

Technical Line

FASB – new guidance

The new revenue recognition standard – real estate

Revenue recognition practices of all real estate entities may be affected by the new standard.

What you need to know

- ▶ Real estate entities will need to exercise more judgment when applying the new revenue standard than they do today when measuring and recognizing gains and losses on property sales using ASC 360-20, *Real Estate Sales*.
- ▶ Entities that sell real estate subject to the revenue standard will generally be able to recognize revenue and associated profit when control of the property transfers. An evaluation of the buyer's initial and continuing investments or the seller's continuing involvement with the property will no longer be required. However, entities must still assess the collectibility of the transaction price using the principles of the new revenue standard.
- ▶ Fees for property management and other services may be recognized differently due to the new requirements to estimate variable consideration and to determine the number of performance obligations contained in the contract.
- ▶ The new standard is effective for public entities¹ for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018.

Overview

Real estate entities will need to evaluate their revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including industry-specific guidance that real estate entities use today.



Building a better
working world

The new standard provides guidance for accounting for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to customers (unless those contracts are in the scope of other US GAAP guidance such as the leasing literature).

The standard's consequential amendments provide a new model for measuring and recognizing gains and losses on the sale of certain nonfinancial assets (e.g., property and equipment, including real estate) to noncustomers that are otherwise not in the scope of the new revenue recognition guidance. Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. Entities that sell nonfinancial assets to noncustomers will follow guidance in Accounting Standards Codification (ASC) 360-10 for presenting a gain or loss on the sale of a long-lived asset.

The new revenue recognition model for the sale of real estate differs significantly from the prescriptive rules in ASC 360-20, *Real Estate Sales*. The new principles-based approach is largely based on the transfer of control. As a result, more transactions will likely qualify as sales of real estate, and revenue (i.e., gain on sale) will be recognized sooner than it is under today's accounting.

The accounting for management fees and other fees that vary based on performance (e.g., percentage of the property's revenues or net operating income) will also change. A property manager will have to estimate, at contract inception, the variable consideration to which it will be entitled and for which it is probable that a significant revenue reversal will not occur. This amount will then be recognized in the period as the performance obligation is satisfied.

This publication considers key implications for the real estate industry and provides an overview of the revenue recognition model with a focus on entities that:

- Own, operate and sell real estate assets
- Provide real estate property management services
- Engage in hospitality management activities
- Construct and sell single-family homes and residential developments (e.g., condominiums)

This publication supplements our Technical Line, [A closer look at the new revenue recognition standard](#) (SCORE No. BB2771), and should be read in conjunction with it.

Real estate entities also may want to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on hospitality and time-sharing issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's hospitality and time-sharing industry task forces are two of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will issue updated guidance.

Contents

1	Summary of the new model	4
2	Scope	6
2.1	Contracts with customers	7
2.2	Sales of nonfinancial assets (including in substance nonfinancial assets)	7
2.3	Sale-leaseback transactions.....	9
2.4	Nonmonetary transactions	9
3	Identify the contract with the customer	10
3.1	Contract modifications	10
4	Identify the performance obligations in the contract.....	12
4.1	Determination of distinct	12
4.2	Series of distinct goods and services that are substantially the same and that have the same pattern of transfer.....	14
5	Determine the transaction price	16
5.1	Variable consideration.....	16
5.2	Price concessions.....	18
5.3	Noncash consideration	18
5.4	Significant financing component	19
6	Allocate the transaction price to the performance obligations	20
6.1	Exceptions to the relative standalone selling price method.....	20
7	Satisfaction of performance obligations.....	23
7.1	Performance obligations satisfied over time	23
7.2	Control transferred at a point in time	25
8	Other measurement and recognition topics	27
8.1	Licenses of intellectual property	27
8.2	Warranties.....	28
8.3	Real estate project costs	28

1 Summary of the new model

The new guidance in ASC 606, *Revenue from Contracts with Customers*, outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer.

The principles in the new standard will be applied using the following five steps:

1. Identify the contract(s) 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 in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

An entity will need to exercise judgment when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity generally will have to provide more disclosures than it does today and include qualitative and quantitative information about its transactions accounted for under the new standard and significant judgments made (and changes in those judgments). On an interim basis, US GAAP will require more disclosure than will be required under IFRS.

Transition and effective date

The new standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, such as the amount by which each financial statement line item is affected as a result of applying the new standard.

How we see it

Entities that are recognizing profit from the sale of a real estate property using one of the alternative recognition methods in ASC 360-20 (e.g., installment method, cost recovery method, deposit method) will need to carefully evaluate the transition approaches in the new standard.

Entities with deferred revenue balances or failed sales from real estate sales that predate their adoption of the new standard may experience "lost revenue." That's because the deferred amounts or previously unrecognized sales will be reflected in the recasted prior periods (under the full retrospective approach) or as part of the cumulative effect adjustment upon adoption (under the modified retrospective approach), but never reported as revenue in a current period within the financial statements.

The illustration below compares the application of the two transition approaches to a real estate sale for which profit was previously deferred under the installment method. Real estate entities that have previously deferred profit from a sale under another method in ASC 360-20 will need to consider specific transition issues that may arise from each respective method (e.g., interest expense and/or continued depreciation of the property under any of the financing, leasing, profit-sharing or deposit methods).

Illustration 1-1: Comparison of transition approaches

Developer A, a public entity with a 31 December fiscal year-end, sold a real estate property with a carrying value of \$6 million for net proceeds of \$11 million. The sale closed on 31 December 2014 but did not qualify for full accrual profit recognition because the terms of the four-year note receivable (i.e., seller financing) provided by Developer A did not meet the initial and continuing investment criteria in ASC 360-20. Under ASC 360-20, Developer A applied the installment method and determined that \$1 million of profit should be recognized at the sale date, \$1 million in 2015, \$1 million in 2016, and \$2 million in 2017 when the initial and continuing investment criteria were expected to be satisfied. Developer A will also recognize interest income from the note as it is received.

The new revenue standard is effective for Developer A for interim and annual periods beginning 1 January 2017. Management evaluates the new revenue standard and concludes that the terms of the seller financing would not have precluded the recognition of the \$5 million of profit at the date of sale.

Full retrospective approach

Developer A presents three years of comparative financial information in its 2017 annual filings with the Securities and Exchange Commission (SEC). In accordance with ASC 250,² the full \$5 million of profit from the sale that occurred on 31 December 2014 would be recorded as a cumulative catch-up to retained earnings as of 1 January 2015 in the recasted financial information. Deferred profit of \$1 million that was previously recognized in both 2015 and 2016 would no longer be included in the income statements of each respective period.

Quarterly SEC filings of Developer A will also reflect this presentation beginning 31 March 2017.

