structuring of Transactions

Loss of Measurement Period → Timing of Acquisitions

ASU 2017-01

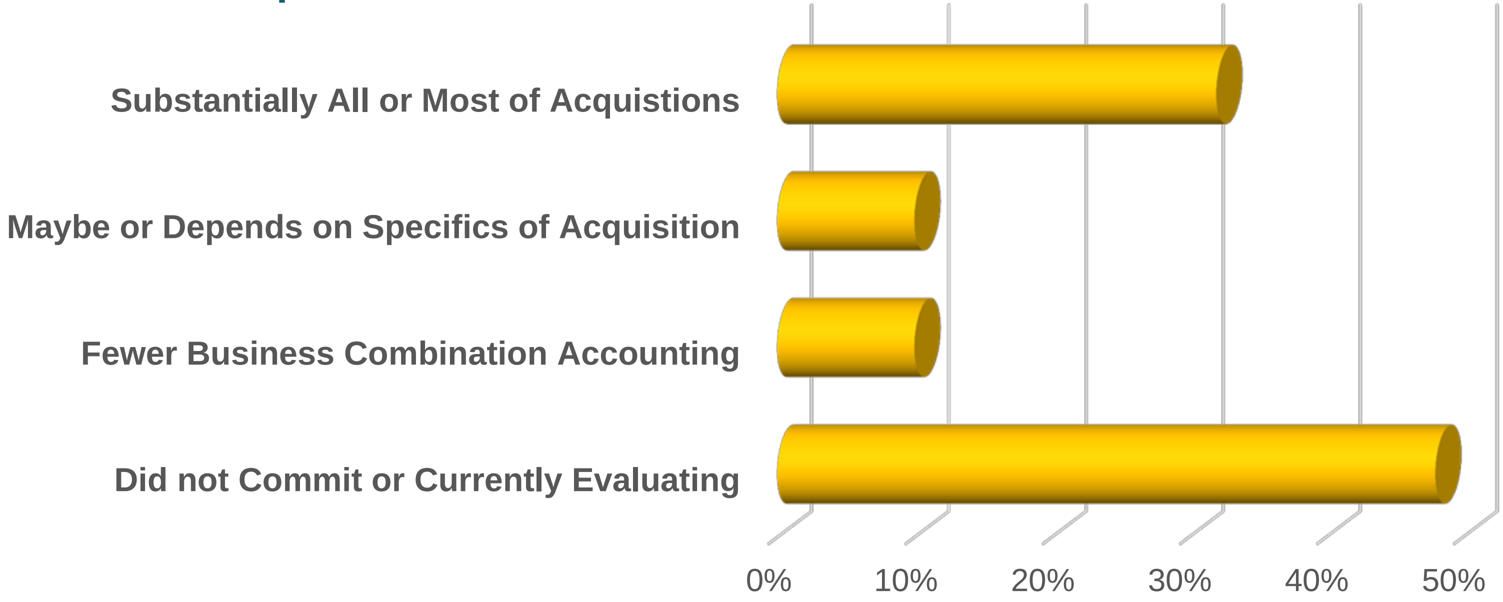
Acquisition of a Portfolio of Properties

Step 1 – Screen	→	Risk Characteristics
Step 2 – Evaluation of Substantive Processes	→	Employees

If Step 2 Conclusion is "Not a Business" Step 1 – Screen Need Not Be Performed

ASU 2017-01

Disclosed Anticipated Future Accounting Asset Acquisitions – All Sectors



ASU 2017-01

December 31, 2016 Form 10-K Disclosure

"The Company expects that acquisitions of real estate or in-substance real estate <u>will not meet the revised definition of a business</u> because substantially all of the fair value is <u>concentrated in a single identifiable asset</u> or group of similar identifiable assets (i.e. land, buildings, and related intangible assets) or because <u>the acquisition does not include a substantive process</u> in the form of an acquired workforce or an acquired contract that cannot be replaced without significant cost, effort or delay."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure
Office

"As a result of this adoption, we evaluated three real estate acquisitions completed during the fourth quarter of 2016 under the new framework and determined that the assets acquired did not meet the definition of a business. Accordingly, we accounted for these transactions as asset acquisitions."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure
Retail

"Given this change in definition, we believe most of our shopping center acquisitions will no longer be considered business combinations but rather asset acquisitions."

