

In depth

A look at current financial reporting issues



Revenue from contracts with customers

The standard is final – A comprehensive look at the new revenue model

Real estate industry supplement

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At a glance

On May 28, the FASB and IASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices.

In depth US2014-01 is a comprehensive analysis of the new revenue standard. This supplement highlights some of the areas that could create the most significant challenges for U.S. GAAP reporters in the real estate industry as they transition to the new standard.

Overview

The new revenue standard will supersede existing revenue recognition guidance; however, certain types of contracts will be scoped out of the revenue standard. Most significantly for real estate, leasing transactions are not within the scope of the new standard. Accounting for leasing transactions is being addressed by a separate standard-setting project that is currently underway.

The new revenue standard is effective for public entities that are U.S. GAAP reporters for the first interim period within annual reporting periods beginning after December 15, 2016 (nonpublic companies have an additional year to adopt). The standard prohibits early adoption for public entities that are U.S. GAAP reporters, but does allow nonpublic companies to adopt the standard using the public company effective date.

This publication focuses on how the standard will affect certain revenue arrangements for real estate companies applying U.S. GAAP. The examples and related discussions are intended to provide areas of focus to assist entities in evaluating the implications of the new standard. The views expressed in this publication are preliminary and may change as interpretations of the guidance evolve.

This publication will predominantly address sales of real estate, real estate asset management considerations, and property management arrangements. Appendix A to this publication provides examples of common real estate transactions and the implications of the new revenue standard as compared to existing U.S. GAAP. Appendix B to this publication provides a detailed example illustrating the practical application of the new revenue standard for a “vertically integrated” homebuilder.

Scope

The new revenue standard will apply to sales of real estate assets to customers, such as sales by homebuilders, merchant builders, land developers, condominium sellers, and timeshare sellers. Sales of real estate that constitute a business, when those sales are made to customers, will also be in the scope of the new standard. The new standard will also apply to property management fees, construction or development fees, leasing commissions, and other types of fees commonly present in real estate arrangements.

Sales of property, plant, and equipment, operating property, and investment property are generally not considered “revenue from contracts with customers” or an output of an entity’s ordinary activities. For the transfer of nonfinancial assets that are not an output of an entity’s ordinary activities (e.g., sale of real estate to a non-customer), the FASB amended ASC 360-20, *Real Estate Sales*, and requires companies to apply other standards, as described below.

If the real estate is being sold to a non-customer and constitutes a business, the guidance in ASC 810, *Consolidation*, applies. For sales of nonfinancial assets to non-customers, the FASB created ASC 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*, which requires entities to apply the guidance from the new revenue standard on the following topics: (a) existence of a contract – to determine when the seller has a contract that creates enforceable rights and obligations; (b) control – to determine when to derecognize the asset; and (c) measurement – to determine the amount of gain or loss to recognize when the asset is derecognized (including any constraints on the transaction price when the consideration is variable).

If derecognition treatment is appropriate (e.g., the seller has transferred control of a business under ASC 810-10 or the seller transferred control of an asset under ASC 610-20), these transactions generally result in a non-operating gain or loss rather than revenue.

Homebuilders, land developers, merchant builders, condominium sellers, and timeshare sellers are expected to be the most affected by the new standard. For these entities, when a performance obligation is satisfied subsequent to a sale to a customer, timing of both revenue and costs may differ from current accounting. Examples include amenities (such as pools, clubhouses, and golf courses), infrastructure, and offsite elements completed after delivery of a portion of the property to customers.

The standard may also affect entities in other industries that enter into real estate transactions. Examples include sales of manufacturing facilities, sales of real estate (e.g., other real estate owned or “OREO”), sales by banks, sales of plants in the power and utility industry, and store carve-outs and divestitures in the retail and consumer industry. The type of real estate sales these transactions represent (e.g., sale of a business or an asset to a customer or non-customer) will dictate which accounting guidance is applicable.

PwC observation:

The new standard could significantly change the timing of revenue recognition for many arrangements. As a result, the standard may require management to perform a comprehensive review of existing contracts, business models, company practices, and accounting policies.

The standard also has broad implications for an entity’s processes and controls. Management may need to change existing IT systems and internal controls to capture different information than needed in the past. The impact could extend to other functions such as treasury, tax, and human resources. For example, changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and key financial ratios.

Changes to financial reporting without changes to tax requirements may necessitate complex tracking of book/tax differences for tax return and deferred tax provision purposes.

Overview of the revenue model

The boards believe a single, comprehensive revenue recognition model for all contracts with customers will lead to greater consistency in the recognition and presentation of revenue and will improve comparability within industries, across industries, and across capital markets.

The standard contains principles that an entity will apply to determine the amount and timing of revenue recognition. The core principle is that an entity recognizes revenue as it transfers goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services.

The five-step approach to revenue recognition

Step 1: Identify the contract(s) with the customer

In many situations, identifying a contract with a customer is one of the easier aspects of the model to apply. However, for sales of real estate, this step may be critical as the appropriate derecognition model will depend primarily on whether there is a sale of an asset or a business to a customer or a non-customer.

Step 2: Identify the performance obligations in the contract

A performance obligation is a promise (whether explicit or implicit) in a contract with a customer to transfer a distinct good or service (or bundle of goods or services) to the customer. A good or service is distinct if (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer and (b) the good or service is distinct in the context of the contract.

Step 3: Determine the transaction price

The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring goods or services, excluding amounts collected on behalf of third parties. Variable consideration, significant financing components, noncash consideration, and consideration payable to a customer can all affect the transaction price.

Step 4: Allocate the transaction price to the performance obligations

The standard generally requires an entity to allocate the transaction price to the separate performance obligations based on their relative standalone selling prices. Standalone selling price is generally the observable price of a good or service sold separately by the entity; however, there could be a number of instances where the standalone selling price is not observable and must be estimated. Entities may utilize a residual approach to estimate the standalone selling price of a good or service, but only if the selling price is highly variable or uncertain. This will often require real estate entities to make estimates of the standalone selling prices for services they do not sell on a standalone basis, which could require judgment.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied

An entity will recognize revenue when (or as) it satisfies a performance obligation by transferring control of a promised good or service to a customer. Performance obligations can either be satisfied at a point in time or satisfied over time.

Sales of real estate

The new revenue standard will apply to transfers of a nonfinancial asset to a customer (either a business or an asset). Transfers of a nonfinancial asset (that does not constitute a business) that is not an output of an entity's ordinary activities is within the scope of ASC 610-20, which incorporates aspects of the guidance in the new revenue standard. This decision was made in response to concerns raised regarding sales of real estate, but it could have broader implications. Derecognition or timing of income recognition might differ depending on the guidance applied.

