100 Introduction

100.1 The accounting literature relating to real estate is varied and complex. It consists of a wide-ranging collection of standards, some of which have broad application to many types of real estate activities and some of which apply only to very specific situations. This *Guide* provides accounting and reporting guidance for real estate transactions, focusing primarily on real estate companies and the accounting requirements unique to real estate transactions. However, much of the *Guide* also applies to companies whose primary business is not real estate but that are involved in real estate transactions (e.g., manufacturers involved in real estate leasing transactions). In addition, this *Guide* addresses accounting considerations that are not unique to real estate companies but are commonly encountered by them (e.g., fair value and impairment considerations).

100.2 This *Guide* is designed as a reference tool that can be used when faced with a real estate accounting issue to quickly gain an understanding of what the rules are, what they require, and how to deal with problems the rules do not address. Consequently, this *Guide* provides basic overview guidance, introduces the applicable literature, gives specifics on how to apply complex accounting requirements, and provides the authors' recommendations on how to deal with gray areas in the literature. This chapter provides a general overview of the real estate industry and the accounting literature related to real estate transactions. Chapters 2 and 3 discuss accounting for costs. Chapter 2 relates to land developers, and Chapter 3 relates to those who build on developed land (e.g., homebuilders and commercial builders). Chapters 4 and 5 address accounting for sales. Chapter 4 relates to sales other than retail land sales, and Chapter 5 covers the unique requirements for retail land sales. Chapters 6 and 7 address leasing transactions. Chapter 6 discusses capital and operating leases, while Chapter 7 addresses sale-leaseback transactions. Chapter 8 provides guidance on determining fair value and impairment of real estate, as well as guidance on accounting for real estate loans and troubled debt restructurings. Chapter 9 discusses the accounting requirements for the most common types of real estate ventures. Chapter 10 provides guidance on financial statement presentation by real estate companies. Finally, Chapters 11-16 of this *Guide* address tax issues related to real estate transactions.

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101 The Real Estate Industry

101.1 While the real estate industry includes a variety of businesses, it generally centers around investment in real estate properties (e.g., land or buildings) in the following categories:

- Single-family residential.
- Multi-family residential (e.g., apartments, townhomes, and condominiums).
- Retail (e.g., convenience stores, restaurants, strip shopping centers, neighborhood shopping centers, and regional malls).
- Commercial (e.g., office buildings).
- Industrial (e.g., warehouses and manufacturing facilities).

101.2 Other businesses, such as the following, may not actually own real estate but are considered part of the real estate industry:

- Construction contractors that provide development or construction services on behalf of owners of real estate, either as general contractors or subcontractors.
- Real estate brokers that act as agents for sellers of real estate.

- Real estate management companies that manage income-producing properties, typically rental properties, for owners.

This *Guide* focuses primarily on companies that invest in real estate properties.

Investment Strategies

101.3 Real estate investment strategies vary based on the desires of the investors. The following are examples of typical investment strategies:

- Land speculation.

- Property development.

- Income production.

101.4 **Land Speculation** Land speculation involves buying land with the intention of holding it for a while and selling it in the same condition (i.e., the land is not developed, and no improvements are added). Instead, the goal is to merely hold the property for a period of time and sell it. Land speculation projects are often riskier than other real estate investments. Consequently, land speculation is rarely a company's primary business. It is typically done in addition to other development or investment activities.

101.5 **Property Development** Property development involves buying land or a building with the intention of enhancing its value by adding physical improvements or increasing its operating profits. Examples of typical development projects include:

- Developing raw land into residential or commercial lots and selling the lots.

- Acquiring land and building homes for sale to homebuyers.

- Acquiring land, constructing a building, leasing it to others, managing the property for a period of time (usually until it reaches a stabilized level of occupancy), and selling it.

- Acquiring fully developed property, rehabilitating the property (or merely improving its cash flows through better management), and selling the property after the improvements are made. (That strategy is often used for older or distressed properties that can be acquired at discount prices.)

In those situations, the developer seeks to profit from the sale of the projects. Thus, the properties are essentially the developer's inventory.

101.6 **Income Production** The income production strategy involves buying or building rental property and managing it for the operating income it generates. The activities involved are similar to those of project developers, except that the owners do not intend to sell the project. Thus, such real estate properties are productive assets rather than inventory.

101.7 With the land speculation and property development strategies, profits are sought primarily from appreciation of the assets, and any income generated during the holding period is incidental. With the income production strategy, profits are sought solely from operations with little or no regard for appreciation. A real estate company may use any or all of those strategies in its business.

Effect of Debt on Real Estate Companies

101.8 Since real estate investments require substantial amounts of capital, real estate companies typically have little available cash and a great deal of debt. Consequently, many of their operating decisions depend on how much financing is available. Since lending institutions are limited in the amount of financing they can provide for a given project (e.g., because of loan-to-value ratio limitations and other regulatory restrictions), a developer often must raise equity capital to acquire more and larger projects. That is normally accomplished by forming partnerships to attract investors to participate in real estate projects.

101.9 Financing constraints can also affect the sale of properties. For example, if a potential buyer is unable to obtain sufficient financing from lending institutions, the seller may finance a portion of the sales price. Also, a developer can hold property only as long as its debt financing is available. For example, if a construction loan on a project is about to mature and permanent financing cannot be obtained, the developer might be forced to sell the property at a discount before the maturity date to avoid foreclosure proceedings.