Modified retrospective approach

The sale of the property by Developer A constitutes a completed contract as defined in the new standard³ because control of all goods (i.e., the property) was transferred on 31 December 2014, before the date of initial application by the entity. Under the modified retrospective approach, the new standard is only applied to contracts that are in progress at the date of initial application (i.e., 1 January 2017). Therefore, Developer A would recognize the remaining \$2 million of deferred revenue at 1 January 2017 as a cumulative catch-up to retained earnings at the beginning of the period. In contrast to what happens when the full retrospective approach is used, the \$1 million of deferred revenue recognized in both 2015 and 2016 continues to be reflected in each respective comparative period.

Developer A also must disclose the \$2 million of profit that would have been recognized in 2017 had ASC 360-20 remained in effect.

2 Scope

ASC 606 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for contracts that are specifically excluded from the scope, which include:

- Lease contracts within the scope of ASC 840, *Leases*
- Insurance contracts with the scope of ASC 944, *Financial Services – Insurance*
- Financial instruments and other contractual rights or obligations (e.g., receivables, debt and equity securities, derivatives)⁴
- Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees*
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange within the scope of ASC 845, *Nonmonetary Transactions*

Entities may enter into transactions that are partially within the scope of the new revenue recognition guidance and partially within the scope of other guidance. In these situations, the new guidance requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard.

For example, in certain transactions, the seller of a real estate property may agree to support the operations of the property for a period of time or provide a guarantee of the buyer's return on investment. Under today's guidance, because these guarantees either prevent the guarantor from being able to account for the transaction as a sale or recognize in earnings the profit from the sale, these "seller support" guarantees are excluded from the scope of ASC 460 and are instead accounted for using ASC 360-20.

Under the new standard, the presence of the guarantee does not, on its own, affect whether an entity can recognize a sale and the associated profit from the transfer of the property. Instead, the fair value of the guarantee will first be separated from the transaction price and recorded as a liability in accordance with ASC 460⁵. The remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., other performance obligations, including the transfer of the asset). The entity then evaluates whether the other performance obligations have been satisfied without considering the guarantee.

In addition, the new standard may affect arrangements involving leases. While ASC 840 provides guidance on allocating an arrangement's consideration between a lease and lease-related executory costs, this guidance refers to ASC 606 for direction on allocating the total consideration between the deliverables subject to ASC 840 and those that are not within the scope of ASC 840. Accordingly, the estimated transaction price should be allocated between the deliverables within the scope of ASC 840 and any deliverables within the scope of the revenue guidance based on the relative standalone selling price of each deliverable (see Chapter 6).

How we see it

In its recent redeliberations of the proposed leases standard,⁶ the FASB tentatively concluded that lessors would be required to apply the new revenue standard to allocate contract consideration between the lease and non-lease components of a contract.

The FASB staff also indicated that activities and costs, such as a lessor's promise to provide services (e.g., common area maintenance or CAM) or pay for utilities consumed by the lessee, would represent non-lease components. If this tentative decision is reflected in any final leasing standard, revenue from these non-lease components will be recognized in accordance with the new revenue standard.

2.1 Contracts with customers

The new revenue guidance defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from existing guidance. Under today's guidance, CON 6⁷ refers to ordinary activities as an entity's "ongoing major or central operations."

Property management services provided by real estate investment trusts (REITs) and companies in the hotel and hospitality industry are examples of services that are the output of an entity's ordinary activities. In addition, the sale of a home by a homebuilder or a residential condominium unit by a real estate developer would also represent ordinary activities.

In contrast, an entity that sells a commercial property that it had used as its corporate headquarters to a real estate entity would likely conclude that its decision to dispose of that asset is not an output of its ordinary activities and, therefore, does not represent a contract with a customer. However, as described in Section 2.2 below, the FASB also added derecognition guidance in its consequential amendments for the sale of nonfinancial assets and in substance nonfinancial assets (e.g., a legal entity that primarily holds nonfinancial assets) that are not the output of an entity's ordinary activities.

2.2 Sales of nonfinancial assets (including in substance nonfinancial assets)

Nonfinancial assets are often sold in transactions that would not represent a contract with a customer because the sale of the asset is not an output of the entity's ordinary activities (e.g., the sale of a former corporate headquarters building by an electronics manufacturer). The Boards noted in the Basis for Conclusions⁸ in the new standard that there is economically little difference between the sale of real estate that is, or is not, an output of the entity's ordinary activities and that the only difference in the accounting for these transactions should be the presentation in the statement of comprehensive income (i.e., revenue and expense when the sale is to a customer or gain or loss when the sale is to a noncustomer).

The FASB amended ASC 360-10, *Property, Plant, and Equipment*, to provide direction on applying the appropriate guidance when derecognizing a nonfinancial asset (e.g., real estate). The amended guidance states that sales of nonfinancial assets, including in substance nonfinancial assets, should be accounted for using new guidance in ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, unless the contract is with a customer (i.e., a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration). If the contract is with a customer, ASC 606 will apply. However, ASC 610-20 does not contain incremental guidance to ASC 606 but rather instructs entities to apply certain control and measurement guidance from ASC 606, including guidance related to:

- ▶ Evaluating the existence of a contract (see Chapter 3)
- ▶ Measuring the consideration (i.e., determining the transaction price) in the contract (see Chapter 5)
- ▶ Determining when control of the nonfinancial asset has transferred (i.e., when a performance obligation is satisfied) (see Chapter 7)

Judgment will be required when determining whether to apply ASC 606, ASC 610-20 or ASC 810-10 to sales of real estate.

Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. Entities that sell nonfinancial assets to noncustomers will follow guidance in ASC 360-10 for presenting a gain or loss on the sale of a long-lived asset.

The amended guidance in ASC 360-10 also indicates that there may be certain circumstances in which neither ASC 606 nor ASC 610-20 are applied when derecognizing a nonfinancial asset. The sale (deconsolidation) of real estate in a subsidiary or group of assets to noncustomers that meets both of the following requirements is accounted for in accordance with the derecognition guidance in ASC 810, *Consolidation*:

- It is a business
- It is not also an in substance nonfinancial asset (because the group of assets or subsidiary also contains significant financial assets)

It is important to note that, if both criteria are met, ASC 810 is applied whether or not the assets transferred are in a legal entity. The following table summarizes the application of the appropriate derecognition guidance for common real estate sales transactions:

ASC topic	When applied?	Possible transactions
ASC 606	Sales of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a “business”) to customers	Sales of residences by homebuilders and real estate developers
ASC 610-20	Sales of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a “business”) to noncustomers	Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by REITs, real estate funds and non-real estate entities
ASC 810-10	Sale (deconsolidation) of real estate in a subsidiary or group of assets that constitutes a “business” and is composed of <u>both</u> substantial financial and nonfinancial assets to noncustomers	Sales by any entity of real estate and substantial financial assets that together are a “business”

How we see it

The FASB did not define an “in substance nonfinancial asset” in the consequential amendments. As a result, entities may consider making judgments similar to those they make today when determining whether a group of assets or subsidiary is “in substance real estate” under ASC 360-20.⁹

An entity that derecognizes a subsidiary or group of assets that meet the definition of a business will need to exercise significant judgment to determine whether the transaction also constitutes the transfer of an in substance nonfinancial asset that will be subject to the guidance in ASC 610-20 rather than ASC 810-10.