"…we expect future acquisitions of single investment properties will not result in the recognition of transaction cost expenses, as the single investment properties will likely not meet the definition of a business…."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure Diversified

"As a result, we anticipate that <u>fewer</u> of our acquisitions made in the normal course of business <u>will meet the definition of a business</u>, as our typical acquisitions consist of properties whereby substantially all of the fair value of gross assets acquired is concentrated in a single asset (land, building and in-place leases)."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure
Industrial

"This standard is effective for periods beginning after December 31, 2017, however we plan to adopt this standard in 2017 for the annual and interim reporting periods beginning after December 31, 2016. We do not expect the adoption to have a significant impact on the Consolidated Financial Statements."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure
Lodging/Resorts

"While we are currently evaluating the potential impact of the standard, <u>we currently expect that certain future hotel acquisitions may be considered asset acquisitions</u> rather than business combinations, which would affect capitalization of acquisitions costs (such costs are expensed for business combinations and capitalized for asset acquisitions)."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure

Lodging/Resorts

"We are evaluating the effect of ASU No. 2017-01 on our consolidated financial statements and related disclosures"

ASU 2017-01

Disclosed Anticipated Future Accounting Asset Acquisitions

Sector	Substantially All or Most of Acquistions	Maybe or Depends on Specifics	Fewer Business Combination Accounting	Did not Commit or Currently Evaluating
Office	39%	11%	6%	44%
Industrial	33%	0%	11%	56%
Retail	26%	10%	23%	42%
Apartments	50%	0%	17%	33%
Diversified	42%	8%	17%	33%
Lodging/Resorts	13%	20%	0%	67%