The nature of sales of real estate will need to be evaluated to determine if they are sales of assets or businesses, and whether those sales are to customers or non-customers. Significant judgment will be required to determine if the sale of real estate constitutes an asset or a business. Under U.S. GAAP, substantially all sales of rental real estate (with leases in place) may be considered sales of businesses to non-customers.

The appropriate revenue recognition model to apply depends on which sales scenario exists, as illustrated in the table below.

Scenario	Revenue recognition model
<p>Scenario 1: Sales of real estate to customers Sales of real estate (businesses and assets) to customers in the ordinary course of business (e.g., timeshares, condominiums, homebuilding, etc.)</p>	Apply the new revenue standard to the entire transaction.
<p>Scenario 2: Sales of real estate (asset sales) to non-customers Sales of real estate outside of the ordinary course of business (non-customers) that does not constitute a business (e.g., sale of vacant building or empty land lot)</p>	<p>Apply ASC 610-20, which requires entities to apply certain aspects of the new revenue standard to determine:</p> <ol style="list-style-type: none"> 1. if an enforceable contract exists, 2. if control of the asset has transferred to the buyer, and 3. the amount of gain or loss to recognize when the asset is derecognized, considering any constraint on income due to variable consideration.
<p>Scenario 3: Sales of real estate (businesses) to non-customers Sales of real estate that constitute a business</p>	Refer to the derecognition model in the consolidation guidance (ASC 810), which has been modified to no longer scope out sales of real estate. This guidance also refers to ASC 610-20, which incorporates aspects of the new revenue standard, as described above for “Scenario 2.”
<p>Scenario 4: Partial sale of real estate Sales of real estate (businesses and assets) to a joint venture to be accounted for as an equity method investment (e.g., seller retains interest but does not control the joint venture)</p>	<p>The appropriate accounting model to apply to the partial sale will depend on whether the transaction is a partial sale of a business or asset. The derecognition model in the consolidation guidance (ASC 810) or the partial sale model in the nonmonetary transaction guidance (ASC 845) may need to be considered.</p> <p>Determining the appropriate gain recognition and accounting treatment of the retained interest will depend on which model is applied.</p>

Note: Refer to Appendix A for discussion of the accounting considerations relevant to certain real estate sales scenarios outlined in the table above.

The current real estate sales guidance in U.S. GAAP was largely written in the 1970s to address perceived financial reporting abuses in the real estate sector. It is viewed by many in the industry as a rigid, rules-based approach; therefore, some may welcome the changes resulting from the new revenue standard. The current guidance has two primary objectives: (a) the appropriateness of derecognition, which is assessed by evaluating whether a sale has been consummated for accounting purposes (this is not necessarily based solely on whether a legal sale has occurred); and (b) measurement of profit.

Under current U.S. GAAP guidance, sales of real estate are assessed to determine whether “risk and rewards” have transferred, including consideration of any continuing involvement by the seller. These rules are complex, and often a sale is not recognized or a large amount of profit is deferred based on the maximum exposure to loss (rather than the expected exposure). Many view the maximum exposure to loss concepts in the existing guidance to be inconsistent with revenue models applied in other industries.

Today, if a sale of real estate meets the criteria for sale accounting, the transaction is evaluated for “full accrual” profit recognition (which allows for full profit recognition upon sale). Typically, the most significant factor impacting profit recognition is whether there is sufficient initial and continuing investment. A sale may be recorded under the deposit method (no sale recognized), installment method, cost recovery method, or reduced profit method if the investment is not sufficient. Over time, a transaction may migrate (usually with incremental investment from the buyer, such as principal payments on seller financing) from one method to another and ultimately, to the full accrual method. Further, certain types of continuing involvement may require reduction in the amount of profit recognized (under the appropriate method) until the continued involvement is eliminated or expires on a maximum-exposure-to-loss basis (potentially deferring all the profit if the exposure is not capped).

Sales of real estate may be recognized earlier under the new standard as it eliminates these prescriptive requirements. Collectibility, contract enforceability, and transfer of control will be the key factors in determining whether to recognize revenue under the new standard.

While most forms of continuing involvement today may not prevent derecognition under the new standard, these factors can call into question whether control of the asset has transferred. Certain terms in a transaction (such as significant seller financing) may also call into question whether an entity has a contract with a customer that is in the scope of the standard. Common terms that could prevent derecognition of a real estate asset include repurchase rights or obligations. Appendix A to this publication provides examples of common forms of continuing involvement and their implications under current guidance and the new standard.

PwC observation:

In recent years, the Emerging Issues Task Force (EITF) has addressed perceived conflicts between the real estate sale guidance (ASC 360) and consolidation guidance (ASC 810). Specifically, these decisions addressed partial sales of real estate and the potential deconsolidation of in-substance real estate entities when a default on nonrecourse debt exists. In each of these instances, the EITF concluded that the real estate sale guidance should prevail.

In the new revenue recognition standard, the board reversed these historical positions of the EITF to conclude that sales of real estate to non-customers that meet the definition of a business, should be subject to the derecognition rules in ASC 810 (formerly FAS 160), which will likely result in transactions achieving derecognition earlier than under the existing guidance.

Sales of real estate to customers

The scope of the new standard specifically includes sales of real estate, whether a business or an asset, to customers. This may include sales by homebuilders, land developers, merchant builders, condominium sellers, and timeshare sellers.

Under the new standard, a performance obligation can be explicit or arise in other ways. Legal or statutory requirements can create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as an entity's practice of providing customer support, might also create performance obligations.

The new standard will significantly affect the accounting for sales of real estate in situations where certain performance obligations are satisfied after the legal sale of the assets. Such performance obligations could be explicitly defined in the contract (e.g., an "amenity" such as a pool or clubhouse) or implicitly required by the builder in order to get zoning for the subdivision and sale (e.g., roads, infrastructure, schools, firehouse, street lights, etc.).

Homebuilders, land developers, and merchant builders construct assets (that they own during construction) for sale to customers upon completion of construction. Therefore, these arrangements are fundamentally different than those in the construction industry where the entity is constructing an asset on behalf of the owner and the entity does not own or control the asset during construction.