The FASB currently has a project¹⁰ on its agenda to clarify the definition of a business. In this project, it also hopes to clarify the accounting for the acquisition or disposal of an in substance nonfinancial asset. The timing and outcome of this project are unclear.

2.3 Sale-leaseback transactions

While the FASB made it clear that ASC 360-20 should no longer be applied to sales and transfers of real estate, the guidance on sale-leaseback transactions involving real estate that are within the scope of ASC 840-40, *Sale-Leaseback Transactions*, was retained. A number of amendments were made to narrow the scope of ASC 360-20, and the FASB specifically stated¹¹ that entities should not analogize to the retained guidance when evaluating any transaction that is not a sale-leaseback.

The Boards' current joint project on leases is expected to provide new guidance for sale-leaseback transactions that will eventually replace the guidance in ASC 360-20 and ASC 840-40. However, the timing of a new leases standard is unclear.

2.4 Nonmonetary transactions

As discussed in Section 5.3, the new standard provides guidance for contracts with customers involving the exchange of nonmonetary consideration. As a result, the FASB has excluded contracts that fall within the guidance of ASC 606 and ASC 610 from the scope of ASC 845. The specific guidance in ASC 845 for exchanges of real estate involving monetary consideration also has been eliminated. The FASB clarified that the exchange of a nonfinancial asset (including an in substance nonfinancial asset) for a noncontrolling ownership interest in the receiving entity is within the scope of ASC 845.

The prescriptive guidance in ASC 360-20 for evaluating a buyer’s initial and continuing investment has been replaced by the collectibility assessment in the new standard.

3 Identify the contract with the customer

To apply the new revenue guidance, an entity must first identify the contract, or contracts, to provide goods and services to customers. Such contracts may be written, oral or implied by the entity’s customary business practice but must be enforceable by law and meet specified criteria. These criteria include approval of the contract by all parties and their commitment to perform their respective obligations, the ability to identify each party’s rights regarding goods and services to be transferred and the associated payment terms, and whether the contract has commercial substance.

In addition, before an arrangement with a customer is considered a contract in the scope of the new revenue guidance, an entity must conclude that it is probable that it will collect the transaction price. The transaction price is the amount to which the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer as opposed to the contract price. The term “probable” is defined as “the future event or events are likely to occur,” consistent with the definition in ASC 450, *Contingencies*. To assess collectibility, an entity should evaluate the customer’s ability and intent to pay the transaction price when due.

The transaction price may be less than the stated contract price if an entity concludes that it has offered or is willing to accept a price concession or other discount. Such concessions or discounts are forms of variable consideration (see Section 5.2) that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price. The estimated transaction price would then be evaluated for collectibility. The following table illustrates these concepts:

Stated contract price	\$ 2,000,000
Price concession - amount entity estimates it will offer or accept as a reduction to the contractual price	<u>(\$200,000)</u>
Transaction price	\$ 1,800,000

How we see it

In most real estate arrangements, a signed, written contract specifies the asset to be transferred or management services to be provided in exchange for a defined payment. This generally will result in a straightforward assessment of most of the contract criteria.

However, entities that sell real estate and provide financing to the buyer may find that more judgment is required to evaluate the collectibility of the transaction price. These entities may be used to applying the strict quantitative criteria in ASC 360-20 for determining whether a buyer’s initial and continuing investment is sufficient to allow for sale and profit recognition, which has been eliminated. In contrast, there is little guidance in the new standard to help entities determine whether the terms of seller-provided financing, and the borrower’s ability to fulfil those terms, still allow the collectibility threshold to be met.

The new standard provides guidance for entities to follow when an arrangement does not meet the criteria of a contract.

3.1 Contract modifications

A contract is modified when there is a change in the scope or price (or both). Changes to existing contracts, such as change orders or upgrades during the construction of a home or condominium, are examples of contract modifications.

An entity must determine whether the modification should be accounted for as a separate new contract or as part of the existing contract. Two criteria must be met for a modification to be treated as a separate new contract: (1) the additional goods and services are distinct from the goods and services in the original arrangement and (2) the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. In this respect, only modifications that *add* distinct goods and services to the arrangement can be treated as separate new contracts. In determining the standalone selling price for the new contract, entities have some flexibility, depending on the facts and circumstances.

A contract modification that does not meet the criteria to be accounted for as a separate new contract is considered a change to the original contract and is treated as either the termination of the original contract and the creation of a new contract or as a continuation of the original contract, depending on whether the goods or services to be provided after the contract modification are distinct. A modification is accounted for on a prospective basis (i.e., as a termination of the original contract and creation of a new contract) if the goods and services to be provided as a result of the modification are distinct from the goods and services in the original contract, but the consideration does not reflect the standalone selling price of the new goods or services. The remaining consideration is allocated to the remaining performance obligations. An entity should account for a modification as a continuation of the original contract if the remaining goods or services to be provided are not distinct from the goods and services already provided and therefore, form part of a single performance obligation that is partially satisfied at the date of the modification. Such modifications are accounted for on a cumulative catch-up basis. See Chapter 4 for further discussion of identifying performance obligations in the contract.

Only contract modifications that add distinct goods or services can be treated as separate contracts.

4 Identify the performance obligations in the contract

After identifying the contract, an entity will evaluate the contract terms and its customary business practices to identify all promised goods or services within the contract and determine which of those promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations (i.e., the unit of account for purposes of applying the standard). The revenue standard identifies several activities common to real estate entities that are considered promised goods and services, including the sale of goods produced or resale of goods purchased (e.g., real estate properties); the performance of a contractually agreed-upon task for a customer (e.g., property management); and the construction, manufacture or development of an asset on behalf of a customer.

Promised goods and services represent a performance obligation if (1) the goods or services are distinct (by themselves or as part of a bundle of goods and services) or (2) if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

4.1 Determination of distinct

The new standard outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct:

- Consideration at the level of the individual good or service (i.e., the goods or services are capable of being distinct)
- Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract)

Both of these criteria must be met to conclude that the good or service is distinct. When the criteria are met, the individual units of account must be separated.