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102 Forms of Ownership

102.1 Real estate companies operate in a variety of legal forms. The selection of legal form is based on many of the same considerations as in other industries (e.g., the type of project, the developer's financial needs, tax attributes, and legal considerations). Also, a developer may form one entity to develop several projects, or a separate entity may be formed for each project (e.g., so that different investors can be solicited for each project). This section discusses legal forms that real estate companies may take.

Sole Proprietorships

102.2 In a sole proprietorship, the real estate is owned by a single individual. This form is simple and can provide many tax advantages. However, it also has significant disadvantages. For example, proprietorships may have difficulties raising capital, and they offer no liability protection to the owner. Thus, most real estate companies are not sole proprietorships.

Corporations

102.3 A corporation is a separate legal entity, and title to the property is in the name of the corporation. Stockholders' voting rights are generally determined based on their percentage of voting common stock. Corporations can generally offer stockholders protection from personal liability, although lenders may circumvent this protection by requiring stockholders to personally guarantee loans to the corporation. Key disadvantages to real estate companies are the high cost of forming and maintaining corporations and the difficulties associated with dissolving them. Thus, the corporate form may be used by developers, builders, or management companies, but noncorporate forms are often used for individual projects.

102.4 **Tax Considerations** The tax attributes of a corporation vary significantly depending on whether it is a C corporation or an S corporation. Generally, a C corporation's earnings are taxed at corporate rates, losses generate tax benefits only to the extent they can be offset against corporate taxable income, and tax credits generate tax benefits only to the extent they can be offset against corporate taxes. There is no pass-through to the stockholders. Distributions of corporate earnings to

stockholders are not deductible by the corporation, but they are taxable to the stockholders, thus effectively imposing a double tax on the distribution of earnings. For more detailed guidance, refer to *PPC's 1120 Deskbook* and *PPC's Tax Planning Guide—Closely Held Corporations*.

102.5 S corporations are pass-through entities; that is, profits, losses, and tax credits generally pass through to the stockholders in proportion to their ownership interests. Corporations that wish to elect S corporation status must meet certain IRS requirements, and there are limitations on the deductibility of S corporation losses by stockholders. For more detailed guidance, refer to *PPC's 1120S Deskbook* and *PPC's Tax Planning Guide—S Corporations*.

Noncorporate Ventures

102.6 **Partnerships** Most noncorporate real estate ventures are legally organized as partnerships. A partnership is a separate legal entity, and title to property is held in its name. There are two types of partnerships—

- *General Partnership.* In a general partnership, each partner is a general partner and has unlimited liability.

- *Limited Partnership.* In a limited partnership, at least one partner (the general partner) has unlimited liability, and the remaining partners are limited partners whose direct liability is usually limited to their capital investment.

Individuals, corporations, and other partnerships can be general or limited partners.

102.7 The formation of a partnership usually requires preparation of a partnership agreement that sets forth the rights and obligations of each partner. The following are examples of matters that are typically discussed in a partnership agreement:

a. *Allocation of Profits and Losses.* Profits and losses may be allocated differently from the proportion of contributed capital. Also, the allocations may vary depending on the source of the profit or loss. For example, partnerships that operate rental property may allocate operating profits and losses differently from profits and losses on the sale of the rental property.

b. *Transfer of Partnership Interests.* Ordinarily, general partnership interests can be transferred only with the approval of the other general partners. In a limited partnership, approval of one or more limited partners also may be required. On the other hand, the transfer of a limited partner's interest typically does not require approval by the other limited partners, but it may require the approval of one or more of the general partners.

c. *Designation of Managing Partner.* The partnership agreement normally designates one of the general partners (e.g., the developer) as the managing partner and specifies the managing partner's powers and responsibilities.

102.8 The managing partner's ability to control partnership activities is usually limited. The following are examples of such limitations:

a. The managing general partner may be provided responsibility for day-to-day operations but be required to consult with the other general partners, and perhaps with one of the limited partners, on decisions regarding the sale of partnership property.

b. The managing partner may be given control, but a limited partner may have the ability to replace the managing partner.

102.9 **Taxation of Partnerships** Income, losses, and tax credits from the partnership generally pass through to the partners in the proportion specified in the partnership agreement. Income is therefore taxed at individual rates, and tax credits reduce individual income taxes. However, the deduction of losses generally may be limited based on the partner's activities and the extent and nature of the partnership interests. For more detailed guidance, refer to *PPC's 1065 Deskbook* and *PPC's Tax Planning Guide—Partnerships*.

102.10 **Undivided Interests** Undivided interests are another form of noncorporate real estate venture, though less common than partnerships. In an undivided interest arrangement, the investors have joint title to the property, and operations are shared to the extent of each investor's interest. Investors may have joint or several liability, depending on the obligation. There are two primary types of undivided interest arrangements:

- Tenancy in common.

- Joint tenancy.

102.11 The primary difference between the two arrangements is in the right of survivorship of the investors' interests. In tenancy in common, if an investor dies, that ownership interest is passed to the heirs. In joint tenancy, the ownership interest passes to the other investors. Other differences may also exist depending on the applicable state law.

Limited Liability Companies

102.12 Limited liability companies (LLCs) are a creation of state law. Each state establishes its own LLC rules and characteristics. Generally, an LLC is an entity (owned by members) with the corporate characteristic of limited liability for its owners, and certain partnership characteristics. These include the lack of continuity of life and limits on transferability of interests. Also, unlike a limited partner in a partnership, a member of an LLC can participate in its management.

102.13 **General Tax Treatment** The attractiveness of LLCs depends on their treatment as partnerships for federal income tax purposes. The IRS has issued numerous IRS revenue rulings and private letter rulings relating to the tax consequences of operation as an LLC. For more detailed tax guidance, refer to *PPC's Guide to Limited Liability Companies*.