Management will need to assess whether these transactions meet the criteria for performance obligations satisfied over time. The new standard states that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met: (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs; (b) the entity's performance creates or enhances an asset (e.g., work in process) that the customer controls; or (c) the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date. If none of these criteria are met, an entity satisfies the performance obligation at a point in time.

It will be important for all entities to assess and make a determination as to which pattern of revenue recognition (point in time versus over time) is applicable.

Sales by homebuilders

Under current guidance, there is frequently only one sale recognition point for real estate transactions even in cases where some costs will be incurred at a later date (e.g., amenities). Current real estate guidance requires a “cost accrual” model relating to these sales transactions under ASC 970-340-25-9 and 25-10 (formerly FAS 67). For example, a homebuilder may sell an individual home before completing roads, amenities, or offsite costs (e.g., schools, firehouses, stop lights) for which it is committed pursuant to the contract with the customer. Today, upon each sale, the homebuilder accrues a liability for the unit’s pro-rata portion of future costs and includes this amount in the cost of sale at the time the sale is recorded, even though these costs have not yet been incurred. In some jurisdictions, amenity work may be performed and paid for under a separate contract with a government authority rather than with the customer, in which case this issue might not apply.

However, under the new revenue standard, there may be multiple performance obligations that could result in different timing of revenue recognition for portions of the transaction price for the same unit. Refer to Appendix B of this publication for a detailed example of the impact of the new standard on a sale by a homebuilder.

PwC observation:

The nature of an entity’s operations may significantly affect how revenue is recognized. The issue discussed above is relevant for “vertically integrated” homebuilders that are also responsible for land development. A homebuilder that buys finished lots and is solely responsible for the delivery of the home may reach different accounting conclusions.

Sales of timeshares and condominiums

Today, certain types of real estate sales (such as sales of timeshares or condominiums) have specialized accounting and may qualify for “percentage of completion” revenue recognition. This specific literature will be eliminated by the new standard, and these sales might not meet the criteria for revenue recognition over time under the new standard.

For example, the new standard includes an illustration (ASC 606-10-55-173 through 55-182) of a real estate developer that enters into a contract to sell a specified condominium unit once construction is complete, and receives a deposit from the customer at contract inception. The asset (unit) does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The determination of the appropriate revenue recognition is therefore dependent on whether the developer has an enforceable right to payment for its performance to date throughout the contract, which may differ based on jurisdiction. If it is determined that the right to payment is legally enforceable, the developer will recognize revenue over time. If not, the developer will recognize revenue at the point in time at which control of the unit is transferred to the customer.

The new revenue standard could also result in delayed revenue recognition for sales of condominiums and timeshares due to the potential for having multiple performance obligations that are satisfied over time.

Contract costs

Incremental costs of obtaining a contract are costs the entity would not have incurred if the contract had not been obtained (e.g., sales commissions). Under the new standard, an entity is required to recognize an asset for the incremental costs to obtain a contract that management expects to recover. As a practical expedient, an entity is permitted to recognize the incremental cost of obtaining a contract as an expense when incurred if the amortization period would be one year or less.

An entity recognizes an asset for costs to fulfill a contract when specific criteria are met. Management will first need to evaluate whether the costs incurred to fulfill a contract are in the scope of other standards (e.g., inventory, fixed assets, or intangibles). Costs that are in the scope of other standards should be either expensed or capitalized as required by those standards. If fulfillment costs are not in the scope of another standard, an entity recognizes an asset only if the following criteria are met: (a) the costs relate directly to a contract, (b) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and (c) the costs are expected to be recovered.

An asset recognized for the costs to obtain or fulfill a contract will be amortized on a systematic basis as control of the goods or services to which the assets relate is transferred to the customer. An entity recognizes an impairment loss to the extent that the carrying amounts of an asset recognized exceed (a) the amount of consideration the entity expects to receive for the goods or services less (b) the remaining costs that relate directly to providing those goods or services.

Currently homebuilders record sales commissions and other direct contract acquisition costs at the time of closing (that is, at the same time as the related revenue recognition). However, under the new model, this may become more complex. A portion of the contract acquisition costs may need to be allocated to the various performance obligations (if more than one) and recognized when the related revenue on those performance obligations is recognized.

Warranties

Under the new standard, an entity will account for a warranty (e.g., a home warranty) as a separate performance obligation if the customer has the option to purchase the warranty separately. An entity accounts for a warranty as a cost accrual if it is not sold separately. However, if a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, that service is a separate performance obligation.

An entity that promises both a quality assurance and service-based warranty, but cannot reasonably separate the obligations and account for them separately, will account for both warranties together as a separate performance obligation recognized over the warranty period.

The guidance in the new standard on warranties is generally consistent with current guidance under U.S. GAAP. However, it could be challenging in some instances to separate a single warranty that provides both a standard warranty (e.g., for defects in construction) and a service element (e.g., an extended warranty or a maintenance arrangement). Also, determining the estimated standalone selling price for warranty-related services when such services are not sold separately requires judgment and could be challenging.

Service element warranties are less common in the real estate industry, but may exist and need to be evaluated. For example, in timeshare transactions, other contractual arrangements (such as annual assessment fees) could include a service element.

Sales of real estate to non-customers

Certain sales of real estate that are “not an output of an entity’s ordinary activities” (e.g., sales to non-customers) will be subject to aspects of the guidance in the new standard as outlined in the table above. This may include: (a) certain sales of real estate by a real estate company primarily engaged in leasing such property or (b) the sale of property, plant, and equipment by a manufacturer or retailer (including “non-traditional” real estate or integral equipment considered to be real estate). Such transactions may also be constructively completed through the sale of equity in an entity that is “in substance” the sale of real estate.

Because ASC 360-20 provides guidance for recognizing profit on *all* real estate sales, regardless of whether real estate is an output of an entity’s ordinary activities, the FASB considered the implications of retaining the guidance in ASC 360-20 for contracts that are not within the scope of the new revenue standard. The FASB noted that retaining the existing real estate guidance for real estate sales could result in an entity recognizing the profit or loss on a real estate sale differently depending on whether the transaction is a contract with a customer. However, there is economically little difference between the sale of real estate that is an output of an entity’s ordinary activities (e.g., sales to customers) and the sale of real estate that is not (e.g., sales to non-customers). Consequently, the FASB concluded that the difference in accounting should relate only to the presentation of the profit or loss in the income statement. ASC 360-20 was therefore superseded, except for certain guidance related to sale-leaseback transactions.

