REVENUE RECOGNITION - KEY CONSIDERATIONS FOR THE REAL ESTATE INDUSTRY

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With you today

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Agenda

- Overview and latest developments of ASC 606
- Real estate sales
- Sales of real estate to customers
- Management and leasing service revenue
- Hospitality
- Non-lease elements/non-lease components
- Transition approach
- Required disclosures
- Implementation considerations
Objectives

By the end of this webcast, you will be able to:

• Describe at a high level the revenue recognition standards

• Discuss implications of the new revenue recognition guidance to the real estate industry

• Determine how your revenue recognition accounting policies, processes and controls may be affected by the new guidance

• Gain insight into key considerations for implementation
OVERVIEW OF ASC 606
Background

• Final standards issued by FASB and IASB in May 2014
• Many changes made since issuance
  – FASB - Issued 7 additional final ASUs
  – IASB - Issued an amended IFRS 15
• FASB Transition Resource Group (TRG)
  – Purpose was to discuss implementation issues and identify issues that warrant further attention
• AICPA’s industry-specific task forces (16)
  – Purpose is to identify and provide guidance on implementation issues
  – Over 150 issues have been raised
Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
Key steps

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) each performance obligation is satisfied
REAL ESTATE SALES
Identify the party to the contract and which guidance is applicable

- Real estate is a nonfinancial or an in-substance nonfinancial asset.
  - The buyer is important!!
  - The nature of the buyer will impact the accounting.

<table>
<thead>
<tr>
<th>Who</th>
<th>ASC Topic</th>
<th>Example</th>
</tr>
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<tbody>
<tr>
<td>Sales to customers of real estate</td>
<td>606</td>
<td>Sales by real estate developers and homebuilders</td>
</tr>
<tr>
<td>Sales to noncustomers of real estate</td>
<td>610</td>
<td>Sales by REITs, real estate funds with historic cost reporting, real estate holding entities, and non-real estate entities</td>
</tr>
<tr>
<td>Sales to noncustomers of real estate in</td>
<td>810</td>
<td>Sales of an asset group, which may include real estate, that together qualifies as a business and are not considered in-substance nonfinancial assets.</td>
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Considerations in a sale

• When does a sale occur?
  – Under 606 and 610 a sale occurs when the buyer has the ability to direct the use of or obtain substantially all of the benefits from an asset.
  – Does the buyer have control of the real estate?

• ASC 360-20, *Real Estate Sales*, provides detailed guidance on whether a seller has continuing involvement with the real estate

• ASC 606 eliminates the 360 guidance

• Instead a seller must evaluate if it is probable that it will collect the consideration it expects to be entitled to and when control is transferred to the buyer.
SALES OF REAL ESTATE TO CUSTOMERS

Condominium developers
Step 1. Identify the contract with the customer

• Sale of a residential unit
  – The buyer agrees to provide consideration to the developer and, in exchange, obtains legal title and the exclusive right to control the use of the asset

• Evaluating the contract criteria
  – Purchase and Sale Agreement generally satisfies:
    • The entity can identify each party’s rights regarding goods or services to be transferred
    • The entity can identify the payment terms for the goods or services to be transferred
    • The contract has commercial substance

• Both parties are committed to perform
  – Developer is committed to provide the residential unit
  – Evaluation of the buyer’s commitment will involve significant judgment over:
    • the amount of an initial deposit
    • the Developer’s ability to retain the deposit should the buyer elect to cancel the contract
Step 2. Identify the performance obligations in the contract

- **Sale or transfer of common areas:**
  - Common areas are generally transferred to a third party (e.g., a homeowners’ association or municipality) rather than the homeowner
  - **Assess if the third-party is deemed “a customer”**
    - If Yes - the developer would have to wait until it transferred control of the common area to recognize the revenue allocated from a condo sale that occurred before control of the common area was transferred
    - If No, accounting for common areas will remain consistent with current guidance
Step 3. Determine the transaction price

• Collectibility
  – Assess a customer’s ability to pay based on the customer’s:
    • Financial capacity
    • Intention to pay considering all relevant facts and circumstances
  – Determine if the transaction price contains any variable consideration before assessing collectibility
    • Rebates, discounts, price concessions offered explicitly or implicitly to the customer
  – Buyer’s funding position:
    • Self funded
    • Financed by third party
    • Financed by developer
Step 5. Recognize revenue when (or as) each performance obligation is satisfied

- Criteria for developers (particularly condominium units) to continue to recognize revenue over time if they can determine that either criteria is met:
  - the performance creates or enhances an asset that the customer controls as the asset is created or enhanced or
  - the performance does not create an asset with an alternative use and there is an enforceable right to payment from the customer for performance completed to date
Step 5. Recognize revenue when (or as) each performance obligation is satisfied