102.14 **Liability Considerations** Because the LLC laws are not uniform among the states, each state law must be separately reviewed to determine what types of liabilities (for example, malpractice by another member, torts, general creditor claims) the members will be protected against.

102.15 **Accounting for LLCs** While LLCs are unique legal entities, they do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. FASB ASC 272-10, *Limited Liability Entities*, provides guidance on applying existing accounting literature to LLCs. FASB ASC 323-30, *Investments—Equity Method and Joint Ventures—Partnerships, Joint Ventures, and Limited Liability Entities*, provides accounting guidance for certain investments in LLCs.

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103 Accounting Literature

Complexity of Real Estate Transactions

103.1 Real estate transactions tend to be more complex than those of commercial businesses. The reasons for that complexity include—

a. *Nonroutine Transactions.* In most commercial businesses, purchases and sales are routine transactions, and payment terms are relatively simple. Negotiations, if any, are normally limited to price. On the other hand, most real estate transactions are not routine. There are two major reasons for that:

(1) Real estate is generally a big ticket item. Big ticket items ordinarily involve some degree of negotiation, and those negotiations often involve more than sales price. The seller may offer favorable financing terms or other incentives to make the sale.

(2) Each real estate property is unique. Although some properties may be similar in many respects, no two properties are the same. Those differences in real estate properties make sales difficult to standardize.

b. *Investment Vehicles.* Real estate has historically been a popular investment vehicle for both active and passive investors. Developers often attempt to minimize their own capital investment in their real estate projects, and they often try to raise equity from private investors. Consequently, a wide variety of investment vehicles have evolved (joint ventures, syndications, real estate investment trusts, etc.), with each one having different financial, tax, and operating

characteristics. Also, a developer may form a separate entity, with a separate group of investors, for each project. Accordingly, a developer that is running multiple projects may be involved with several different entities. Such arrangements can add to the complexity of each transaction.

c. *Tax Implications.* Real estate investments have enjoyed a number of tax advantages over other types of investments, and real estate has historically been a popular tax shelter. However, tax laws and regulations impose additional operating and financial restrictions (e.g., restrictions on the form of organization) that must be satisfied to obtain or keep those tax advantages. Thus, transactions often must be structured to maximize both the financial results and tax benefits associated with the projects, and that can make those transactions more complex.

103.2 As real estate transactions became more complex, they became more difficult to account for, and real estate accounting practices became more diverse. In response to that growing complexity and diversity, the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) issued pronouncements beginning in the early 1970s to provide guidance for specific real estate transactions. Much of that early guidance (or its subsequent offshoots) remains as GAAP guidance today.

Current Generally Accepted Accounting Principles (GAAP) for Real Estate

103.3 The following paragraphs summarize the Topics and Subtopics in the FASB Accounting Standards Codification (FASB ASC or Codification) that apply specifically to real estate or are particularly relevant to real estate entities or transactions. The guidance generally applies both to real estate entities whose primary business involves developing real estate for sale or lease and to all other entities that engage in transactions involving real estate regardless of their principal business activities.

103.4 **GAAP Guidance Applicable to Real Estate Transactions or the Real Estate Industry** The following FASB ASC Topics and Subtopics contain guidance that deals exclusively with real estate transactions or the real estate industry:

- *FASB ASC 310-10, Receivables—Overall.* This Subtopic provides guidance to lenders on accounting for real estate acquisition, development, and construction (ADC) arrangements.

- *FASB ASC 360-20, Property, Plant, and Equipment—Real Estate Sales.* This Subtopic provides accounting guidance for the sale of real estate other than retail land sales. The Subtopic prescribes criteria that must be met before a sale of real estate other than retail land sales can be accounted for under the full accrual method and the different criteria and profit recognition methods that apply if the full accrual method is not applicable. Chapter 4 discusses

accounting for sales of real estate other than retail land sales.

• *FASB ASC 410-30, Asset Retirement and Environmental Obligations—Environmental Obligations.* This Subtopic provides the guidelines for recognizing, measuring, displaying, and disclosing environmental remediation liabilities. The Subtopic's accounting and disclosure requirements are discussed further in Chapters 2 and 10, respectively.

• *FASB ASC 470-30, Debt—Participating Mortgage Loans.* This Subtopic establishes how borrowers should account for a participating mortgage loan when lenders participate in the operating results of the real estate project, appreciation of the project's market value, or both. The Subtopic is discussed further in Chapter 8.

• *FASB ASC 840, Leases.* This broad transaction Topic provides specific guidance on accounting for leases involving real estate, including sale-leaseback transactions and sales-type leases of real estate. Chapter 6 discusses leasing real estate, and Chapter 7 discusses sale-leaseback transactions.

• *FASB ASC 970, Real Estate—General.* This Topic provides the guidance for (a) capitalizing costs that are associated with acquiring, developing, constructing, selling, and renting real estate projects and (b) allocating capitalized costs and costs that are not capitalized to individual components of a real estate project. This Topic also includes guidance on accounting for investments in real estate ventures in the form of corporate joint ventures, general and limited partnerships, and undivided interests. Chapter 2 discusses land development costs; Chapter 3 discusses building costs; and Chapter 9 discusses accounting for investments in real estate ventures.

• *FASB ASC 970-605, Real Estate—General—Revenue Recognition.* This Subtopic provides guidance for recognizing income from real estate syndication activities. The Subtopic also discusses determining the sales value of property and fee income, accounting for nonrefundable fees, exposure to losses, allocating cash payments, and recognizing partnership interests. Although real estate syndicates are generally organized as limited partnerships, trusts, or joint ventures, they are typically publicly held. Therefore, this FASB ASC Subtopic is not discussed in this *Guide*.