As noted in the table above, an entity that sells a business to a non-customer will now refer to the derecognition model in the consolidation guidance (ASC 810), which focuses on the consolidation and changes in ownership interest (including disposals) of a subsidiary (a legal entity). This guidance has been modified to remove the scope exception that previously existed for sales of in-substance real estate and refers to the guidance in ASC 610-20 to determine: (a) the amount of consideration to be included in the calculation of the gain or loss on sale, and (b) when a sale of real estate (business) should be derecognized. Sales of real estate assets (that do not constitute a business) to non-customers will also follow the guidance in ASC 610-20.

Under ASC 610-20, to measure the appropriate gain or loss on sale, an entity will apply certain elements of the new revenue standard to determine the transaction price, including all of the following: (a) estimating variable consideration; (b) constraining estimates of variable consideration; (c) the existence of a significant financing component; (d) noncash consideration; and (e) consideration payable to a customer.

To determine when to derecognize the real estate, a seller will apply certain elements of the new revenue standard, including identifying the contract and assessing when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators that control has transferred, which include, but are not limited to, the following:

- The seller has a present right to payment for the asset.
- The seller has transferred legal title of the asset.
- The seller has transferred physical possession of the asset.
- The buyer has the significant risks and rewards of ownership of the asset.
- The buyer has accepted the asset.

Assessing the indicators that control has transferred could require judgment, such as determining whether the buyer has the significant risks and rewards of ownership of the asset. Various forms of continuing involvement may indicate that the significant risks and rewards of ownership have not been transferred to the buyer and still remain with the seller.

Appendix A includes examples that further discuss the accounting considerations for sales of real estate to non-customers.

Partial sales of real estate

Sales or a contribution of real estate to a newly formed joint venture in which the seller retains an ownership interest are common transactions in the real estate industry and are considered “partial sales.” These transactions are outside of the scope of the new revenue standard. For joint ventures accounted for under the equity method of accounting (e.g., the seller retains an ownership interest but does not control the joint venture), an entity will need to evaluate the transaction to determine the appropriate accounting model to apply to the partial sale, which will depend on whether the transaction represents a partial sale of a business or an asset.

For a partial sale that constitutes a business, the derecognition model in the consolidation guidance (ASC 810) will need to be evaluated to determine whether control of the business has been lost. Within the consolidation guidance, sales or transfers of nonfinancial assets (including partial sales of real estate that constitute businesses to non-customers) require an entity to evaluate the guidance in ASC 610-20 to determine: (a) the amount of consideration to be included in the calculation of the gain or loss on sale and (b) when a sale of real estate (business) should be derecognized. Refer to additional discussion in the section titled “Sales of real estate to non-customers” above.

For a partial sale that constitutes an asset, the guidance for nonmonetary transactions in ASC 845, *Nonmonetary Transactions*, will need to be evaluated to determine if full or partial gain recognition is appropriate.

Determination of the appropriate gain recognition and accounting treatment of the retained interest will depend on which model is applied.

Real estate asset management

Revenue recognition in the real estate asset management industry can be complex as there are many variations of investment structures aimed at achieving returns or investment income for investors. Asset managers will recognize revenue they expect to be entitled to, subject to a constraint. The constraint will limit the amount of consideration that may be recognized to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. As a result, there could be changes in how revenue is recognized in the real estate asset management industry.

The impact of the new standard will vary depending on an entity’s existing accounting policies. Areas most affected could include recognition of upfront fees (which may now be deferred in some cases), upfront costs, and performance-

based fees. Some of the key issues companies will need to address include identifying who the “customer” is, and how to identify the distinct performance obligations.

Customer considerations

The new standard requires an entity to identify the contract with the customer. As part of this step, an entity must determine which party is its customer. This important step has ramifications throughout the revenue model and might significantly affect how the standard is applied. Asset managers will need to apply judgment in some situations to determine whether the customer is the investor or the fund itself. This issue may evolve as industry constituents begin applying the guidance to typical investment structures.

While not determinative, certain factors may point to the fund or investor being the customer. Management will need to weigh the different factors, and reach a conclusion based on the overall facts and circumstances.

A factor that points to the fund being the customer is a fund’s ability to enter into contracts with third parties for additional services such as fund accounting or transfer agent activities. Also, in certain fund structures, there may be numerous investors that the manager does not deal with directly. For example, in many registered investment companies, some investors purchase shares through a third-party distributor that holds the shares in “omnibus account” along with other investors. An omnibus account is often used by third-party distributors to simplify the subscription and redemption process into a fund. There may be situations where the asset manager does not have visibility into the underlying investors that make up the omnibus account.

In other situations, factors may point to the investor as the customer. If the investor is heavily involved in negotiating specific fees, or interacts directly with the manager, this could indicate that the investor is the customer. Also, if there are very few investors in a fund, this could indicate that the investors have the potential to play a more direct role in the arrangement. As noted above, these factors are not determinative, and management will have to consider all facts and circumstances.

Determining which entity is the customer is important when it comes to identifying the performance obligation(s), timing of revenue recognition, and capitalizing contract costs. The FASB acknowledged these alternate perspectives during its public deliberations, but ultimately did not formally take a position given the wide variety of arrangements in the asset management industry. In our view, the conclusion should be based on the facts and circumstances of each arrangement and should not be viewed as an “accounting policy” election.

Performance obligations

Another key assessment that affects the timing of revenue recognition is whether there is more than one performance obligation in a contract. There are often several different fees the asset manager is entitled to, such as management fees and performance fees. The new standard will require a manager to consider whether the services being performed should be viewed as a single performance obligation, or whether some of these services are “distinct” and should therefore be treated as separate performance obligations.

Even though these services and related fees are often included in different contracts, they may represent a single performance obligation. The new standard requires an entity to combine contracts that are entered into at or near the same time and account for them as a single contract if they are: (a) negotiated as a package, (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract, or (c) the services in the contracts represent a single performance obligation. Since these contracts are typically entered into at the same time in the asset management industry, the contracts would be combined and accounted for as a single contract if, for example, the services performed under the contract represent a single performance obligation.

The new standard requires an entity to assess the services promised in a contract with a customer and identify as performance obligations those services that are distinct. A service is distinct if: (a) the customer can benefit from the service either on its own or together with other resources that are readily available to the customer and (b) the service is distinct in the context of the contract. If a service is not distinct, the entity must combine the services until such a point that a bundle of services are viewed as distinct. In some cases, this will result in all services being combined into a single performance obligation.