In many cases, goods or services are capable of being distinct but may not be distinct within the context of the contract. The standard provides factors to determine whether goods or services are not separately identifiable and should be combined as one performance obligation (i.e., they are not distinct in the context of the contract). These factors, if present, would indicate that goods and/or services should be combined:

- The entity integrates the good or service with other goods or services promised in the contract into a bundle that represents the combined output described in the contract.
- The good or service significantly modifies or customizes another good or service promised in the contract.
- The good or service is highly dependent on, or highly interrelated with, other goods or services promised in the contract.

If an entity determines that the promised good or service does not meet both criteria (i.e., capable of being distinct and distinct within the context of the contract), and thus is not distinct, the entity has to combine that good or service with other promised goods or services until a distinct bundle is formed. This distinct bundle is accounted for as a single performance obligation, illustrated in the following example:

Illustration 4-1: Construction of a residential home

Homebuilder B enters into a contract to build a new home for a customer on land owned by Homebuilder B. Ownership of the home and land are transferred to the customer when construction is completed. The homebuilder is responsible for the overall management of the project and identifies various goods and services to be provided, including design work, procurement of materials, site preparation and foundation pouring, framing and drywall, mechanical and electrical work, installation of fixtures (e.g., windows, doors, cabinetry) and finishing work.

Analysis: Homebuilder B first evaluates whether the customer can benefit from each of the various goods and services either on their own or together with other readily available resources. Homebuilder B determines that these goods and services are regularly sold separately to other customers by other contractors. Therefore, the customer could generate economic benefit from each of the goods and services either on their own or together with the other goods and services that are readily available to the customer, although they would have to be provided in the context of a different property. Consequently, Homebuilder B determines that the goods and services are capable of being distinct.

Homebuilder B then evaluates whether the goods and services are distinct within the context of the contract. Homebuilder B determines that the contract requires that it provide a significant service of integrating the various goods and services (the inputs) into the new home (the combined output). Therefore, Homebuilder B's promise to transfer the various individual goods and services in the contract are not separately identifiable from other promises in the contract. That is, the various goods and services are all conveyed via a completed home.

Because both criteria for identifying a distinct good or service are not met, Homebuilder B determines the goods and services are not distinct and accounts for all of the goods and services in the contract as a single performance obligation. See Chapter 7 for discussion of satisfaction of performance obligations.

It is unclear how amenities provided by a homebuilder or residential condominium developer will be accounted for under the new guidance. Often, amenities are sold or transferred in connection with the sale of individual units of a real estate project. In evaluating these transactions, entities should consider:

- The parties involved (e.g., customer and homeowner's association)
- Whether separate performance obligations exist and what they are (e.g., goods or services)
- To which parties the promises (potentially performance obligations) are made

How we see it

All real estate entities will need to determine whether separate performance obligations exist within their contracts. We expect these judgments may be more complex for homebuilders, developers of residential condominiums and entities that, in addition to property sales, provide property management services because the nature of these contracts requires the entity to perform multiple activities that may (or may not) represent separate performance obligations.

Entities that provide property management services will need to determine which activities comprise a series of distinct services.

4.2 Series of distinct goods and services that are substantially the same and that have the same pattern of transfer

As mentioned above, goods and services that are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer must be accounted for as a single performance obligation to that customer if both of the following criteria are met:

- ▶ Each distinct good or service in the series that the entity promises to transfer consecutively represents a performance obligation that would be satisfied over time (see Section 7.1) if it were accounted for separately.
- ▶ The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see Section 7.1.4).

Property management services (e.g., maintenance, janitorial, leasing, back office), would likely meet both criteria. However, because property management service contracts are usually composed of multiple underlying activities, significant judgment may be required to determine which activities within a services contract would meet both criteria. The following illustrates how a real estate entity might evaluate performance obligations in a property management contract:

Illustration 4-2: Identifying performance obligations in a property management contract

Operator R enters into a five-year contract with Owner S to provide property management services for a regional mall. The contract stipulates that Operator R will perform the following functions:

- ▶ Manage day-to-day operations of the mall for a fee of 5% of the property’s quarterly lease revenues
- ▶ Provide leasing services for a fee of \$5 per square foot for new lease agreements and \$3 per square foot for renewal lease agreements

Operator R evaluates each of the services provided in the contract to identify whether separate performance obligations are present. Operator R also considers the underlying activities that comprise each of the services to determine whether they meet the criteria to be accounted for as a single performance obligation (or whether the service may be several performance obligations).

Operator R also determines that the leasing services are distinct from the management services (i.e., the leasing and management services are not combined to form a single performance obligation). Both services are capable of being distinct and are distinct in the context of the contract because the services are not highly interrelated with one another. The activities that are necessary to perform the day-to-day management of the property are independent of those that are required to negotiate and execute leases with tenants.

Analysis of management services

Operator R first evaluates the activities that must be performed in order to manage the day-to-day operations of the property. Operator R identifies a number of activities that comprise the overall property management services, including maintenance, janitorial, security, landscaping, snow removal, tenant relationship management and back office support. While each of these activities are individually capable of being distinct, Operator R concludes that they are not distinct within the context of the contract because the ultimate objective of the management services is to perform any activities that are necessary to ensure the property is open and operating as intended.

In addition, Operator R determines that the management services represent a series of services that are substantially the same and have the same pattern of transfer to Owner S. While the specific activities that occur each day may vary slightly (e.g., landscaping may occur in the summer while snow removal occurs in the winter), the overall service of property management is substantially the same and has the same pattern of transfer (i.e., transfers daily) over the term of the contract. Further, each distinct service represents a performance obligation that would be satisfied over time (i.e., over the length of the contract, not at a point in time) and has the same measure of progress (e.g., time elapsed), thereby meeting the stated criteria.

Analysis of leasing services

Operator R then evaluates the activities that comprise the leasing services. Operator R identifies several activities that occur throughout the leasing process, including monitoring of upcoming vacancies, new tenant identification, proposal preparation, lease negotiation and document preparation. While certain of these activities may be capable of being distinct (i.e., document preparation could be outsourced), Operator R concludes they are not distinct within the context of the contract because the ultimate objective of the leasing services is to execute individual leases with tenants to maintain the overall occupancy of the property.

Operator R will need to define the leasing performance obligation by determining whether the leasing services are a single performance obligation or a number of performance obligations (i.e., the execution of each lease).

How we see it

As illustrated above, entities will need to first determine which services in the contract are distinct and therefore could represent separate performance obligations. Then, these services will need to be evaluated to determine whether they are substantially the same, have the same pattern of transfer and meet the two criteria discussed above and therefore must be combined into one performance obligation. This evaluation may require significant judgment when a property manager performs activities beyond day-to-day operation of the property.