• *FASB ASC 974, Real Estate—Real Estate Investment Trusts.* This Topic applies to real estate

investment trusts (REITs) and other entities making loans on or investments in real estate. REITs are generally required to have at least 100 owners and are usually publicly held. Therefore, the Topic is not discussed in this *Guide*.

- *FASB ASC 976, Real Estate—Retail Land Sales.* This Topic provides accounting guidance for retail land sales. It includes the profit recognition methods available to retail land sales. Chapter 5 discusses accounting for retail land sales.

- *FASB ASC 978, Real Estate—Time-sharing Activities.* This Topic provides accounting guidance for real estate time-sharing transactions, including determining sales value and selling costs, assessing the buyer's commitment, and accounting for uncollectible receivables. The Topic is discussed further in several chapters.

103.5 **Other GAAP Guidance.** Other GAAP guidance that may be particularly relevant to real estate entities or real estate transactions includes the following:

- *FASB ASC 272, Limited Liability Entities.* This Topic provides guidance on applying existing accounting literature to LLCs. The guidance in this Topic includes accounting for an LLC formed by combining entities under common control or by converting from another form of entity, accounting for income taxes, and preparing financial statements.

- *FASB ASC 275, Risks and Uncertainties.* This Topic includes disclosure requirements that provide financial statement users information about situations that could have a significant impact on the entity's financial condition in the near term. The Topic requires disclosures in the financial statements regarding: (a) nature of operations, (b) use of estimates in preparing financial statements, (c) certain significant estimates, and (d) an entity's vulnerability resulting from certain concentrations. Disclosures concerning risks and uncertainties are discussed further in Chapter 10.

- *FASB ASC 310-10, Receivables—Overall.* This Subtopic includes most of the guidance for determining allowances and income recognition for impaired loans. This Subtopic also includes certain disclosure requirements related to the allowance for loan losses for all entities that provide lending for the activities of others. The Subtopic is discussed in Chapters 8 and 10.

- *FASB ASC 310-40, Receivables—Troubled Debt Restructurings by Creditors.* This Subtopic

provides the accounting guidance for lenders in troubled debt restructurings. Section 806 discusses that accounting in more detail.

- *FASB ASC 360-10, Property, Plant, and Equipment—Overall.* This Subtopic addresses how to account for the impairment of real estate and other long-lived assets in service. Impairment issues are discussed in Chapter 8.

- *FASB ASC 450, Contingencies.* This Topic includes guidance on accounting for loss contingencies (e.g., losses on loans receivable). Chapter 8 discusses the application of loss contingencies to loans receivable that are held by real estate entities.

- *FASB ASC 470-60, Debt—Troubled Debt Restructurings by Debtors.* This Subtopic provides the accounting standards for borrowers in troubled debt restructurings. Section 808 discusses that accounting in more detail.

- *FASB ASC 835-20, Interest—Capitalization of Interest.* This broad transaction Subtopic provides the conditions and methods for computing capitalized interest, including interest on land development and building construction, and discusses capitalization of interest on investments in and advances to real estate ventures and other investees that are accounted for by the equity method. Chapter 2 discusses accounting for land development costs; Chapter 3 discusses accounting for building construction costs; and Chapter 9 covers equity method investments in real estate ventures.

- *FASB ASC 860, Transfers and Servicing.* This broad transaction Topic provides guidance on accounting and disclosure for the extinguishment of liabilities and transfers of financial assets, including secured borrowings and collateral. Chapter 4 addresses transfers of receivables; Chapter 6 discusses transfers of leased property and rental payments; and Chapter 10 discusses related financial statement disclosures.

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104 New Authoritative Literature on Revenue Recognition

104.1 In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606). The ASU introduces a comprehensive, principles-based framework for recognizing revenue in FASB ASC 606, and supersedes FASB ASC 605, *Revenue Recognition*, and virtually all industry-specific revenue guidance in the FASB ASC. Among other things, the ASU is intended to improve GAAP by providing a framework to address revenue issues, create more consistency and comparability of revenue recognition across entities and industries, and improve the usefulness of information provided to users through more robust disclosure requirements.

104.2 As described further in paragraph 104.18, this new guidance is effective for nonpublic entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Nonpublic entities may adopt the new guidance before then, but generally not before annual periods beginning after December 15, 2016. The authors believe nonpublic entities will not adopt the new guidance early and instead will use the time available to fully analyze the effects of the new guidance, including the effects on compliance with loan covenants.

104.3 One of the stated goals of the FASB in issuing the ASU was to eliminate industry-specific guidance. Consistent with that goal, the guidance specific to sales by real estate entities has been eliminated. That guidance was detailed and developed over a number of years in response to practice issues. Determining how to apply the principles-based guidance in the ASU to sales by real estate entities will take time. This *Guide* therefore limits the discussion of ASU No. 2014-09 to this section, which has the following two parts:

a. The first part, which begins in paragraph 104.4, is an overview of the guidance in the ASU and is therefore broader than just sales by real estate entities. For example, the ASU uses the term *goods and services*. That is not a term customarily used for sales of real estate, but it nevertheless includes sales of real estate and any related services, such as management agreements.

b. The second part, which begins in paragraph 104.19 presents the authors' preliminary observations about the likely effect of ASU No. 2014-09 on accounting for sales of real estate by small and midsize nonpublic entities.

