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NAREIT Alert Important Industry Updates from NAREIT

June 23, 2016

On June 6, the Financial Accounting Standards Board (FASB or Board) issued a proposal (the Proposal) to clarify 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 new *Revenue from Contracts with Customers* Standard (the Revenue Standard). Additionally, the Proposal would provide guidance for partial sales of nonfinancial assets (*e.g.,* real estate). The Revenue Standard and related amendments replaced the accounting guidance which previously applied to sales of real estate (*i.e.,* the former *FAS 66, Accounting for Sales of Real Estate (FAS 66))*.However, the Revenue Standard did not include a definition for the term *in substance nonfinancial assets* or guidance for how to account for partial sales of real estate.

The Proposal would "mark to market" all partial sales transactions as if the issuer sold its entire interest in the in-substance nonfinancial assets and therefore would require entities to measure the retained interest resulting from partial sales transactions at fair value. For example, if a REIT sold half of its 40% joint venture interest in a portfolio of real estate assets, it would recognize gain or loss in the financial statements as if it sold all of its interests in the joint venture. This treatment would represent a fundamental change from current U.S. GAAP. Under current guidance, the retained interest is measured at carry-over basis (*i.e.,* depreciated cost) and therefore the seller only recognizes gain or loss from the actual sale. Thus, the Proposal (if finalized) would trigger full gain or loss recognition attributable to the entire property even from partial sales of real estate.

NAREIT believes that the Proposal would be of particular interest of equity REITs that sell partial interests. If you are interested in participating in a NAREIT task force that will evaluate the Proposal and develop a comment letter, please contact Christopher Drula, NAREIT's VP of Financial Standards, at cdrula@nareit.com by June 30. The comment letter deadline is Aug. 5, 2016.

Background

The current scope of the nonfinancial asset guidance includes the transfer of *in substance nonfinancial assets.*However, the term *in substance nonfinancial assets* is not defined in U.S. GAAP. Thus, the Board is seeking to provide clarity for what is meant by this term. Additionally, the current nonfinancial asset guidance does not address partial sales of nonfinancial assets. NAREIT raised this issue previously in comment letters submitted to the Board, as well as in meetings with Board members. While FAS 66 provided prescriptive rules-based guidance for the partial sales transactions; the Revenue Standard does not specifically address these fact patterns.

The Proposal represents the second phase of a project that the Board added to its agenda in 2013. The objective of the project is to clarify the definition of a business by adding guidance to assist in the evaluation of whether a transaction should be treated as an acquisition (or disposal) of assets or acquisitions (or disposals) of businesses. The Board addressed the issues identified in the project in three phases:

- Phase 1 – The Board issued a proposal to clarify the definition of a business;
- Phase 2 – The Board issued the Proposal to (1) clarify the scope of recently issued guidance on sales of*in-substance nonfinancial assets* and (2) provide guidance on partial sales of nonfinancial assets; and,
- Phase 3 – In a future phase, the Board plans to discuss whether there are differences between the accounting for the acquisition and sale of assets and businesses that could be eliminated.

Scope of the Proposal

The Proposal would apply to the sale of all nonfinancial assets and *in substance* non-financial assets unless other guidance in U.S. GAAP would apply. Thus, the Proposal would *not* apply to the sale of businesses, equity method investments, or other revenue transactions. Given the FASB's related *Clarifying the Definition of a Business* Proposal, NAREIT believes that fewer real estate transactions will meet the proposed definition of a business combination, and therefore would be within the scope of the Proposal.

Proposed Definition of In-Substance Nonfinancial Asset

The Proposal would define an *in-substance nonfinancial asset* as an asset of a reporting entity that is included in either of the following:

- A contract in which substantially all the fair value of the assets (recognized and unrecognized) promised to a counterparty is concentrated in nonfinancial assets; or,
- A consolidated subsidiary in which substantially all the fair value of the assets (recognized and unrecognized) in the subsidiary is concentrated in nonfinancial assets.

Proposed Partial Sales Guidance

After executing a partial sale transaction, the Proposal would require an entity to measure its retained interest at fair value. This would result in full gain or loss recognition upon the sale of a nonfinancial asset (or in-substance non-financial asset). Under current U.S. GAAP, the retained interest is measured at its carry-over basis (*i.e.,*marking the retained interest to fair value and recognizing a gain or loss is prohibited). *This represents a fundamental change from existing U.S. GAAP.*

Proposed Effective Date

NAREIT understands that the Board is seeking to evaluate the comments received on the *Clarifying the Definition of a Business Proposal* concurrently with the Proposal, with the aim of aligning the effective dates with the Revenue Standard.

The Proposal would be effective for public companies in fiscal years beginning after Dec. 15, 2017, including interim periods within those years. The FASB would permit early adoption for fiscal years beginning after Dec. 15, 2016.

The Proposal would be effective for non-public companies in fiscal years beginning after Dec. 15, 2018, and interim periods within fiscal years beginning after Dec. 15, 2019. The FASB would permit early adoption for fiscal years beginning after Dec. 15, 2016.

Contact: Christopher Drula at cdrula@nareit.com or George Yungmann at gyungmann@nareit.com.