- Accounting for costs incurred to sell real estate projects
  - ASC 970, *Real Estate — General*
    - Accounting for real estate development and “costs incurred to sell real estate”
    - Continue to apply ASC 970 for capitalizing real estate project costs and allocating costs of common areas
    - Eliminates guidance under ASC 970 on cost incurred to sell
  - ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*, to account for costs incurred to obtain a contract
    - Incremental costs of obtaining a contract with a customer are recognized as an asset if the entity expects to recover them
    - Entities may need to apply significant judgment to determine which costs represent incremental costs to obtain a contract
    - The types of costs that developers can capitalize will be limited by the new standard
MANAGEMENT & LEASING SERVICE REVENUE
Step 2. Identify the performance obligations in the contract

• Identify the promised services
  – Day-to-day management including maintenance, security, back office support, etc.
  – Leasing of available spaces
  – Coordinating or oversight of construction of the tenant’s improvements

• Consider additional services that are not readily observable
  – Advertising of the property and on-site events
  – Evaluating potential tenants and negotiating lease terms
Step 3. Determine the transaction price - variable consideration

Step 4: Allocate the transaction price

- Fees for performance obligations under property management and leasing service contracts are generally variable and require judgment, for example:
  - Management services for a fee of 5% of the property’s quarterly gross revenues
  - Incentive fee of 2% of the property’s annual net operating income (NOI)
  - Construction supervision fee of 5% of total hard costs of tenant improvements

- Keep in mind that fees may consist of both a fixed and variable component that may relate to a single performance obligation

- **Step 4: Allocate the transaction price**
  - Only applicable when there are multiple performance obligations
  - Allocated based on the standalone selling price (SSP)
Step 5. Recognize revenue when (or as) each performance obligation is satisfied

- **Property management:**
  - Variable consideration allocation exception recognizes management fees for services related to a distinct period of time
  - Contract may include a fixed fee which would be generally recognized over the term of the contract (may differ from variable consideration pattern)

- **Leasing services:**
  - Real estate owner typically consumes benefit from the leasing services upon execution of the lease – recognition of revenue at a point in time
  - Possible for leasing services to be simultaneously received and consumed by the real estate owner if oversight of tenant improvements is determined to be included in the single performance obligation – recognition of revenue over time
HOSPITALITY
Hospitality: Owned and Leased Property Revenues

• Step 1: Identify the contract with the customer
  – Types of contracts
    • Non-cancellable – contract would be for the entire length of the reservation
    • Night-before or day-of cancellation policy – daily contract with optional purchases for additional nights
  - Package or other ancillary revenue
    • Generated when a hotel guest chooses to purchase goods and services separately from the hotel room
    • When connected with the reservation, owner should consider the related terms to identify enforceable rights and obligations created under the reservation
Step 2: Identify the performance obligations

- One performance obligation to provide lodging facilities as the separate components (room, toiletries, housekeeping, etc.) are not distinct within the context of the contract
  - Highly dependent and interrelated as part of the obligation to provide a lodging facility
- One performance obligation for non-cancellable reservations
- Separate performance obligations for each day of the stay in cancellable reservations (daily contract) (unless the option for additional night(s) is a material right)
Hospitality: Owned and Leased Property Revenues

• Step 2: Identify the performance obligations
  – Package reservations could contain multiple obligations
  – Option to acquire good and services in addition to hotel reservation
    • Consider if the option is a material right
    • If offered only to hotel guests, and discount is incremental to the range typically given, it is a material right
    • If offered to both guests and non-guests, it is not a material right
Hospitality: Owned and Leased Property Revenues

• Step 4: Allocate the Transaction Price
  – Only applicable when there are multiple performance obligations
  – Allocate based on standalone selling price (SSP)
  – If an option for free or discounted ancillary services contains a material right and is determined to be a separate performance obligation, the transaction price should be allocated to each performance obligation, including the material right, on a relative SSP basis.
  – Refer to Example 49 of ASC 606
• Step 5: Recognize revenue
  - Hotel room only reservations are performance obligations satisfied over time as the hotel guest simultaneously receives and consumes the benefits provided by the hotel.
  - Typically most ancillary goods or services do not meet the criteria to be considered performance obligations satisfied over time.
  - For package reservations, if more than one performance obligation is identified, the hotel owner is required to determine the pattern of recognition for each performance obligation.
  - Similarly, if an option for free or discounted ancillary services (vouchers) is determined to be a separate performance obligation, the owner determines when to recognize revenue for the option. The owner should recognize revenue from the option for free or discounted ancillary services that contains a material right, when those future goods or services are transferred or when the option expires. (Timing could be different than current method of package allocation.)
Sources

• The following URL is for the home page for the AICPA Hospitality Entities Revenue Recognition Task Force which contains the list of implementation issues and exposure drafts of issue papers
  – Copy and paste the following URL into your web browser:
Accounting for leases