For example, a retail property manager may be responsible for identifying and executing leases with seasonal tenants, attracting on-site events (e.g., automobile tent sales) or placing advertising or promotional signage around the property. If an entity determines that these activities represent separate performance obligations, and the contract does not specify separate revenues that reflect the standalone selling prices of these services, the base management fee must be allocated to each separate performance obligation (see Chapter 6).

5 Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. The entitled amount is meant to reflect the amount that the entity has rights to under the present contract and may differ from the contractual price (e.g., if the entity expects or intends to offer a price concession).

The consideration promised in a contract may include fixed or variable amounts. When determining the transaction price, entities must estimate the variable consideration expected to be received. The requirement to estimate variable consideration at contract inception in property management contracts and certain real estate sales agreements may represent a significant change for real estate entities. The transaction price also will include the fair value of any noncash consideration, the effect of a significant financing component (i.e., the time value of money) and the effect of any consideration payable to a customer.

5.1 Variable consideration

The transaction price may vary in amount and timing as a result of discounts, credits, price concessions, incentives or bonuses. In addition, consideration may be contingent on the occurrence or nonoccurrence of a future event or earned as a percentage of an underlying measure (e.g., sales, profits, operating performance).

An entity is required to estimate variable consideration using either the “expected value” approach (i.e., the sum of probability-weighted amounts) or the “most likely amount” approach (i.e., the single most likely outcome), whichever better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a “free choice.” The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at each reporting date.

The Boards indicated¹² that the most likely amount approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus but not a portion of that bonus). The following provides an illustration of a real estate entity estimating variable consideration resulting from future profit participation from a sale of real estate.

Illustration 5-1: Estimating variable consideration

Developer D sells a newly constructed commercial property with a cost basis of \$1.9 million for \$2 million, plus a right to receive 5% of future operating profit from the property for the first year. Developer D has no additional ongoing performance obligations. Developer D determines there are a number of possible outcomes of consideration to be received based on the performance of the property (i.e., the buyer’s ability to secure tenants for the entire property at favorable rental rates). The buyer currently has executed leases or letters of intent from prospective tenants for 50% of the property.

Analysis: Developer D has to determine whether the “expected value” or “most likely amount” approach better predicts the variable consideration to be received. Developer D determines that the “expected value” approach is the better predictor of the variable consideration since multiple outcomes are possible.

Based on the buyer's current pre-leasing, Developer D estimates the following future profit participation:

Future profit	Probability
\$50,000	10%
\$25,000	70%
\$ 0	20%

Assume for purposes of this illustration that the constraint, discussed further below, does not limit the amount that can be included in the transaction price at contract inception (i.e., assume it is probable that a significant revenue reversal will not occur). Using a probability-weighted estimate, Entity A would include \$22,500 [$(\$50,000 \times 10\%) + (\$25,000 \times 70\%) + (\$0 \times 20\%)$] in the transaction price associated with this variable consideration. That is, the transaction price would be \$2,022,500.

Developer D updates its estimate of the transaction price at the next reporting date, and after considering that the buyer now has letters of intent or executed leases for 75% of the property, determines it is now 75% likely to receive future profit participation of \$50,000 and 25% likely to receive \$25,000. As a result, Developer D's estimate of variable consideration is updated to \$43,750 [$(\$50,000 \times 75\%) + (\$25,000 \times 25\%)$] and additional revenue (i.e., gain on sale) of \$21,250 ($\$2,043,750 - \$2,022,500$) is recognized.

5.1.1 *Constraining estimates of variable consideration*

The constraint may be applied to variable consideration resulting from the sale of real estate or property management arrangements.

To include variable consideration in the estimated transaction price, the entity has to first conclude that it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. For purposes of this analysis, "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. The Boards provided factors that may indicate that revenue is subject to a significant reversal:

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility, judgment or actions of third parties, weather conditions).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The indicators provided by the Boards are not meant to be an all-inclusive list, and entities may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not necessarily mean that it is probable that a change in the estimate of variable consideration will result in a significant revenue reversal.

For example, when determining how the constraint affects the estimate of variable consideration, sellers of real estate and property managers will need to consider a variety of factors, including their experiences with similar arrangements, uncertainties that may exist in the latter years of a long-term contract, and market and other factors that may be outside of their control. All entities will want to make sure they sufficiently and contemporaneously document the reasons (including supporting and non-supporting evidence considered) for their conclusions.

When an entity is unable to conclude that it is probable that a change in the estimate of variable consideration that *would* result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when an arrangement includes variable consideration, an entity should update both its estimate of the transaction price and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at each reporting date.

The following provides an illustration of the application of the constraint to the estimation of variable consideration:

Illustration 5-2: Evaluating the constraint

Assume the same facts as in Illustration 5-1 except that the buyer of the property has just begun negotiations with prospective tenants and has not signed lease agreements for a significant amount of space.

Analysis: Developer D uses the “expected value” approach and estimates it is 25% likely to receive future profit participation of \$50,000, 50% likely to receive \$25,000 and 25% likely to receive none. Using a probability-weighted estimate (prior to considering the constraint), Entity A would include \$25,000 [$(\$50,000 \times 25\%) + (\$25,000 \times 50\%) + (\$0 \times 25\%)$] in the transaction price associated with this variable consideration. That is, the transaction price would be \$2,025,000. Because the constraint would be set at \$25,000 (i.e., the amount for which it’s probable that a significant reversal will not occur), the full \$25,000 may be recognized.

How we see it

While the Boards noted in the Basis for Conclusions¹³ that entities should evaluate the magnitude of a potential revenue reversal relative to total consideration (i.e., fixed and variable), the Boards did not include any quantitative guidance for evaluating the significance of the amount. This will require entities to use significant judgment when making this assessment.

5.2 Price concessions

As discussed in Chapter 3, before determining that a contract is in the scope of the new standard, an entity has to assess whether it is probable that it will collect the consideration to which it expects to be entitled in exchange for transferring goods or services (i.e., the transaction price). When determining the transaction price, an entity must evaluate its intention or willingness at the outset of the contract to accept less than the stated contract price (i.e., offer or accept a price concession). A price concession is a form of variable consideration and, as such, must be considered when estimating the amount an entity expects to receive under the contract.

5.3 Noncash consideration

The new standard specifies that when an entity receives, or expects to receive, noncash consideration (e.g., in the form of goods or services), the fair value of the noncash consideration (measured in accordance with ASC 820, *Fair Value Measurement*) is included in the transaction price. If an entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the noncash consideration indirectly by reference to the estimated standalone selling price of the promised goods or services to the customer.

5.4 Significant financing component

A significant financing component may exist when the receipt of consideration does not match the timing of the transfer of goods or services to the customer (i.e., the consideration is prepaid or is paid well after the services are provided). Entities will not be required to adjust the transaction price for this component if the financing is not significant to the contract. Further, an entity is not required to assess whether the arrangement contains a significant financing component unless the period between the customer's payment and the entity's transfer of the goods or services is greater than one year.