In future editions as the effective date becomes nearer, the guidance will be expanded to provide further details on implementing and applying the new requirements, including illustrations of financial statement presentation and disclosure[1].

An Overview of the Guidance in ASU No. 2014-09

104.4 **Scope** FASB ASC 606 applies to all contracts with customers with the following exceptions:

- Lease contracts that follow the guidance in FASB ASC 840, *Leases*.
- Insurance contracts within the scope of FASB ASC 944, *Financial Services—Insurance*.
- Certain financial instruments and other contractual rights or obligations.
- Guarantees, excluding product or service warranties.
- Certain nonmonetary exchanges.

In addition, the revenue from a single contract may require applying the guidance of multiple FASB ASC topics (for example, an equipment lease contract with a maintenance service provision, and a corporate sponsorship of a nonprofit organization's event with both contribution and exchange elements).

104.5 **Core Principle** The core principle of FASB ASC 606, as stated at FASB ASC 606-10-05-3, is “an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” The ASU provides the following five-step decision-making model for achieving this core principle:

- Step 1: Identify customer contracts.

- Step 2: Identify performance obligations in the contract.

- Step 3: Determine the price of the transaction.

- Step 4: Allocate the transaction price to each performance obligation.

- Step 5: Recognize revenue as performance obligations are satisfied.

104.6 Step 1—Identify customer contracts. A contract is a legally enforceable agreement between two or more parties and may take many forms (i.e., written, verbal, or implied by ordinary business practices). The contract must include all of the following:

- Commercial substance; that is, a transfer of goods or services will result in future cash flows.

- Approval and commitment by each party to fulfill its obligations.

- Identifiable payment terms and rights to goods or services.

- Probable collectibility.

104.7 A contract is *not* considered to exist if each party has the right to terminate an unperformed contract without compensating the other party. For a contract to be unperformed, both of the following items must exist: (a) no goods or services have been transferred, and (b) no consideration has been received or is entitled to be received for the transfer of goods or services.

104.8 FASB ASC 606 also provides guidance on when to combine contracts with the same customer, how to identify and account for contract modifications, and how to account for consideration received on agreements that do not meet the criteria for a contract discussed in paragraph 104.6.

104.9 Step 2—Identify Performance Obligations in the Contract. A performance obligation is a

promise to a customer to transfer a distinct good or service or a series of distinct goods or services that are essentially the same and transfer to the customer in the same pattern. A good or service is distinct if both of the following are met:

- The customer benefits from the transfer of the good or service either on its own or with resources that are readily available. FASB ASC 606 refers to the good or service as having the capability to be distinct.

- The promise to transfer the good or service is separately identifiable from other promises in the contract.

104.10 The guidance provides indicators to assist in assessing whether the good or service is capable of being distinct. The entity regularly selling a good or service separately is an indicator that the customer would benefit from the transfer of the good or service on its own or combined with other readily available resources. Indicators that a promise to transfer a good or service is separately identifiable include:

- Lack of significant integration services (that is, the good or service is not used in the creation of another good or service in the contract).

- Lack of significant modification or customization to another good or service in the contract.

- Lack of dependence or interrelation with other goods or services (i.e., the customer not purchasing the good or service would have no significant impact to other goods or services purchased in the contract).

If a good or service does not meet the above criteria, it would be combined or bundled with other goods or services until the bundled goods or services meet the criteria to be considered distinct.

104.11 Step 3—Determine the Price of the Transaction. FASB ASC 606-10-32-2 defines the transaction price as the amount an entity should expect to receive for providing the defined goods or services to the customer, excluding any sales taxes or similar amounts that are collected on behalf of third parties. In determining the transaction price, an entity would consider the following:

- *Variable consideration.* The price of a transaction may be variable if discounts, credits, performance bonuses, and other similar factors are involved. For example, a construction contractor may be able to receive a performance bonus if construction is completed by a defined date. If the price is variable, the entity should estimate the amount of consideration based on

either *the expected value* or *the most likely amount*. The expected value is determined by summing the probability-weighted amounts of the possible collectible amounts. The most likely amount is the one single amount the entity expects to be entitled to receive and this is often used when there are only two possible results—either yes or no. An entity should use the method that is expected to result in the best estimate of the amount to which it will be entitled. For example, a contract with a bonus for completion before a certain date would utilize the most likely amount method based on whether or not completion is expected before the specified date; however, a bonus paying varying amounts based on the number of days to completion would normally utilize the expected value method based on the probability-weighted amount for expected days to completion.

• *Constraints on estimates of variable consideration.* When uncertainty exists in the estimate of variable consideration, an entity should only include amounts for which it is probable that a significant reversal of cumulative revenue recognized would not occur once the variable consideration is known.

• *Significant financing component.* If the contract explicitly or implicitly provides a significant financing benefit to either the entity or the customer, the consideration should be adjusted for the time value of money. A practical expedient is, however, provided that allows the entity to not consider whether a significant financing component exists for contracts in which the entity expects to receive payment in one year or less from the time the goods or services are transferred.

• *Noncash consideration.* If consideration will be paid in a form other than cash, the entity should record the transaction at the fair value of the noncash consideration. If the fair value of the noncash consideration cannot be reasonably estimated, the entity should measure it indirectly by considering the standalone selling price of the goods or services. Variable noncash consideration is subject to the guidance for estimating variable consideration discussed above.

• *Consideration payable to the customer.* If the entity pays, or expects to pay, consideration to the customer, whether in the form of cash or discounts, coupons, vouchers, etc., the entity should reduce the transaction price by this amount. However, if the payment is for the customer providing distinct goods or services to the entity, the entity should generally account for the payment as a purchase of goods or services. Variable consideration payable to a customer is subject to the guidance for estimating variable consideration discussed above.