- ASC 840 requires the determination of lease and non-lease elements in a contract.
- Reimbursements received by lessors for common area maintenance (CAM), real estate tax and insurance expenses are executory costs that have been considered part of the lease element.
- For leases executed after the adoption of ASC 842, CAM and other good / services will be considered a non-lease component.
- Non-lease elements / components will be accounted for under ASC 606.
Accounting for leases

• ASU 2018-11, Leases (Topic 842) – Targeted Improvements, provides lessors with a practical expedient, by class of underlying asset, to not separate nonlease components if both 1) timing and pattern of transfer are same for nonlease component and 2) lease component classified as operating lease.
TRANSITION APPROACH
## Transition Methods

<table>
<thead>
<tr>
<th>Transition Method</th>
<th>2018 Impact</th>
<th>2019 Impact</th>
<th>Date of cumulative effect adjustment (e.g., calendar year end private co.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Retrospective (with or without one or more practical expedients*)</td>
<td>Restate all contracts except those covered by practical expedients</td>
<td>Apply to all contracts</td>
<td>January 1, 2018 (in 2019 Financial Statements)</td>
</tr>
<tr>
<td>Modified Retrospective (cumulative effect at the date of adoption**)</td>
<td>No contracts restated</td>
<td>Apply to all contracts***</td>
<td>January 1, 2019 (in 2019 Financial Statements)</td>
</tr>
</tbody>
</table>

*One or more of four available practical expedients may be elected. Consistent application of each one elected to all contracts in all reporting periods presented is required. If one or more are elected, incremental disclosures are required.

**One practical expedient may be elected. If elected, consistent application to all contracts in all reporting periods presented is required along with incremental disclosures.

***ASC 606 may be applied to either: (a) all contracts at the date of initial application or (b) only contracts not completed, or contracts for which substantially all of the revenues have not been recognized, at the date of initial application. Must disclose which approach was taken.
• **Practical expedients**—One or more may be elected:
  - Contracts that begin and end within the same annual reporting period do not have to be restated
  - For completed contracts with variable consideration, the transaction price at completion of the contract may be used
    - For transition purposes, a completed contract is one for which all or substantially all of the revenue has already been recognized under legacy U.S. GAAP (e.g., ASC 605)
  - Contracts with remaining performance obligations as of the date of initial application are exempt from certain disclosures
  - For contracts modified before the beginning of the earliest period presented using ASC 606, an entity may apply certain guidance in ASC 606 to the contract as modified as of the beginning of the earliest period presented using ASC 606
Modified retrospective transition method

**Practical expedient**: For contracts modified before the beginning of the earliest period presented using ASC 606, an entity may apply certain guidance in ASC 606 to the contract as modified as of the date of initial application
  - If elected, consistent application to all contracts in all reporting periods presented is required
  - If elected, incremental disclosures are required

**Disclose the effects on each line item in the financial statements of applying the new guidance in the period of adoption**
  - Need to know what revenue and other financial statement line items would have been in the period of adoption if the entity had continued to apply legacy U.S. GAAP in that period
## Transition Method Pros and Cons

<table>
<thead>
<tr>
<th></th>
<th>Full retrospective</th>
<th>Modified retrospective</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pros</strong></td>
<td>• Provides for greatest comparability</td>
<td>• Generally viewed as being less time consuming (prior to adoption)</td>
</tr>
</tbody>
</table>
| **Cons**         | • Comparability is somewhat hindered to the extent any practical expedients are elected  
                   • Generally viewed as being more time consuming, particularly when:  
                   - One or more comparative periods are presented  
                   - There is a large population of multiyear contracts  
                   • Comparability is hindered to the extent one or more comparative periods are presented  
                   • Required to provide information based on what each line item would have been in the year of adoption under legacy U.S. GAAP  
                   - Requires dual bookkeeping in year of adoption |
Balance sheet presentation

- Entity recognizes a contract asset or contract liability by comparing its performance under the contract (i.e., transferring control of performance obligations) to Customer’s performance under the contract (i.e., making payments)
  - Contract asset
    - Entity’s performance > Customer’s performance
  - Contract liability
    - Entity’s performance < Customer’s performance
  - Titles are not prescriptive
    - However, it must be clear by the title that a contract asset is not a receivable

- Receivables are only recognized for the unconditional right to receive consideration
  - Recognized separate from other assets
Disclosures

• Objective is to help financial statement users understand the nature, amount, timing and uncertainty of the related revenue and cash flows

• Detailed quantitative and qualitative information about the following must be disclosed:
  – Disaggregated revenue
  – Contract assets, contract liabilities and receivables
  – Performance obligations in general and the transaction price allocated to the remaining performance obligations at the end of the reporting period
  – Significant judgments related to when performance obligations are satisfied and used to estimate and allocate the transaction price
  – Capitalized customer contract costs
Disclosure Requirements

