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NAREIT/REALpac
Impact of Revenue Recognition Proposal on Accounting for Real Estate Sales

Financial Accounting Standards Board
April 28, 2010

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Real Property Association of Canada
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Agenda

1. REESA Process
2. Objective of NAREIT/REALpac Review
3. Effects of Proposed Revenue Recognition Model
4. Common Real Estate Transactions
5. Key Issues/Concerns Identified
6. Improvement To Financial Reporting?
7. Conclusions

1. Real Estate Equity Securitization Alliance (REESA) Process

- **REESA is a global alliance of real estate industry organizations working together on the standardization of global real estate accounting.**
  - Extensive work on IASB/FASB joint convergence projects since 2006
- **REESA Members leading the analysis for the Revenue Recognition project:**
  - Sally Glenn, NAREIT (U.S.)
  - George Yungmann, NAREIT (U.S.)
  - Teresa Neto, REALpac (Canada)
- **Other REESA organizations providing input to the Revenue Recognition project:**
  - Asia Public Real Estate Association (Singapore)
  - British Property Federation (U.K.)
  - European Public Real Estate Association (Europe)
  - Property Council of Australia (Australia)
- **Other contributors to the project:**
  - Representatives of the Big 4 accounting firms serving preparers under both U.S. GAAP and IFRS

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2. Objective of NAREIT/REALpac Review

- Review potential effects of proposed revenue recognition model on existing guidance regarding the accounting for real estate sales? IF FAS 66 is to be “retired”, would the proposed standard provide a sufficient basis for accounting for real estate sales?
- Illustrate the impact of the proposed model on the most common real estate transactions.
- Identify key concerns/issues.
- Will the proposed revenue recognition model improve financial reporting?
- Conclusions.

3. Effects of Proposed Revenue Recognition Model
a) Scope

- **Scope of proposed model is more narrow than FAS 66.**
- **Proposed model as currently presented would be applicable only to sales of inventory property.**
- **Sales of investment property or owner-occupied property would fall outside the scope of the proposed model.**
  - No other relevant standard addresses the accounting for the gain/loss on sale of long-term held properties.
- **Although the sales of investment property are not typically an “output of an entity’s ordinary activities”, they are common transactions for the real estate industry.**
  - Properties are turned over when the maximum value has been deemed to have been obtained with the capital being recycled into a new property.
- **In addition to inventory property, NAREIT/REALpac would support the application of the principles of the proposed revenue recognition model for sales of investment property and owner-occupied property, expanded for gain/loss accounting.**

3. Effects of Proposed Revenue Recognition Model
b) Elimination of partial revenue recognition methods

- **FAS 66 provides for various methods of revenue recognition that allow for *partial* recognition of revenue:**
  - Installment method
  - Cost recovery method
  - Percentage of completion method [1]
  - Reduced-profit method
- **The proposed model is based on *one* revenue recognition principle.**
  - Recognize revenue when performance obligation is satisfied.
- ***Timing* of revenue recognition will be different under proposed model versus FAS 66.**
  - *Amount* of revenue recognized may not differ from FAS 66.

(i) Percentage of completion method is used under the proposed model where control is transferred continuously (e.g. construction of real estate for sale)

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3. Effects of Proposed Revenue Recognition Model
c) Loss of significant guidance

- **Specific and prescriptive guidance will be lost as provided by FAS 66 around:**
  1. Buyer's financial commitment to transaction
  2. Collectability of transaction price
  3. Continuing involvement
  4. Sales to limited partnerships/joint ventures where the seller is a partner or has an interest
  5. Seller's obligation to guarantee seller's return
  6. Partial sales
  7. Condominium sales
  8. Sale-leaseback transactions (FAS 98) – being addressed in Leases project.
- **Proposed model provides principles that address each of the above areas.**

3. Effects of Proposed Revenue Recognition Model
d) Paradigm shift in recognizing revenue

- **One of the underlying principles of FAS 66 is that <u>profit</u> must be determinable in order to fully recognize revenue.**
  - Collectability a key consideration.
- **Cost a key consideration under partial revenue recognition methods (e.g. cost recovery method, performance-of-services method).**

<u>New model</u>:

- **Proposed model considers collectability in *measurement* of revenue**
- **Cost considered in identification of performance obligations.**

4. Common real estate transactions
i) Partial sales

Facts – Company A sells 70% interest in an investment property with carrying amount $1,800,000 to Company B for $1,500,000. Company A and Company B are independent of each other and except for Company A's 30% interest in the property, all other criteria for recognizing revenue under FAS 66 full accrual method and the proposed model have been satisfied.