104.12 Step 4—Allocate the Transaction Price. If the contract has more than one performance obligation, the transaction price should be allocated to each separate performance obligation based on the relative standalone selling price of each good or service. The standalone selling price is the amount the entity might sell a good or service for when it was the only good or service being transferred. When observable standalone selling prices are not available, the entity should estimate the amount considering all reasonably-available information. The ASU discusses appropriate estimation methods, including an adjusted market assessment approach, an expected cost plus a margin approach, and a residual approach. Generally, discounts and changes in variable consideration are allocated proportionately to all performance obligations based on the initial allocation of the transaction price. However, when an entity meets certain criteria, discounts and variable consideration may be allocated to one or more specific performance obligations, rather than all performance obligations. If subsequent price changes occur, the entity should allocate the change on the same basis as at contract inception, and price changes allocated to completed performance obligations should be recognized as an increase or decrease in revenue in the period the change occurs. Note that for contracts with only one performance obligation, this step is not relevant.

104.13 Step 5—Recognize Revenue. Revenue should be recognized when, or as, the performance obligation is satisfied. The performance obligation is satisfied when the good or service is transferred to the customer, which occurs when the customer takes control of the good or service. This transfer may occur over a period of time or at a point in time. The good or service is considered an asset when it is transferred, even if only for a brief moment, because the customer has the ability to control or direct the use of the asset. For example, if a legal service is performed, the customer receives the benefits of the service and can control how it uses the benefits of the legal advice.

104.14 Transfer occurs over time when at least one of the following criteria is met:

- As the entity performs the obligation, the customer is simultaneously receiving and consuming the benefits.

- The customer controls the asset as the entity creates or enhances it.

- The performing entity has no alternative use for the asset being created (for example, it is not salable to another customer), and the entity has an enforceable right to receive payment for its performance completed to date.

If one of the above criteria is met, the entity would recognize revenue over time in a manner that reflects its progress toward completion of the performance obligation. Output methods, such as milestones reached or units produced, or input methods, such as machine hours or labor hours, may be used to measure the progress.

104.15 If the performance obligation does not meet at least one of the criteria for completion over time discussed in the previous paragraph, it is completed at a point in time. In that case, the entity satisfies its performance obligation at the time the customer obtains control of the asset. The following items are indicators that the customer has obtained control of the asset:

- The customer has a present obligation to pay for the asset.
- Legal title of the asset has passed to the customer.
- The customer has received physical possession of the asset.
- Significant risks and rewards of ownership of the asset have been transferred to the customer.
- The customer has accepted the asset.

104.16 **Costs Associated with Obtaining or Fulfilling a Contract** To obtain a contract, an entity may incur incremental costs that it would not have incurred if it had not obtained the contract. If the entity expects to recover the costs, they should be recorded as an asset unless the asset would be amortized over one year or less. In that case, the costs may be expensed as incurred. Likewise, an entity may incur costs in fulfilling a contract. The entity should recognize a contract asset for these costs if all the following criteria are met (except when otherwise covered under other authoritative accounting literature, such as for inventory or software):

- The costs are directly related to a contract or an anticipated contract.
- The costs generate or enhance resources that will help satisfy future performance obligations.
- The entity expects to recover the costs.

The asset recognized should be amortized consistent with the transfer of the goods or services to the customer, and should also be subject to impairment testing.

104.17 **Disclosures** While providing some exceptions for nonpublic entities, FASB ASC 606

significantly expands the required disclosures related to revenue. Nonpublic entities are required to disclose information that assists the users in understanding the nature, timing, amount, and uncertainty of revenues and cash flows associated with customer contracts. Both quantitative and qualitative information are required to be disclosed for contracts with customers, such as the following:

- Revenue from contracts with customers presented separately from other revenue sources either on the face of the income statement or in the notes to the financial statements.

- Impairment losses recognized on receivables or assets associated with contracts with customers presented separately from other impairment losses on the face of the income statement or in the notes to the financial statements.

- When performance obligations are typically satisfied, such as upon delivery or shipment, when services are rendered, or when services are completed.

- Significant payment terms, including any significant financing components, presence of variable consideration, and any constraints on the estimate of variable consideration.

- The nature of goods and services promised, including arrangements for another party to transfer goods or services.

- Any obligations for returns, refunds and any warranties associated with performance obligations.

- Significant judgments or changes in judgments related to the amount and timing of revenue recognition, such as when performance obligations are satisfied; how the transaction price is determined and allocated to performance obligations; and the methods, inputs, and assumptions used in assessing constraints for estimates of variable consideration.

- If performance obligations are satisfied over time (rather than at a point in time), the methods used to recognize revenue, such as the input or output methods utilized and how they were applied.

104.18 **Transition and Effective Date** In August 2015, due to numerous preparer, practitioner, and user requests for additional time to assess and implement the new guidance, the original effective dates of ASU No. 2014-09 were deferred by one year through the issuance of ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*. For nonpublic entities, the amendments of ASU No. 2014-09 (as amended by ASU No. 2015-14) are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Thus, for calendar year-end entities, the guidance must first be applied for the year ended December 31, 2019. The ASU allows nonpublic entities to adopt its guidance earlier, but only as of (a) an annual reporting period beginning after December 15, 2016, including interim reporting periods within that annual period, or (b) an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies the provisions of the ASU. An entity must adopt the amendments of the ASU using one of two approaches:

- Full retrospective approach: All prior reporting periods would be presented as though the new guidance had always been effective in accordance with the guidance in FASB ASC 250-10-45 for retrospective application of a change in accounting principle. If this option is chosen, the ASU provides certain practical expedients that the entity may choose to apply. The date of the cumulative effect adjustment would be the start of the reporting period of the earliest period presented (i.e., January 1, 2017, for a calendar year nonpublic entity that chooses not to early adopt and presents *comparative* statements and January 1, 2018, for a calendar year nonpublic entity that chooses not to early adopt and presents *single-year* statements).