• Disclosure of performance obligations
  – When the entity typically satisfies its performance obligations
  – The significant payment terms of its contracts
  – The nature of goods or services that the entity has promised to transfer to the customer
  – The types of warranties and related obligations

• Disclosure of transaction price allocated to unsatisfied performance obligations
  – The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied or partially satisfied
  – An explanation of when the entity expects to recognize the revenue allocated to unsatisfied or partially satisfied performance obligations
Disclosure Requirements

• Practical expedient:
  – Entities can avoid providing the information required by this disclosure for contracts with an original expected duration of less than one year
  – An entity that uses this practical expedient will be required to disclose that fact
Revenue Recognition Resource Center

Information about the new guidance in ASC 606

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), which added Topic 606 to the FASB’s Accounting Standards Codification (ASC) and will replace almost all pre-existing revenue recognition guidance in legacy generally accepted accounting principles (GAAP) with a robust framework for addressing how an entity should account for its revenue. Implementation by calendar year-end public entities must occur no later than January 1, 2018 and by other calendar year-end entities no later than the year ending December 31, 2019.

This resource center provides access to high-level and detailed information about the new revenue recognition guidance. Check back often as additional information will be added in the near future.

RESOURCES

WHITE PAPER

Revenue recognition: Overview of ASC 606

An overview of the new guidance in ASC 606 (as amended) and highlights of the fundamental changes ASC 606 will bring to accounting for revenue.

Need help implementing the new revenue recognition standard?

Let the professionals at RSM help guide your company through the challenges of implementing 606.

First Name *
Last Name *
Email Address *
Company *
Business Phone *
Select State *

Submit

Additional resources

Financial Reporting Resource Center: Revenue recognition

Non-audit client additional resources

Migrating to Advanced Revenue Management (ARM) – are you ready?
IMPLEMENTATION PLAN
Implementation Plan

• Develop an implementation plan
  – Designate individuals/team to lead implementation
  – Read the standard, obtain further training as needed
  – Review current revenue streams and revenue recognition to ensure appropriate understanding of existing policies/practices
  – Create a timeline including milestones for adoption

• Meet with key stakeholders (audit committee, board, owners, etc.) to educate them on the new standard and potential impact (i.e. changes in timing, variable consideration, etc.)
Discovery

• Evaluate existing contracts under the new 5 step model
  - Identify any new potential performance obligations
  - Identify potential changes to the transaction price (i.e. changes in variable consideration, significant financing component, etc.)
  - Determine the standalone selling price (SSP) for each performance obligation

• Identify changes to the allocation and timing of revenue recognition under ASC 606
  - Identify the drivers for unwanted changes (if any)
  - Determine if changes to standard contract terms or lack of standard contract terms is driver for changes
• Assess internal controls
  - Evaluate controls in-place, determine adequacy of controls over both revenue recognition as well as the adoption of new accounting standards

• Assess whether current accounting system can perform necessary allocations under ASC 606 for contracts with multiple performance obligations
  - Review disclosure requirements and assess the accounting systems ability to generate information to meet the new disclosure requirements
Implementation

• Update revenue recognition policy memo’s

• Design controls to address the gaps identified in the Discovery phase
  – Ensure appropriate training is provided to employees impacted by changes (including sales force)

• Modify accounting system as needed to account for transactions under ASC 606 & meet disclosure requirements
  – Test modifications prior to going live to ensure system is functioning as intended
  – Make sure controls in place over modifications are appropriate

• Assess draft disclosures against ASC 606 to determine the completeness of the disclosures
LESSONS LEARNED
Lessons Learned

• Internal Controls
  − New or enhanced controls over contract approval
    • Standardized contracts with limited deviations from standard language to ensure modifications do not create unintended performance obligations, contract terms, etc.
  − Refresh controls over adopting new accounting standards in general (leasing standard is not far behind)

• Accounting System
  − Adequacy of current system to account for revenue under ASC 606, including the ability to generate necessary data for compliance with disclosure requirements

• Compensation Plans
  − Structure of commission plans may need to be revisited to address capitalization and amortization concerns
  − May be impacted by changes to the timing of revenue recognition
Lessons Learned (continued)

• Compliance Matters
  – Changes in the timing of revenue may impact financial covenant compliance related to financing arrangements (if discussions are being held with lenders now for revenue recognition, keep in mind leasing too)
  – Changes in the timing of revenue may impact income taxes, including deferred tax assets and liabilities
  – Communication with external auditors throughout the adoption process will be key to prevent last minute audit issues
    • Agreement with auditors throughout the implementation on matters such as: performance obligations, pattern of revenue recognition, disclosures, changes to internal controls, etc. should be reached now and not wait until the audit

• Get started now if you haven’t already!!