In general, identifying the separate performance obligations will be heavily dependent on which entity is deemed the customer. For example, if the fund is the customer, a distribution service may be a distinct service that the fund could obtain from another party, and accordingly, a separate performance obligation. On the other hand, if the investor is the customer, the service of distributing the funds to that customer may not be distinct as it is just a necessary prerequisite to allow the asset manager to provide the asset management services to that customer. This is an area of significant judgment and it is possible that views will evolve in advance of the standard becoming effective.

Variable consideration

The transaction price is the consideration the real estate asset manager expects to be entitled to in exchange for satisfying its performance obligations. Management must determine the amount of the transaction price at contract inception and update any estimates of variable consideration at each reporting date. One of the primary performance obligations in the asset management industry is the delivery of asset management services. This performance obligation is satisfied over time, as asset management services are delivered.

If the amount the entity expects to be entitled to is variable, the variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. In making this assessment, an entity should consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to: (a) the amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility), (b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, and (c) the contract has a large number and broad range of possible consideration amounts.

Management fees for real estate funds are usually based on net assets under management, while performance fees are usually based on profits generated from the underlying investments held by funds subject to certain thresholds (e.g., internal rate of return). As such, management fees and performance fees are variable consideration that is subject to the constraint. Also, an entity will need to consider whether there is some minimum amount of variable consideration that needs to be recorded even if the full amount of variable consideration cannot be recorded.

PwC observation:

The boards included the constraint in response to feedback that revenue could be recognized prematurely for variable consideration. We expect that some entities will recognize revenue earlier under the new guidance because they will be able to recognize amounts before all contingencies are resolved.

Management fees

A fixed percentage asset-based management fee is variable consideration that is subject to the constraint in the revenue standard. For management fees, an asset manager will update its estimate of the variable consideration each reporting period. Because the management fee is calculated based on net assets under management, any uncertainty related to the variable consideration will generally be resolved as of the end of each reporting period. The asset manager will allocate the transaction price associated with the management fees to the services provided during the period because the fee relates specifically to those services. In many circumstances, analysis of the pattern of transfer of asset management services will result in recognition of management fees in a manner that is consistent with current practice under U.S. GAAP.

Performance fees

The new standard may impact the timing of recognition of performance fees, as these fees are variable consideration and subject to the constraint. Accordingly, performance fees that have a broad range of possible outcomes and are highly susceptible to market volatility will often not be included in the transaction price until the uncertainty is resolved or almost resolved. Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint. Management will reassess its estimate of the transaction price each reporting period, including any estimated minimum amount of variable consideration.

Real estate asset managers of funds with a finite life (e.g., ten years) often receive performance fees (or carried interest) that are subject to clawback on a cumulative basis based on the performance of the fund over its life. Thus, it is possible

the manager will have to return the cash distribution if the fund underperforms in the future. Periodic cash receipt from a fund as a result of its current performance will not necessarily indicate that the entity is able to recognize the amount as revenue.

Accordingly, for funds with a finite life, the entity will need to determine the appropriate time when the performance fees (or a portion thereof) overcome the constraint on variable consideration and can be included in the transaction price. This may be before the end of the fund's life. Later in the fund's life cycle, it may be probable that a significant reversal in the amount of cumulative revenue recognized will not occur for some portion of the fee given the fund's cumulative performance in relation to remaining assets. For example, a fund that holds a limited number of remaining investments could sustain total losses on those investments and still exceed the performance fee hurdle; therefore, revenue should be recognized for the portion of the performance fee that is not constrained.

PwC observation:

Application of the new guidance may result in significant changes for entities that record performance fees under Method 2 (otherwise known as the “hypothetical liquidation method”) today, where performance fees are recognized as revenue at the amount that would be due under the contract at any point in time as if the contract was terminated at that date. As a result, there is a possibility that fees earned by exceeding performance targets early in the measurement period could be reversed due to missing performance targets later in the measurement period under today's guidance.

The new guidance requires a higher degree of certainty before recording performance fees than the approach under Method 2. As discussed above, management must conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur prior to recognizing revenue.

Other considerations

Property management contracts

Entities in the real estate industry frequently enter into property management and incentive performance fee revenue arrangements with related parties or third parties. For fixed fee arrangements, revenue will likely be recognized ratably over time as this is likely the best reflection of progress given an equal amount of effort provided over time. However, the fees for these arrangements are not typically fixed.

More frequently, property management fees are based on a fixed percentage of revenue or net operating income of the property each month. Generally, these contracts do not provide for any clawback of prior fees if property performance deteriorates. These contracts are often subject to termination with 30 days advance notice or upon sale of the underlying property. In addition, incentive-based contracts provide for participation by the property manager expressed as a percentage of the change in the value of the property at a point in time or upon sale or refinancing.

Arrangements to provide property management services over a period of time will likely be viewed under the new standard as a single performance obligation. Today, such fees are recognized at the end of each operating period, typically each month. If the management arrangement is considered a series of monthly performance obligations, then there will not be many differences in the accounting applied today and under the new revenue standard.

Incentive fees based on the fair market value of the property upon sale or refinancing of the property (or upon termination of the contract) represent variable consideration. Such amount can only be recognized to the extent that the performance obligation is satisfied and the amount of variable consideration is not constrained. Generally, this will occur only when the measurement period has ended and it is probable that a clawback of the incentive will not occur as a result of subsequent declines in performance or value.

Tenant construction management

Many real estate entities perform construction management services on behalf of their tenants (e.g., oversight and management of construction of tenant improvements). These arrangements are similar to other construction management contracts except on a smaller scale.

Under existing guidance, fees a landlord earns a fee for performing construction management services for the build out of tenant improvements are typically recorded over the construction period. Under the new standard, entities will need to evaluate the criteria to determine if the arrangement qualifies for recognition over time (i.e., over the construction period).

The arrangement may qualify for recognition over time if construction of tenant improvements has “no alternative use” to the entity and the entity is entitled to payment for performance to date, even if the tenant terminates the contract. If it does not qualify, fees for tenant construction performed prior to lease commencement may need to be deferred and recognized when the performance obligation is satisfied, which may be upon commencement of the lease. This is because control of the tenant improvements may not transfer until the tenant obtains control of the leased asset (i.e., lease commencement).

Leasing commission revenue

Many real estate entities provide leasing services on behalf of third parties or related parties (e.g., equity method ventures with other parties). In general, the associated fees are earned at the inception of the lease and upon renewal of the lease. The fees are typically a fixed percentage of contractual future revenues to be received by the property owner from the tenant. Renewal periods are contingent upon the exercise of a renewal by the tenant.