- Modified retrospective approach: The cumulative effect of adopting the new guidance is recognized on the date of initial application (i.e., January 1, 2018, for a calendar year nonpublic entity that chooses not to early adopt). If this option is chosen, comparative periods are not restated. The authors believe nonpublic entities will generally choose this approach.

Certain disclosures are required in the year of adoption depending on the application method selected.

Preliminary Observations about the Likely Effect of ASU No. 2014-09 on Accounting for Sales of Real Estate by Small and Midsize Nonpublic Entities

104.19 Because of the variety of ways real estate is sold, detailed guidance has long been provided on recognition of revenue from sales of real estate. The guidance in FASB ASC 360-20 is the codification of long-standing guidance. It describes various methods of recognizing revenue and prescribes when they should be used, as summarized by the flow chart at FASB ASC 360-20-55-21.

104.20 The ASU retains FASB ASC 360-20 but restricts its scope to sale-leasebacks. However, this is only a temporary measure, and once the leasing project discussed in section 105 is complete, FASB ASC 360-20 will be replaced with guidance under the leasing project. The new FASB ASC 606 does not provide specific guidance on revenue recognition methods, and, consistent with the FASB's general objective of eliminating industry-specific guidance, does not provide guidance on how the characteristics of real estate sales affect revenue recognition. The ASU also eliminates discussions of specific revenue recognition methods from other parts of the FASB ASC; examples follow:

a. The discussion of the installment and cost recovery methods in FASB ASC 605-10-25-3 and 25-4 is eliminated.

b. The discussion of the percentage of completion and completed contract methods in FASB ASC 605-35-25 is eliminated.

c. The discussion of the deposit method in FASB ASC 840-40-25-11 remains, but that is only in the context of sale-leasebacks.

104.21 All sales of real estate are included in the scope of the current authoritative accounting literature. Following the guidance in FASB ASC 606-10-15-3, FASB ASC 606 only applies to sales of real estate that are part of the seller's ordinary activities. For example, a sale of developed land by a real estate developer would be in the scope of FASB ASC 606, but a sale of developed land that a wholesale distributor acquired in anticipation of building operating facilities would not be in the scope of FASB ASC 606. However, the ASU added a new section FASB ASC 610-20 that essentially extends the guidance in FASB ASC 606 to sales of real estate not included in the scope of FASB ASC 606. In substance, then, revenue recognition will still be the same for all sales of real estate.

104.22 Paragraph BC478 of the “Background Information and Basis for Conclusions” section of the ASU suggests that the ASU will have limited effects on revenue recognition for sales that are relatively straightforward. The authors believe that will be the case for most real estate sales of small and midsize nonpublic entities.

104.23 Nevertheless, the authors believe guidance will need to be developed on how to apply the general principles in the ASU to the characteristics of real estate sales, either authoritatively or nonauthoritatively. For example, once the ASU becomes effective are the methods of recognizing revenues discussed in FASB ASC 360-20 still available and should their use be determined the same as they are now? Future editions of this *Guide* will update the status of these considerations. However, the authors offer the following *preliminary* observations on revenue recognition for sales of real estate by small and midsize nonpublic entities:

a. One of the conditions for revenue recognition, which has no counterpart in the current

authoritative accounting literature, is in FASB ASC 606-10-25-1, which requires that “it is probable” that the entity will “collect the consideration to which it will be entitled.” However, FASB ASC 606-10-32-19 requires using a discount rate that reflects “the credit characteristics” of the buyer when the seller provides financing. In addition, Paragraphs BC239 and BC265 of the “Background Information and Basis for Conclusions” section suggest that revenue recognition is not precluded when it is less than probable that the consideration to which the seller is entitled will be collected. The authors also note that, as discussed in paragraph 104.5, in describing the objective of revenue recognition, FASB ASC 606-10-05-3 uses the phrase “consideration to which the entity *expects to be* [emphasis added] entitled.”

As a practical matter, the authors believe most small and midsize nonpublic entities believe it is probable they will collect all consideration from real estate sales to which they are entitled. That is consistent with the conclusion of the FASB in Paragraph BC43. However, the authors believe it would not make sense to preclude any recognition of revenue if the entity believed there is the risk that it would not be able to collect all of the amount to which it is entitled. The authors therefore believe the right practice answer is for the transaction price to be determined considering credit risk. That is analogous to the guidance on variable consideration in FASB ASC 606-10-32-5.

b. Revenue recognized will likely be the same in the following situations:

- Title to the real estate transfers upon completion, the reporting entity provides no services after title transfers, and the reporting entity does not provide financing for the buyer. For example, revenue recognition for homebuilders and land developers would likely be the same, with revenue recognized at closing, which is when the buyer obtains control of the real estate.

- Title to the real estate transfers upon completion, the reporting entity provides services after title transfers, and the reporting entity does not provide financing for the buyer. Typically, any such services are distinct and under the current authoritative accounting literature any consideration is allocated between the sale of the real estate and the services. For example, the allocation of consideration between construction of a small strip shopping center and an agreement to manage the property would likely be the same, with revenue from sale of the shopping center recognized at closing, which is when the buyer obtains control of the shopping center, and revenue from managing the property recognized over the management period, which is when the buyer obtains the benefits of the service.