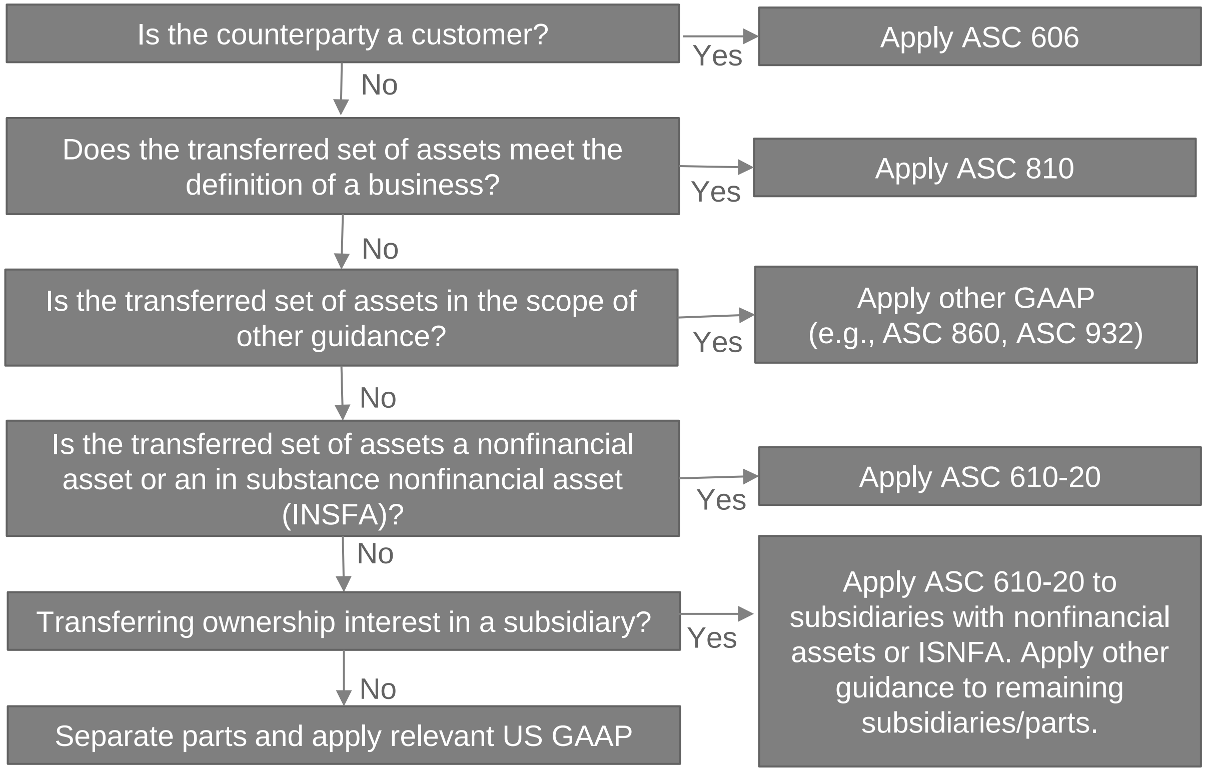
ASU 2017-05

Overview

- Clarifies the scope of ASC 610-20
- Defines in substance nonfinancial asset
  - An *in substance nonfinancial asset* is a financial asset that is in a group of assets in which “substantially all” of fair value is concentrated in nonfinancial assets
- Provides guidance on the derecognition of nonfinancial assets and in substance nonfinancial assets, including partial sales of those assets

ASU 2017-05

Scoping



ASU 2017-05

Scoping – other real estate considerations

- Contributions of nonfinancial assets to equity method investments or joint ventures are in the scope of this guidance
- Most transactions that today are in the scope of ASC 845 on nonmonetary exchanges will now be in the scope of this guidance
- All transfers of equity method investments generally will be in the scope of ASC 860
  - Exception for equity method investments that are in substance nonfinancial assets removed

ASU 2017-05

Derecognition and measurement

- Derecognition
  - Step 1 — Seller evaluates whether it has lost control under ASC 810. If yes, it continues to step 2. If no, the asset is not derecognized.
  - Step 2 – Seller evaluates whether it has transferred control using the principles in ASC 606.
- Measurement
  - Consideration is the transaction price determined using ASC 606 plus carrying value of any liabilities assumed by the buyer.
  - Noncontrolling interest received or retained by selling entity measured at fair value.
    - Currently measured at carrying value under ASC 360-20

ASU 2017-05

Transition

- When is it effective?
  - 2018 for calendar-year end public entities
  - 2019 for all other calendar-year end entities
  - Early adoption permitted in 2017
  - Period of adoption must be aligned with adoption of ASC 606
- What are the transition provisions?
  - Full retrospective or modified retrospective
  - Transition method for transactions with customers and noncustomers does not have to be the same