When an entity concludes that a financing component is significant to a contract, it determines the transaction price by discounting the amount of promised consideration. The entity uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The discount rate has to reflect the credit characteristics of the borrower in the arrangement; using a rate explicitly stated in the contract that does not correspond with market terms in a separate financing arrangement would not be acceptable. Subject to certain limitations, the transaction price will need to be accreted when there is a prepayment that is determined to be a significant financing component.

6 Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, the standard generally (with some exceptions) requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis).

To allocate the transaction price on a relative selling price basis, an entity must first determine the standalone selling price (i.e., the price at which an entity would sell a good or service on a standalone basis at contract inception) for each performance obligation. Generally, the observable price of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity has to estimate the standalone selling price.

The standard discusses three estimation methods: (1) an adjusted market assessment approach, (2) an expected cost plus a margin approach and (3) a residual approach, but these are not the only estimation methods permitted. The standard allows an entity to use any reasonable estimation method (or combination of approaches), as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services and customers.

Under ASC 360-20, an entity that sold an asset and retained a management contract at a below market rate was required to use a prevailing rate to “impute” compensation for the management services. The new standard requires the seller to separately estimate the standalone selling prices of the real estate asset and the management services and allocate total consideration received in the contract on a relative basis.

How we see it

Entities that regularly provide third-party management services should already be equipped to make these estimates. However, entities that infrequently provide these services on a standalone basis, but elect to do so in connection with the sale of a real estate asset, may need to develop new processes to estimate the standalone selling price and retain sufficient documentation to support the reasonableness of their calculations.

Under the relative standalone selling price method, once an entity determines the standalone selling price for the performance obligations in an arrangement, the entity allocates the transaction price to those performance obligations based on the proportion of the standalone selling price of each performance obligation to the sum of the standalone selling prices of all of the performance obligations in the arrangement.

6.1 Exceptions to the relative standalone selling price method

The standard requires an entity to use the relative standalone selling price method to allocate the transaction price except in two circumstances. The first exception requires an entity to only allocate a discount in a contract to the specific goods or services to which it relates rather than proportionately to all of the separate performance obligations. To apply this exception, the entity must meet certain criteria¹⁴ that are unlikely to be satisfied in most types of real estate contracts.

The second exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the standard's overall objective of allocating revenue in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

In the Basis for Conclusions¹⁵, the Boards discussed an example of a contract to provide hotel management services for one year (i.e., a single performance obligation that is a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer) for which the consideration is variable and based on the operating results of the property. In this example, the variable consideration (e.g., management fees) that relates specifically to an entity's efforts to transfer the services for a certain period within a contract (e.g., a month, a quarter), which are distinct from the services provided in other periods within the contract, are allocated to those distinct periods instead of being spread over the entire performance obligation.

The following illustration depicts the application of this exception by a property manager that determines that the services it is providing represent a single performance obligation:

Illustration 6-1: Property management fees

On 1 January 2018, Operator E enters into a one-year contract with a shopping center owner to provide property management services. Operator E receives a 5% management fee based on the shopping center's quarterly lease revenues, as defined in the agreement. This is a form of variable consideration.

Analysis: Operator E concludes that the management services represent a single performance obligation recognized over time because it determines that it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (i.e., the services transfer to the customer over time and Operator E uses time elapsed to measure progress).

Operator E determines that the transaction price is allocated to each individual quarter because the quarterly management fee relates specifically to the entity's efforts to satisfy the performance obligation during each quarter, and the allocation is consistent with the objective of allocating an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised services.

For example, if the revenue generated by the property was \$2.0 million in the first quarter of 2018, Operator E would recognize revenue of \$100,000 (\$2.0 million x 5%) at 31 March 2018.

Property managers may allocate variable consideration to the period in which the related services were performed, if certain criteria are met.

How we see it

Property managers will need to evaluate their contracts to determine whether the exception for allocating variable consideration will apply to contracts that are based on a percentage of the operating results of the underlying property, including contracts that an entity concludes contain only one performance obligation. Some entities will find that applying the exception and therefore recognizing management fees that relate specifically to the entity's efforts to transfer the service in a distinct period is relatively straightforward. However, certain contracts may contain multiple revenue streams that relate to a single performance obligation. For example, in addition to a variable fee, a contract could also include a fixed fee that would generally be recognized over the term of the contract using the entity's selected measure of progress (e.g., time elapsed).

Some property management contracts contain incentive fees that are based on the performance of the underlying property over a different period than the base management fees (e.g., annually versus quarterly). The following illustration depicts the complexity that entities may face and the significant judgment that may be required when recognizing revenues from these arrangements:

Illustration 6-2: Incentive-based fees

Assume the same facts as in Illustration 6-1 except that Operator E also receives a fee of 2% of the property's annual net operating income (NOI). The shopping center has stabilized occupancy, and no significant tenant vacancies are expected during the term of the agreement. The shopping center is located in a region that periodically receives significant snow accumulation from December through May, which results in extensive snow removal costs in certain years.

Analysis: Operator E evaluates variable consideration in the form of the incentive fee. While most of the property's operating costs are predictable, Operator E determines that the variability of snow removal costs can significantly affect NOI of the property. Because of the potential variability in NOI, Operator E uses the "expected value" approach and concludes that there is an equal (33.3%) likelihood of the property generating NOI of \$1.2 million, \$1.5 million and \$1.8 million. Based on this approach, Operator E initially estimates that it will earn \$30,000 [$.02 \times ((\$1.2 \text{ million} \times 33.3\%) + (\$1.5 \text{ million} \times 33.3\%) + (\$1.8 \text{ million} \times 33.3\%))$] from the incentive fee.

In this scenario, the incentive fee is based on the annual NOI of the property; however, Operator E must determine whether any of the variable consideration should be recognized in the distinct period (i.e., quarter) when the underlying services were performed. Operator E considers whether it is probable that a significant reversal in the incentive fees will not occur prior to the end of the annual period. This assessment requires consideration of the unique facts and circumstances of the arrangement.

Assume Operator E cannot conclude at contract inception that a significant reversal of revenue from the incentive fees is probable to not occur because NOI could be significantly affected by snow removal costs. Snow removal costs result from factors that are beyond its influence (e.g., future weather patterns). Therefore, Operator E applies the constraint to the annual incentive fee and only includes in the allocable transaction price the fees that would be earned from the estimated outcome of NOI for which it is probable that a significant reversal in incentive fees will not occur, or \$24,000 ($\$1,200,000 \times .02$). Operator E would subsequently update its estimate of the transaction price (and its evaluation of the constraint on variable consideration) at each reporting period.