For example, a real estate entity may be a broker in a third-party leasing arrangement where the tenant will be paying an aggregate of \$10 million and \$6 million in rent for an initial period of ten years and a subsequent option period of five years, respectively. Under the terms of the broker contract, the broker receives a commission of \$600,000 (6% of \$10 million) upon the tenant taking possession of the leased space for the initial period and, potentially, an additional \$360,000 (6% of \$6 million) upon the beginning of the renewal period in the event the tenant exercises the renewal.

From the perspective of the real estate entity providing these broker services, there is likely a single performance obligation that is satisfied when the tenant takes possession of the space, at which point the broker has no remaining services to provide. However, the portion of the transaction price associated with the potential renewal period is variable consideration, since the renewal is uncertain at the inception of the lease. An estimate of variable consideration is included in the transaction price and recognized as revenue only if the entity concludes it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the tenant decides whether or not to renew its lease.

For real estate leasing commissions, the exercise of a particular tenant renewal may be affected by a multitude of factors including the terms of the contract, tenant operations (both general and property-specific), and general market conditions. Accordingly, it may be difficult to assert that historical experience is predictive of the outcome of a particular lease (that is, whether the tenant will renew the lease). Entities will need to consider a number of factors in determining whether leasing commissions earned for extension periods should be included in the transaction price, or whether such amounts are constrained. For example, there may be certain indicators that the renewal is likely to be exercised at some point prior to the renewal, such as extensive tenant improvements by the tenant during the lease period or the property representing a flagship location.

Disclosures

The revenue standard includes a number of disclosure requirements intended to enable users of financial statements to understand the amount, timing, and judgments related to revenue recognition and the corresponding cash flows arising from contracts with customers.

The more significant disclosure requirements include:

- The disaggregation of revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors
- An explanation of the significant changes in the contract asset and the contract liability balances during the reporting period

- An analysis of the entity's remaining performance obligations, including the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied), the nature of the goods and services to be provided, the timing of satisfaction, and significant payment terms
- Significant judgments and changes in judgments that affect the determination of the amount and timing of revenue from contracts with customers
- Disclosure of the closing balances of capitalized costs incurred to obtain and fulfill a contract and the amount of amortization recognized during the period

PwC observation:

While there is some relief provided to nonpublic reporting entities from the above disclosure requirements, the extensive disclosure requirements for public reporting entities may be particularly onerous and complex.

Transition

An entity can apply the new revenue standard retrospectively, including using one or more of the following practical expedients:

- For completed contracts, an entity is not required to restate contracts that begin and end within the same annual reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in prior periods.
- For all reporting periods presented before the date of initial application, an entity is not required to disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when it expects to recognize that amount as revenue.

An entity should apply any expedients it elects to use consistently to all contracts within all reporting periods presented. In addition, an entity is required to disclose the expedients it has used and a qualitative assessment of the estimated effect of applying the expedients, to the extent possible.

An entity can alternatively choose to recognize the cumulative effect of initially applying the new standard to existing contracts as an adjustment to the opening balance of retained earnings in the annual reporting period that includes the date of initial application, with some additional disclosures.

Entities that elect the simplified transition method are required to disclose, for reporting periods that include the date of initial application:

- The amount by which each financial statement line item is affected in the current reporting period by the application of the new standard as compared with the guidance in effect before the change
- An explanation of the reasons for significant changes identified between the reported results under the new standard and the guidance in effect before the change

Entities that elect this method must also disclose this fact in their financial statements.

Appendix A – Common real estate sales transactions

This Appendix provides examples of common real estate sales transactions and the consideration of certain forms of continuing involvement. The examples discuss the guidance under the new standard as well as other guidance that will be applicable to certain types of real estate sales scenarios.

Example 1: Sale recognition (absent any forms of continuing involvement)

Seller and Buyer enter into a purchase and sale agreement for an existing office property on September 30, 20X1. Closing occurs with consideration and title transferring from Seller to Buyer on December 15, 20X1.

Existing U.S. GAAP

The sale is recognized at the time of the closing, once title has transferred and all consideration has been exchanged, as this is typically the date the sale has been “consummated” in accordance with ASC 360-20-40-7.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Under the new revenue standard, when and how revenue is recognized is driven by the terms of the contract with the customer. Typically, an approved contract where both parties demonstrate commitment to fulfill their respective obligations will meet the criteria for sale recognition at the time control transfers to Buyer. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

PwC interpretive response:

In this example, if there are no forms of continuing involvement that preclude Seller from transferring control to Buyer, it is likely that the sale will be recognized under the new standard when consideration is paid to Seller and title transfers to Buyer on December 15, 20X1.

Example 2: Seller is required to develop the property in the future

Seller sells a parcel of land to Buyer. In connection with the sale, Seller also agrees to develop a single tenant industrial warehouse to be used by Buyer in its business.

Existing U.S. GAAP

Under ASC 360-20-40- 61 through 40-63, profit allocable to (a) the performance after the sale of the land and (b) the sale of land should be recognized when the sale meets the criteria of ASC 360-20-40-5 if the future costs of development can be reasonably estimated at the time of sale. If such costs cannot be reasonably estimated, no profit should be recognized at the time of the sale. The profit is allocated to the sale of the land and the subsequent development or construction on the basis of estimated costs of each activity with the same profit margin attributed to each activity.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will need to determine if the bundle of goods and services represents one performance obligation or two separate performance obligations. Goods and services will be accounted for as separate performance obligations if both of the following criteria are met:

- The promised good or service is capable of being distinct because the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.
- The promised good or service is distinct within the context of the contract because the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

In this example, it is expected that the sale of the parcel of land and development of the warehouse will be considered distinct as the customer can benefit from each on its own and they are separately identifiable; therefore, the contract includes two performance obligations. Seller will allocate the transaction price to the two performance obligations based on their standalone selling prices and recognize revenue as each performance obligation is satisfied.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize of the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

In this example, Seller will likely conclude that the sale of land and the development of the property represent two separate performance obligations, as discussed. While current U.S. GAAP requires a constant profit margin to be recorded on both elements (that is, the sale of land and the development of the property), the new guidance could result in different profit margins on each performance obligation.

Example 3: Seller-provided financing

Scenario #1

Buyer purchases a multi-tenant property from Seller with nonrecourse financing provided by Seller to Buyer representing 98% of the purchase price. The loan includes interest-only payments over the five-year term with a balloon payment in year five.