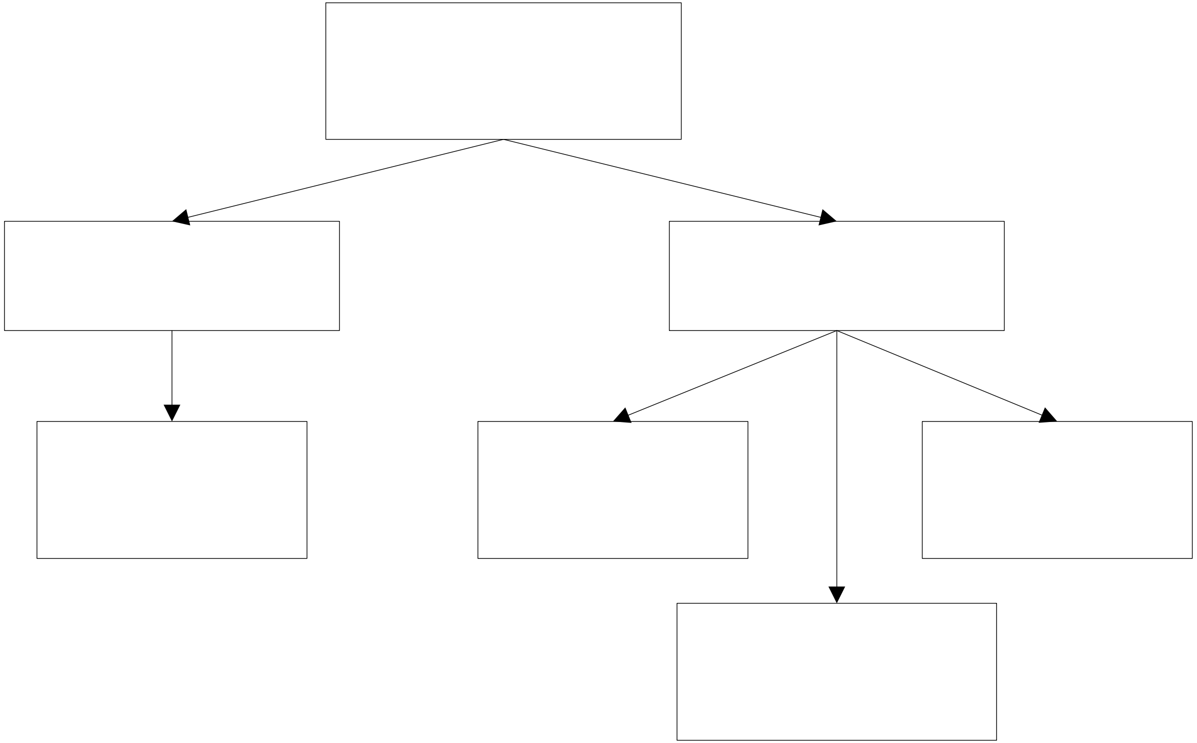
ASU 2017-05
Polling question

- What transition method will you use for the adoption of ASC 610-20?
  - Full retrospective adoption (i.e., recast all periods within the financial statements)
  - Modified retrospective application (i.e., apply to the most current period presented within the financial statements)
  - Undecided

Hedge Accounting
FASB Proposed Changes

Accounting for Derivatives Under ASC 815 (FAS 133)

Current Accounting



Accounting for Derivatives Under ASC 815 (FAS 133)

Current Accounting

Mark to Market

	Revenue
-	Expenses
+/-	Derivative gain/loss
=	Net Income

Hedge Accounting

	Revenue
-	Expenses
=	Net Income

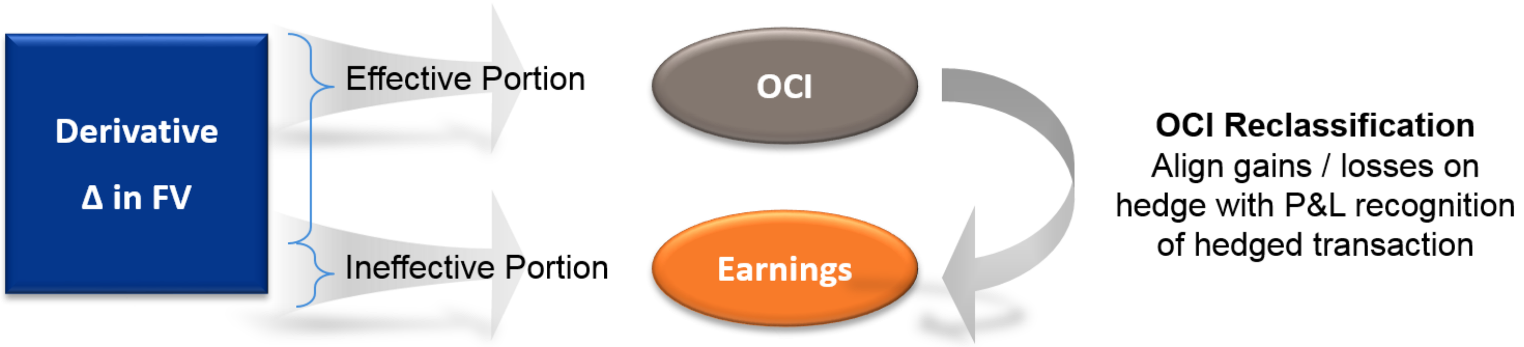
Derivative gains/losses deferred into OCI