7 Satisfaction of performance obligations

Under the new standard, an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Control of the good or service refers to the ability to direct its use and to obtain substantially all of its remaining benefits (i.e., the right to cash inflows or reduction of cash outflows generated by the good or service). Control also means the ability to prevent other entities from directing the use of and receiving the benefit from a good or service.

The standard indicates that an entity has to determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. These concepts are explored further in the following sections.

7.1 Performance obligations satisfied over time

An entity transfers control of a good or service over time (rather than at a point in time) when any of the following criteria are met:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- ▶ The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
- ▶ 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.

7.1.1 *Customer simultaneously receives and consumes benefits as the entity performs*

In some instances, the assessment of whether a customer simultaneously receives and consumes the benefits of an entity's performance will be straightforward (e.g., daily cleaning services for which the simultaneous receipt and consumption by the customer is readily evident). However, in circumstances in which simultaneous receipt and consumption is less evident, the standard clarifies that revenue recognition over time is appropriate if "an entity determines that another entity would not need to substantially reperform the work that the entity completed to date if that other entity were to fulfill the remaining performance obligation to the customer." In making this determination, entities will not consider practical or contractual limitations that limit transfer of the remaining performance obligation.

Real estate entities that provide property management and other services will need to carefully evaluate their contracts to determine whether the services performed are simultaneously received and consumed by the customer (i.e., real estate owner). It may be apparent that services such as routine and recurring maintenance, cleaning and "back-office" functions meet the criteria for recognition of revenue over time. However, determining whether other services, such as leasing or development activities, are simultaneously received and consumed by the real estate owner, or that another entity would not need to substantially reperform activities completed to date, will require significant judgment. These judgments will also be affected by an entity's conclusion about the number of performance obligations (i.e., single or multiple) in the contract (see Chapter 4).

How we see it

As part of its redeliberations of the proposed leases standard, the FASB tentatively decided that services included in leasing contracts (e.g., CAM) may represent non-lease components that will be recognized in accordance with the new revenue standard. Real estate lessors should follow developments in this area as these decisions⁶ are tentative and may change before the Boards complete the leases project. Real estate entities may need to consider whether these services are simultaneously received and consumed by their tenants to determine the appropriate recognition method to apply.

7.1.2 *Customer controls asset as it is created or enhanced*

The second criterion to determine that control of a good or service is transferred over time is that the customer controls the asset as it is being created or enhanced. For example, many construction contracts also contain clauses indicating that the customer owns any work-in-progress as the contracted item is being built.

We plan to discuss the application of this criterion to construction contracts in our upcoming Technical Line, *Revenue recognition – engineering and construction services*.

7.1.3 *Asset with no alternative use and right to payment*

The last criterion to determine that control is transferred over time has the following two requirements that must both be met:

- ▶ The entity's performance does not create an asset with alternative use to the entity.
- ▶ The entity has an enforceable right to payment for performance completed to date.

Asset with no alternative use

An asset created by an entity has no alternative use if the entity is either restricted contractually or practically from readily directing the asset to another use (e.g., selling to a different customer). An entity has to make this assessment at contract inception and does not update its assessment unless the parties approve a contract modification that substantively changes the performance obligation.

The Boards specified that a contractual restriction on an entity's ability to direct an asset for another use must be substantive (i.e., a buyer could enforce its rights to the promised asset if the entity sought to sell the unit to a different buyer). In contrast, a contractual restriction may not be substantive if the entity could instead sell a different unit to the buyer without breaching the contract or incurring significant additional costs.

Further, a practical limitation exists if an entity would incur significant economic losses to direct the unit for another use. A significant economic loss may arise when significant costs are incurred to redesign or modify a unit or when the unit is sold at a significantly reduced price.

Enforceable right to payment for performance completed to date

An entity has an enforceable right to payment for performance completed to date if, at any time during the contract term, the entity would be entitled to an amount that at least compensates it for work already performed. This right to payment must be present, even in instances in which the buyer can terminate the contract for reasons other than the entity's failure to perform as promised.

The laws or legal precedent of a jurisdiction may affect an entity's conclusion of whether a present right to payment is enforceable.

To meet this criterion, the amount to which an entity is entitled must approximate the selling price of the goods or services transferred to date, including a reasonable profit margin. Compensation for a reasonable profit margin doesn't have to equal the profit margin expected for complete fulfillment of the contract but must at least reflect either:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination
- A reasonable return on the entity's cost of capital for similar contracts

The standard clarifies¹⁶ that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. The entity has to examine information that may contradict the payment schedule and may represent the entity's actual right to payment for performance completed to date (e.g., an entity's legal right to continue to perform and enforce payment by the buyer if a contract is terminated without cause).

7.1.4 Measuring progress

When a performance obligation is satisfied over time, the standard provides two methods for measuring progress under the contract: an input method or an output method. While the standard requires an entity to continuously update its estimates related to the measure of progress selected, it does not allow a change in methods. A performance obligation is accounted for under the method the entity selects (i.e., either the input or output method) until it has been fully satisfied.

Under an input method, revenue is recognized "on the basis of the entity's efforts or inputs to satisfy the performance obligation ... relative to the total expected inputs to the satisfaction of that performance obligation." The standard includes resources consumed, labor hours expended, costs incurred and time elapsed as possible input methods. The standard also notes it may be appropriate to recognize evenly expended inputs on a straight-line basis.

Under an output method, revenue is recognized "on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract." Measurements of output may include surveys of performance completed to date, appraisals of results achieved, milestones reached and time elapsed.

The standard does not say either method is preferable, but it says an entity should apply the method it selects to similar arrangements in similar circumstances. If an entity does not have a reasonable basis to measure its progress, the Boards decided that too much uncertainty would exist and, therefore, revenue should not be recognized until progress can be measured.

7.2 Control transferred at a point in time

Control is transferred at a point in time if none of the criteria for a good or service to be transferred over time is met. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in some circumstances, this determination is more complex.

The Boards provided indicators for entities to consider when determining whether control of a promised asset has been transferred:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The entity has transferred physical possession of the asset.

- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

None of these indicators are meant to be individually determinative. The Boards also clarified that the indicators are not meant to be a checklist, and not all of them must be present to determine that the customer has gained control. An entity has to consider all relevant facts and circumstances to determine whether control has transferred. For example, the presence of a repurchase option in a contract may indicate that the customer has not obtained control of the asset, even though it has physical possession.

How we see it

Entities that sell a real estate asset will generally be able to recognize revenue and associated profit when control of the property transfers (i.e., at a point in time) presuming all other requirements are met. In most real estate transactions, control will transfer when the buyer obtains legal title and physical possession of the asset. Sellers of real estate are no longer required to consider the initial and continuing investment and continuing involvement criteria in ASC 360-20, although they must conclude on the collectibility of the transaction price. Today, real estate sales are often structured to meet the restrictive criteria in ASC 360-20. For example, the criteria create a disincentive for selling a property with 100% seller financing.