FAS 66
•No entry at contract inception
•Full accrual method applied on date of title transfer
•Gain on sale recognized of 70% interest sold of $240,000
•Equity investment recognized for 30% interest retained by Company A

Proposed Model
•No entry at contract inception as net contract position is zero
•One performance obligation identified, the transfer of control of the interest in the property for $1,500,000
•Gain on sale recognized when transfer of 70% interest occurs of $240,000
•Equity investment recognized for 30% interest retained by Company A

No significant impacts to financial statements under proposed model

4. Common real estate transactions
i) Partial sales - continued

Facts – Same facts except: a) assume $500,000 cash received prior to sale and b) assume Company A incurs additional non-selling costs of $700,000 prior to sale, resulting in an impairment loss of $250,000.

FAS 66	Proposed Model
•The deposit is recognized as deferred revenue until the sale is fully recognized •An impairment loss is recognized prior to the sale of $250,000 •No gain or loss is recognized on the date of the sale (title transfer) as property carrying amount equals sales value (proceeds of $1,500,000)	•The cash deposit results in the recognition of a contract liability of $500,000 •The incremental costs indicate an onerous performance obligation and a contract loss and new liability are recognized for $250,000 •When the performance obligation is satisfied, no gain or loss is realized in the P&L – a loss of $250,000 on the transfer of the property is offset by a gain of the same amount reflecting the reversal of the new liability recognized earlier when the additional costs were incurred

No significant impacts to financial statements under proposed model

4. Common real estate transactions
ii) Sale of a property with contract for asset management services

Facts – Company A sells an investment property with a carrying amount of $1,500,000 for $2,000,000 and agrees to manage the property for three years at no additional cost. The market rate for such services is $100,000 per year (present value of contract is $248,685). The relative standalone selling price of the property is $1,715,315. Cash flows from the property are sufficient to service all indebtedness of the property. Assume $2,000,000 is received at the date of sale (minimum initial investment requirement is met under FAS 66).

FAS 66

- A portion of the $2,000,000 transaction price is allocated to the management services contract for the imputed value of those services of $248,685
- A deferred management fee liability of $248,685, and a gain on sale of $251,315 is recognized on the date of sale of the property
- The management fees are recognized as they are delivered over the 3 years.

Proposed Model

- The transaction price is allocated to two performance obligations, the sale of the property $1,751,315 and the management service contract $248,685
- On the date the control of the property is transferred, a performance obligation for the management services is recognized for $248,685, revenue of $1,751,315 and a gain on sale of the property of $251,315 is also recognized.
- The management fees are recognized as a continuous transfer of services over the 3 years

No significant impacts to financial statements under proposed model

4. Common real estate transactions
ii) Sale of a property with contract for asset management services – cont'd

Facts – Same facts except on the date of sale, full title of the property has transferred, and Company A receives $400,000 in cash but expects to collect the full amount of the sales price. The $400,000 does not meet the minimum initial investment requirement test under FAS 66.

FAS 66

- Company A may recognize the cash as a deposit with no gain on sale recognized until the minimum initial investment requirement is met.
- Or, Company A may choose to recognize a portion of the gain using the installment method at that time, up to the proportion the $400,000 represents of the total sales value.
- Deferred management fees may commence being recognized when full profit accrual is allowed (i.e. when sufficient cash has been received to meet the initial investment tests).

Proposed Model

- The transfer of control of the property indicates the performance obligation on the sale of the property has been satisfied and revenue can be recognized.
- No collection issue exists at the time the $400,000 is received, therefore 100% of the revenue associated with the property performance obligation and the full gain on sale of $251,315 is recognized.
- Recognition of a contract liability for management services will depend on timing with which the remaining $1.6M is received.

Impact: Earlier recognition of revenue and gain under proposed model

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4. Common real estate transactions
iii) Condominium sales

Facts – Condo Developer sells two units in a condominium development. Each unit's sales price is $300,000 and each buyer provides a 5% down-payment. The building's construction is 50% complete and all criteria are met such that the percentage of completion method of accounting may be applied to the sales per FAS 66. The cost of one unit is estimated to be $180,000. One year later the buyers take possession of the units, control has transferred to the buyers and all remaining consideration has been received by the Developer.

FAS 66

- The developer recognizes 50% of the revenue and 50% profit on the two units when the contracts are signed and deposits are received since the minimum initial investment requirements are met. Revenue $300,000 and profit $120,000.
- One year later, the remaining 50% revenue and 50% profit are recognized when the buyers take possession of the units.

Proposed Model

- The performance obligation under each contract is for the Developer to transfer control of a unit to the buyer.
- The deposits are recognized as a performance obligation at the time the contracts are signed. No revenue or profit is recognized.
- When control of the units transfer to the buyers, one year later, 100% of the revenue or $600,000 and 100% of the profit or $240,000 is recognized.

Impact: Delayed recognition of revenue and profit under proposed model

4. Common real estate transactions
iii) Condominium sales – cont'd

Facts – Same facts except assume in this scenario that one of the units is being sold to a buyer as a secondary residence. The 5% down-payment does not meet the minimum initial investment test per FAS 66 (10% is required when the buyer is purchasing a secondary residence).