Reclassified into earnings to align with the recognition of the associated hedged transactions.

Accounting for Derivatives Under ASC 815 (FAS 133)

Current Accounting

- Quantitative assessment test performed quarterly (unless shortcut applied)
- Ineffectiveness measured quarterly – reported in current period earnings



FASB Hedge Accounting Proposed Changes

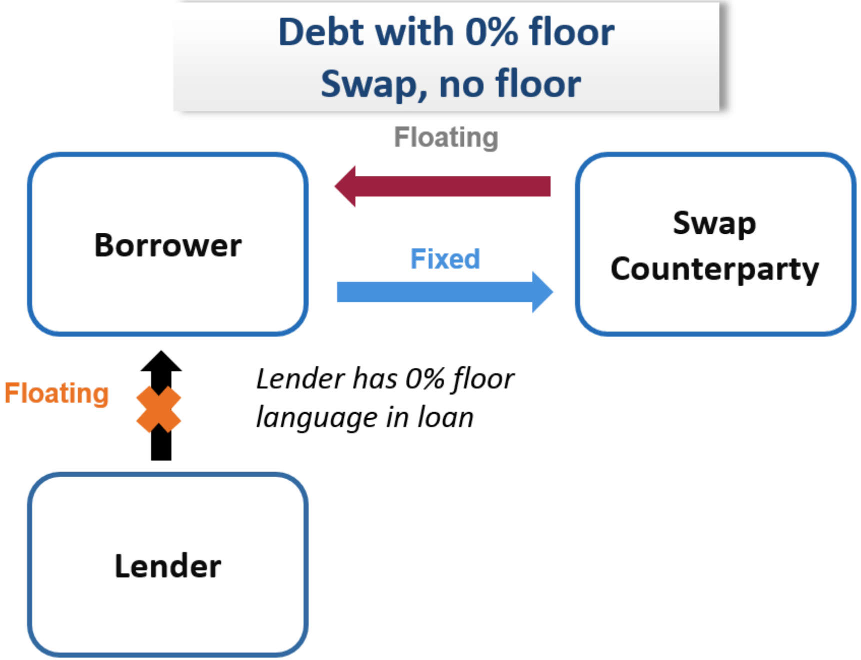
Relevant Proposed Changes

- Key Changes
  - Measuring and presenting ineffectiveness
  - Effectiveness testing requirements
  - Required timing of the inception quantitative effectiveness test
  - Prime, LIBOR, Fed Funds are all eligible hedge risks
  - More easily hedge commodity risk

FASB Hedge Accounting Proposed Changes

Example – 0% Floors in Loans

- Current standard market practice for lenders to insert 0% floors on LIBOR into loan agreements
- Accounting under current guidance
- Accounting under proposed guidance



**When true economic ineffectiveness still exists earnings volatility may still result*

FASB Hedge Accounting Proposed Changes
Adoption and Transition

- When are expected adoption dates?
  - Expect proposed guidance to be finalized in 2017
  - Early adoption beginning January 1, 2018
- What are the transition provisions?
  - Modified retrospective transition approach
    - New guidance only applied prospectively
    - Adjustment to retained earnings for prior period ineffectiveness