8 Other measurement and recognition topics

The new revenue standard includes guidance for licenses and warranties that may result in changes in practice for certain real estate entities. The FASB also issued consequential amendments to ASC 970, *Real Estate – General*, which is commonly applied to real estate transactions.

8.1 Licenses of intellectual property

The standard provides guidance for recognizing revenue from distinct licenses of intellectual property, which includes licenses granted by hospitality entities, that differs slightly from the overall model.

When the license is the only promised item in the contract, the specific license guidance is applicable to that license. However, licenses of intellectual property are frequently included in multiple-element arrangements with promises for additional goods and services that may be explicit or implicit. For example, a hospitality entity may license its brand for use by a hotel owner and also provide marketing and reservation management services. If an entity determines that a license is not distinct from other promised goods or services in the contract, the promise to grant a license and (some or all) of the other promised goods or services should be accounted for as a single performance obligation and the specific guidance for recognizing revenue for distinct licenses is not applied.

For distinct licenses, entities need to determine whether they have provided their customers with either (1) the right to access the entity's intellectual property as it exists throughout the license period, including any changes to that intellectual property (i.e., right to access) or (2) the right to use the entity's intellectual property as it exists at the point in time when the license is granted (i.e., right to use). We generally expect that right-to-use licenses will be uncommon in the real estate industry; thus, the remainder of our discussion focuses on licenses that provide a right to access.

An entity provides the customer a right to access its intellectual property when it is required to undertake activities that significantly affect the licensed intellectual property and the customer is therefore exposed to positive or negative effects resulting from those changes. These activities can be part of an entity's ongoing and ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer).

License agreements between hospitality entities and hotel owners generally provide the hotel owner with the right to access the license. Hospitality entities regularly undertake activities that may positively or negatively affect the license and associated brand, rather than directly transfer other goods and services to the customer that should be considered separate performance obligations. Those activities may include analyzing the customer's changing preferences and implementing product and service improvements, pricing strategies, marketing campaigns and operational efficiencies to support the brand name.

The Boards concluded that a license that provides an entity with the right to access intellectual property is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance of providing access," including the related activities undertaken by entity.

The standard also provides an exception for determining the transaction price when the arrangement includes sales- or usage-based royalties on licenses of intellectual property. The standard requires that this particular type of variable consideration not be included in the estimate of variable consideration, as discussed in Section 5.1. Instead, these amounts are recognized only upon the later of when the subsequent sale or usage occurs or the satisfaction (in whole or in part) of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

8.2 Warranties

Warranties are commonly included in arrangements to sell goods or services, whether explicitly stated or implied based on the entity's customary business practices. The new standard identifies two types of warranties.

Warranties that promise the customer that the delivered product is as specified in the contract are called "assurance-type warranties." The Boards concluded that these warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee. For example, homebuilders and developers of residential condominiums often provide various warranties against construction defects and the failure of certain operating systems for a period of time. Under the standard, the estimated cost of satisfying these warranties is accrued in accordance with the current guidance in ASC 460-10 on guarantees.

Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract are called "service-type warranties." If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the warranty based on the estimated standalone selling price of the warranty. The entity then recognizes revenue allocated to the warranty over the period the warranty service is provided. Service-type warranties are infrequent in the real estate industry.

8.3 Real estate project costs

Today's guidance in ASC 970, *Real Estate – General*, addresses the costs incurred to sell real estate projects (e.g., model units, advertising, sales overhead) and rent real estate projects. It also prescribes the accounting for amenities such as golf courses, clubhouses, swimming pools and parking facilities. The FASB amended the guidance for costs incurred to *sell* real estate projects, and they will be accounted for under the new guidance for costs incurred in obtaining a contract that the FASB added in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*. Costs incurred to *rent* real estate projects and the accounting for amenities will continue to follow the guidance in ASC 970.

Under ASC 340-40, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. Recovery can be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing such costs would have been amortized in one year or less.

The standard cites sales commissions as an example of an incremental cost that may require capitalization. For example, sales commissions that are directly related to sales achieved during a time period would likely represent incremental costs that would require capitalization. In contrast, some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not directly related to obtaining a contract. In addition, costs incurred for model units, advertising and sales overhead may not qualify to be capitalized under ASC 340-40 because they are not incremental costs of obtaining a contract.

ASC 340-40 also includes guidance for recognizing costs incurred in fulfilling a contract that are not in the scope of another topic. For most real estate entities, costs incurred in fulfilling a contract (e.g., the costs to construct a building such as materials and labor) are already within

The new standard amends the guidance for costs incurred to sell real estate projects.

the scope of another topic (e.g., ASC 360, *Plant, Property, and Equipment*) and therefore are excluded from the scope of ASC 340-40. ASC 340-40 also provides guidance on amortization and impairment.

Next steps

Real estate entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.

Real estate entities also may want to monitor the discussions of the Boards, SEC staff, the TRG, and hospitality and time-shares industry working groups formed by the AICPA to discuss interpretations and application of the new standard to common transactions. These working groups may address issues that affect all real estate entities.

Public entities also should consider how they communicate the changes caused by the new standard with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

- ¹ The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following: (1) a public business entity (PBE), (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements with the SEC.
- ² ASC 250-10-45-5.
- ³ ASC 606-10-65-1(c)(2).
- ⁴ This exclusion includes contracts within the scope of the following Topics: ASC 310, *Receivables*; ASC 320, *Investments – Debt and Equity Securities*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.
- ⁵ Neither ASC 606 nor ASC 460 provides guidance on recognizing revenue associated with a guarantee.
- ⁶ Minutes of the 22 May 2014 FASB Board Meeting.
- ⁷ Statement of Financial Accounting Concepts No. 6, *Elements of financial statements*.
- ⁸ ASU 2014-09, *Basis for Conclusions*, paragraph 497
- ⁹ Refer to Chapter 1 of our Financial reporting developments, *Real Estate Sales*.
- ¹⁰ Minutes of the 29 May 2013 FASB Board Meeting.
- ¹¹ ASU 2014-09, *Consequential Amendments*, paragraph 63
- ¹² ASC 606-10-32-8
- ¹³ ASU 2014-09, *Basis for Conclusions*, paragraph 217
- ¹⁴ ASC 606-10-32-37
- ¹⁵ ASU 2014-09, *Basis for Conclusions*, paragraph 285
- ¹⁶ ASC 606-10-55-15

EY | Assurance | Tax | Transactions | Advisory

© 2014 Ernst & Young LLP.
All Rights Reserved.

SCORE No. BB2811

ey.com/us/accountinglink

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.