FAS 66

- The developer recognizes 50% of the revenue and 50% profit on only one unit when the contracts are signed. The down-payment relating to the buyer purchasing a secondary residence is accounted for as a deposit.
- One year later, when the buyers take possession of the unit, the remaining 50% revenue and 50% profit on the first unit is recognized while the full 100% of revenue and profit is recognized on the second unit.

Proposed Model

- The intended use of the unit by the buyer has no impact on revenue recognition. The deposits would be accounted for as per the first scenario.
- The accounting is the same as per the first scenario when the buyers take possession of the units.

Impact: Buyer's intent of use of the property has no impact on revenue recognition.

4. Common real estate transactions
iv) Sale of property with continued seller support of operations

Facts – Company A sells a newly constructed investment property with a cost of $1,200,000 to Company B for $2,000,000. Company A guarantees that the cash flows of the property will be sufficient to meet all operating needs of the property for the first three years. There is no debt on the property and the seller's guarantee does not include a return on the buyer's investment. Total projected costs for this contract is $1,920,000 ($1.2M property cost, operating costs $200K in 20X1, $260K for both 20X2 and 20X3) and total projected revenues are $2,580,000. Company A expects to support the operations by $20K in 20X1.

FAS 66

- Company A applies the "performance-of-services" method to recognize revenue and profit on the transaction. Revenues and operating expenses are projected for 3 years.
- On the date of the sale, partial profit is recognized representing 63% or $412,500 of total anticipated profit ($1,200K/$1,920K x profit of $660K). A deferred gain is recognized for remaining $387,500.
- For each of the three years of operations support, additional deferred gain is taken into the P&L, and total consideration adjusted for any required cash support.

Proposed Model

- The performance obligation under the contract is to transfer the control of the property to the buyer. The 3-year guarantee represents variable consideration which is estimated.
- On the date of the acquisition the revenue and gain is recognized based on the estimated consideration, which in this example is $1,980,000. A liability for the expected cash payment required to support the operations is recognized for $20,000.
- The revenue and gain would be adjusted, if necessary, after each of the three years of operations results.

Impact: Earlier recognition of revenue and profit under proposed model

5. Concerns/Issues Identified

- **Where <u>collectability</u> is not reasonably assured, is a recognition threshold warranted?**
  - For a probability expected weighted amount of consideration to be received of less than 50%, revenue is still recognized.
  - Some argue that a sale has not taken place in these cases.

- **Additional guidance will be helpful on when a transaction should be considered a <u>financing</u> or <u>leasing</u> arrangement rather than a sale of property.**
  - Many of the complex transactions currently addressed in the continuing involvement guidance under FAS 66 will need to consider whether these arrangements apply.

5. Concerns/Issues Identified - continued

- **Additional guidance will be helpful on when a transaction's scope falls to other standards pertaining to equity investments, non-controlling interests and joint ventures.**
  - Sales to limited partnerships where the seller has an interest in partnership
  - Partial sales

- **Identification of separate performance obligations may be challenging in certain transactions.**
  - E.g. are the common areas of condominium buildings (fitness centres, recreational rooms, lobby, terraces, etc.) unique performance obligations when such areas are not separately priced in the condo unit sales price?

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6. New Model - Improvement to Financial Reporting?

- **Very difficult question to answer.**
  – Loss of FAS 66 is a perfect example of the classic debate: principles-based standards versus detailed, prescriptive, asset-specific rules.
- **In our opinion, an improvement to financial reporting is assessed by three factors:**
  1. Are the financial statements more <u>relevant</u> and <u>useful</u> to users?
     - We believe transactions accounted for under the proposed revenue recognition model will be more relevant than those accounted for under FAS 66.
     - However, the proposed model must be supported by *substantive and specific disclosures* that articulate how the principles of the proposed model have been applied.
     - FAS 66 promotes consistent calculated answers that may not always be relevant to financial statement users.

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6. New Model - Improvement to Financial Reporting?

2. Is the financial information comparable among entities for economically similar transactions?
   - Financial information will only be more comparable if entities base reporting on the substance of the transaction in accordance with the principles of the proposed model.
   - We expect the timing of revenue recognition to be more comparable because of the single, less complex recognition principle of the proposed model.
   - Measurement of revenue may be less comparable because of the judgment required in assessing collectability and variable consideration.
   - There may be inconsistent determinations on whether non-inventory sales of real estate are ordinary activities of the entities .

3. Does the financial information adequately represent the economic substance of the transaction?
   - We believe the proposed model will better reflect the economic substance of all real estate sales.

7. Conclusions

- **NAREIT/REALpac believe a clearly articulated principles-based revenue recognition standard would provide adequate guidance for accounting for real estate sales.**
- **We believe that retaining FAS 66 is not necessary.**
- **In addition to inventory property, NAREIT/REALpac support the proposed revenue recognition model for sales of investment property and owner-occupied property, expanded for gain/loss accounting.**
- **Where the Boards believe that additional guidance is required, general guidance should be provided rather than bright-line tests.**
- **Application guidance and examples applying the principles of the proposed revenue recognition model to real estate sales would be very useful.**