Existing U.S. GAAP

No sale is recorded. Because the amount of cash paid by Buyer is only 2%, the transaction may be more appropriately viewed as an option to purchase the property. If the amount of cash paid was more significant, but not sufficient to qualify for the full accrual method under ASC 360-20-55-1, the transaction might qualify for sale (i.e., derecognition), but Seller would need to apply either the cost recovery or installment methods (depending on the facts).

Sales of real estate (assets and businesses) to customers (new revenue standard)

The new standard requires a seller to determine whether the buyer is committed to perform its obligations under a contract. In this example, Seller may determine that Buyer has not made a sufficient down payment to qualify for revenue recognition because Buyer could decide to default on its obligation and surrender the real estate to Seller. However, Seller will need to consider all facts and circumstances, not just the extent of the down payment.

If Seller concludes Buyer is not committed to perform its obligations, Seller will continue to re-evaluate this conclusion each reporting period. Unless this criterion is met, revenue will not be recognized until either: (a) Seller has no remaining obligations to transfer goods or services to Buyer, and all, or substantially all, of the consideration promised

by Buyer has been received by Seller and is nonrefundable, or (b) the contract has been terminated and amounts received are nonrefundable.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

PwC interpretive response:

This first scenario will likely result in a similar outcome to today’s accounting with no sale recognized. However, the treatment of the cash received (the down payment) could differ from today’s accounting due to the embedded economic put feature inherent in nonrecourse financing (refer to example on “buyer put options” below for more details).

Scenario #2

Assume the same facts as above, except Seller provides Buyer with a loan representing 90% of the purchase price. The loan terms include principal and interest payments over the five-year term with a balloon payment for any remaining outstanding principal at the end of the term.

Existing U.S. GAAP

Seller will recognize a sale; however, the sale will likely not qualify for the full accrual method because the down payment would not meet the minimum initial investment threshold described in ASC 360- 20-55-1 and 55-2 for this property type. Seller will likely apply either the installment method or cost recovery method.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will be able to recognize the sale if it determines that Buyer is committed to perform its obligations under the contract. If not, Seller will re-evaluate this conclusion each reporting period and record the sale when it determines that Buyer is committed to perform under the contract.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

PwC interpretive response:

Under the new guidance, Seller will need to determine if Buyer is committed to perform its obligations under the contract. That determination will drive when revenue is recorded. This represents a difference from current accounting where some or all of the gain would be deferred under either the installment method or cost recovery method.

Example 4: Option or obligation to repurchase the property

Seller “call” option

Seller sells a property to Buyer. The sales agreement provides Seller with an unconditional option to repurchase the property at some point in the future.

Existing U.S. GAAP

Under ASC 360-20-40-38, if the buyer provides an option to the seller to repurchase the property, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

Sales of real estate (assets and businesses) to customers (new revenue standard)

The accounting depends on the amount of the repurchase price relative to the original sales price, as follows:

- If the repurchase price is less than original sales price, Seller will account for the transaction under the leasing guidance in ASC 840.
- If the repurchase price is greater than or equal to the original sales price, Seller will account for the transaction as a financing. Seller will not derecognize the property and will record a financial liability for the consideration received from Buyer.

If the agreement creates an unconditional obligation, rather than an option, for the seller to repurchase the asset in the future, the resulting accounting will be the same as above under the new standard.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

The existence of an option for Seller to repurchase the property in the future will likely prevent Buyer from obtaining control of the property, therefore preventing Seller from recognizing the sale.

PwC interpretive response:

It is likely that control has not passed to Buyer in this situation, so the sale is not recognized.

Buyer “put” option

Seller sells a property to Buyer. The sales agreement provides Buyer with the ability to put the property back to Seller at any time within three years of the transaction date.

Existing U.S. GAAP

Under ASC 360-20-40-38, if the seller may have an obligation to repurchase the property, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will evaluate at contract inception (without a requirement to reassess) whether Buyer has a significant economic incentive to exercise the put:

- If yes, the sale is not recorded and Seller will account for the transaction as a financing or a lease following the guidance in ASC 840.
- If no, the sale is recorded and Seller will recognize an asset and a liability for any expected returns.

In evaluating whether a significant economic incentive exists, the following factors should be considered:

- Relationship of repurchase price to the sales price and expected market value of the property at potential repurchase date
- Length of time until the put option expires

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

The existence of an option for Buyer to require Seller to repurchase the property in the future may not prevent Seller from transferring control of the property if it is determined that Buyer does not have a significant economic incentive to exercise the put option. This will be based on the facts and circumstances of the transaction.

PwC interpretive response:

Determining whether a buyer has a significant economic incentive to exercise a put option will require significant judgment as it will be based on the facts and circumstances of the transaction. This could result in different entities arriving at different conclusions for the same (or similar) transactions.

If a conclusion is reached that the buyer does not have a significant economic incentive to exercise the put option, the concept of recording an asset and liability for any expected returns may present a challenge as sales of real estate are unique in nature.

Example 5: Guarantees (seller provides a return of or return on the buyer’s investment)

Seller sells a multi-tenant retail property to Buyer. Because some of the leases are expected to expire within the next 6 to 18 months, Seller guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for the first four years after the sale.

Existing U.S. GAAP

Under ASC 360-20-40-41, if the seller guarantees return of the buyer’s investment or guarantees a return on the investment for an **extended** period, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

If the guarantee of a return is for a **limited** period, the deposit method should be used until operations of the property cover all operating expenses, debt service, and contractual payments.

Sales of real estate (assets and businesses) to customers (new revenue standard)

The existence of an obligation to support operations would not preclude the sale transaction and derecognition of the property. Seller will separately account for the guarantee under ASC 460, *Guarantees*, and allocate a portion of the sales proceeds received to the guarantee. The amount allocated to the guarantee will be the fair value of the guarantee and the remaining consideration will be allocated to the sale of the property.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

PwC interpretive response:

Under current U.S. GAAP, this form of continuing involvement precludes sale recognition for accounting purposes. That is, the real estate remains on the seller’s balance sheet. Compared to today, the new standard will result in a dramatically different outcome where the sale is recognized (assuming control has transferred) and the measurement of the gain/loss on sale will be impacted by the fair value of the guarantee.

Example 6: Seller’s participation in future profit (without risk of loss)

Seller sells a property to Buyer for \$10 million. As part of the agreement, Buyer agrees to share 15% of any excess proceeds it receives above \$10 million from a subsequent sale to another buyer at some point in the future.

Existing U.S. GAAP

Under ASC 360-20-40-64, the contingent future profits should be recognized when they are realized. All of the costs of the sale are recognized at the time of sale (i.e., no costs are deferred to periods when the contingent profits are recognized).

Sales of real estate (assets and businesses) to customers (new revenue standard)

The future profit participation is variable consideration, which could impact the transaction price. Seller will estimate the transaction price using either: (a) the “expected value” (sum of probability-weighted amounts) or (b) the “most likely amount” (single most likely outcome) approach. Seller will update its estimate at each reporting period end until the contingency is settled.

Seller is limited to recording income for the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved, and will need to consider whether there are any minimum amounts that should be recorded.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the “Sales to real estate to non-customers” section within this publication).

PwC interpretive response:

If Seller concludes that some minimum amount of the variable consideration is not constrained, the new standard will result in earlier recognition of income than current U.S. GAAP. The assessment of variable consideration will introduce significant judgment and requires updating the estimate each period.

Also, in assessing the variable consideration and whether a significant reversal would occur, Seller needs to consider the amount of cumulative revenue recognized. Since it will have recognized \$10 million at the time of sale, the evaluation of the variable amount needs to consider the potential for 15% of the upside as compared to the \$10 million already recorded. For example, if the entity believes the future sale will be at least \$11 million, then the variable consideration that is being assessed is only \$150,000, which may not be considered “significant” compared to \$10 million.

Appendix B – Application of the new standard for a “vertically integrated” homebuilder

Background

A homebuilder has a 200-unit project (homogeneous units) and sells the individual homes over a four-year period. The homes are sold with a promise (based on the sales contracts or zoning agreements) to complete certain amenities (e.g., a school, roads, or a pool/clubhouse) by the middle of Year 3. In this example, there is no seller-provided financing or other forms of continuing involvement.

The revenue and cost assumptions are as follows (in 000’s except unit numbers):

	Total	Per unit
Total units	200	
Sales price	\$20,000	\$100

	Total	Per unit	Cost ratio
Land/homebuilding construction cost	\$15,000	\$75	88.2%
Costs for non-home construction elements	\$2,000	\$10	11.8%
	\$17,000	\$85	100%

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Contractual revenue:	\$4,000	\$7,500	\$6,500	\$2,000	\$20,000
Costs					
Land/home construction	\$3,000	\$5,625	\$4,875	\$1,500	\$15,000
Total costs for non-home construction elements	-	-	2,000	-	2,000
Total costs	\$3,000	\$5,625	\$6,875	\$1,500	\$17,000

Application of the new standard

Step 1: Identify the contract(s) with the customer

The contracts with the individual homebuyers are the relevant contracts

Step 2: Identify the performance obligations in the contract

In addition to the delivery of the constructed home, there are potentially several performance obligations in this example that may be satisfied at different times. For purposes of simplifying this example, we have assumed that all of the non-home construction elements are completed and delivered simultaneously and therefore can be treated as a single performance obligation separate from the home delivery performance obligation. For this purpose, the standard home warranty is predominantly a “quality assurance” element in many jurisdictions and not treated as separate performance obligations.

Step 3: Determine the transaction price

The transaction price is the sale price for the individual home sales. In this example, there are no other elements that impact the transaction price, such as variable consideration, time value of money (all cash paid at closing), noncash consideration, or consideration paid to a customer.

Step 4: Allocate the transaction price to the performance obligations

The transaction price should be allocated between the identified performance obligations based on their relative standalone selling prices. Possible approaches to estimating standalone selling price include (but are not limited to) expected costs plus a reasonable margin or assessment of market prices for similar goods or services. Generally, the non-home construction elements would not have separate market prices and in this case, possibly neither do the home construction elements since each project is different. For purposes of this example, we allocated based on the relative costs between home and non-home construction performance obligations and assuming a consistent margin between the two. In reality, there is likely a different margin earned on the non-home construction elements, which could result in further complexities.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied

Upon each home settlement (that is, the transfer of control to the buyer), the performance obligation relating to the home delivery is settled. Until the non-home construction performance obligations are completed, none of the related per unit revenue should be recognized. At completion of the non-home construction elements, the portion of the revenue related to units settled to date will be recognized. Thereafter, the non-home construction elements will be recognized upon each home settlement (as control of the non-home construction elements does not transfer prior to home settlement).

Application of the current accounting model

(in 000's except unit numbers)

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Contractual revenue at closing	\$4,000	\$7,500	\$6,500	\$2,000	\$20,000
Costs					
Land/home construction	\$3,000	\$5,625	\$4,875	\$1,500	\$15,000
Allocated non-home construction costs	400	750	650	200	2,000
Total costs	\$3,400	\$6,375	\$5,525	\$1,700	\$17,000
Gross margin	\$600	\$1,125	\$975	\$300	\$3,000

Application of the new standard

(in 000's except unit numbers)

Allocation of transaction price per unit to performance obligations using cost ratio	Revenue	Costs	
Home construction	\$ 88.235	\$ 75.000	88.2%
Non-home construction elements	11.765	10.000	11.8%
Total	\$100.000	\$ 85.000	100%

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Performance obligation revenue:					
Home construction at delivery	\$3,529	\$6,618	\$5,735	\$1,765	17,647
Non-home construction:					
At delivery of non-home elements for closings to date			1,735		1,735
Subsequent to non-home elements at settlement			383	235	618
Total non-home construction			2,118	235	2,353
Total revenue	\$3,529	\$6,618	\$7,853	\$2,000	20,000
Costs:					
Home construction at delivery	\$3,000	\$5,625	\$4,875	\$1,500	\$15,000
Non-home construction:					
At delivery of non-home elements for closings to date			\$1,475		1,475
Subsequent to non-home elements at settlement			\$325*	\$200*	525
Total non-home construction			1,800	200	2,000
Total costs	\$3,000	\$5,625	\$6,675	\$1,700	\$17,000
Gross margin	\$529	\$993	\$1,178	\$300	\$3,000
Difference (new standard vs current accounting model)					\$(0)
Revenue	\$(471)	\$(882)	\$1,353	-	\$(0)
Costs	(400)	(750)	1,150	-	\$(0)
Gross margin	\$(71)	\$(132)	\$203		

*Costs to fulfill the non-home elements performance obligation would likely be capitalized and amortized as control of the non-home elements transfer to the customers.

PwC observation:

Most projects will be substantially more complex than the example provided and may have significant subsequent changes in assumptions/estimates over the life of the project. Further, tracking of income tax temporary differences, already complex for many entities, may become substantially more challenging as a result of the new standard.

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