- Title to the real estate transfers upon completion, the reporting entity provides no services after title transfers, and the reporting entity provides financing for the buyer with a loan to value relationship generally in line with market conditions. Under the current authoritative accounting literature and the amendments of the ASU, revenue would likely be recognized at closing, which is when the buyer obtains control of the real estate.

- The reporting entity has an option to repurchase the real estate sold. Under both the current authoritative accounting literature and the amendments of the ASU, the transaction would likely be accounted for as a lease or financing arrangement because the reporting entity effectively retains control of the real estate.

c. Revenue recognized might be different in the following situations:

- The reporting entity provides financing for the buyer with a loan to value relationship that is significantly greater than market conditions. Even though the loan to value relation is significantly greater than market conditions, the reporting entity believes collection of the selling price is probable. The amendments of the ASU would likely permit recognizing all the revenue at closing, which is when the buyer obtains control of the real estate, but the current authoritative accounting literature might require recognizing revenue using the installment or cost recovery method.

- The reporting entity guarantees that the real estate sold will have a prescribed minimum value at some point. The current authoritative accounting literature would likely require accounting for the transaction as a lease or financing arrangement. However, under the amendments of the ASU, revenue would likely be recognized at closing equal to the difference between the consideration and the fair value of the guarantee, following the guidance in FASB ASC 460-10-30. As discussed in Paragraph BC431 of the ASU, the guarantee does not prevent the buyer from obtaining control of the real estate. The authors believe that in substance there are two performance obligations: selling the real estate and standing ready to honor the guarantee. Revenue from selling the real estate would likely be recognized at closing, which is when the buyer obtains control of the real estate. Revenue from the guarantee would likely be recognized when it is exercised or when it expires unused.

The Joint Transition Resource Group for Revenue Recognition

104.24 Shortly after the issuance of ASU No. 2014-09, the FASB, in concert with the International Accounting Standards Board (IASB), formed the Joint Transition Resource Group for Revenue Recognition (TRG). The 27-member group includes financial statement preparers, auditors, and users spanning a variety of industries, locations, and public and private organizations. The purpose of the TRG is to:

- Solicit, analyze, and discuss issues encountered by stakeholders in implementing the new revenue recognition guidance.

- Inform the FASB and IASB about those implementation issues, allowing the Boards to determine what, if any, action is necessary to address the issues. (The TRG does not issue authoritative guidance.)

- Provide a means to communicate to and educate stakeholders about the new guidance from others involved with implementation.

104.25 ASU No. 2015-14 (the one year deferral of ASU No. 2014-09 discussed in paragraph 104.18) was the first ASU issued as a result of the TRG's input. Future editions of this *Guide* will discuss additional guidance the FASB provides on ASU No. 2014-09 that affects small and midsize nonpublic real estate entities.

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[1] Thomson Reuters currently offers a GAAP Critical Issues Series that provides details on the new revenue recognition ASU. That product is available by visiting **tax.thomsonreuters.com** or calling (800) 431-9025.

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105 Significant Proposed Accounting Standards

105.1 This *Guide* generally does not address the FASB's ongoing projects and proposed standards in significant detail because FASB projects do not change current accounting until after extensive due process and deliberations. Furthermore, tentative decisions reached during a project can, and often do, change quite significantly prior to issuance of final guidance. However, the authors believe that accountants should be aware of certain projects on the FASB's agenda. The guidance in the proposed standards is extensive, and this section highlights only a few of the important aspects of each project. Additional information may be obtained from the FASB website at **www.fasb.org**. Future editions of this *Guide* will be updated for any final standards issued as a result of these projects.

Accounting for Leases

105.2 The goal of this project is to ensure that all assets and liabilities arising from lease contracts are recognized in the balance sheet. The proposed guidance provides both lessee and lessor accounting requirements. It would apply to all leases except leases of intangible assets, minerals, natural gas and similar exploration leases, and biological asset leases, such as timber.

105.3 In August 2010, the FASB released an exposure draft of a proposed ASU, *Leases*. The FASB also held several public roundtables and other types of workshops to get feedback from a variety of constituents. Because of the extent of changes made to the initial exposure draft during redeliberations, the FASB issued a revised exposure draft in May 2013, with a comment period that ended in September 2013. The FASB will consider comments received on the revised proposal as well as feedback obtained in outreach efforts, before finalizing the standard.

105.4 The major provisions in the proposal include:

- A lessee should recognize assets and liabilities arising from a lease with a maximum possible term greater than 12 months. The asset, referred to as a *right-of-use asset*, represents the entity's right to use the leased asset over the term of the lease. The liability represents the obligation to make lease payments.

- A lessee may make an accounting policy election regarding short-term leases with a maximum possible term of 12 months or less. The election would allow the lessee to take an operating approach and recognize the lease payments as an expense on a straight-line basis.

- The recognition and measurement of the expenses and cash flows of the lease are based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits of the asset, which is determined based on the nature of the asset:

    - Type A leases are most leases of assets other than property (i.e., equipment) and are based on more than an insignificant portion of the economic benefits of the assets being consumed.

    - Type B leases are most leases of property (i.e., land or buildings) and are based on an insignificant portion of the economic benefits of the assets being consumed.

- For lessees, right-of-use assets are measured at the present value of expected lease payments plus any initial direct costs. Type A leases take a financing approach with amortization and interest each recognized separately in the income statement. Type B leases take a straight-line approach with a single lease expense recognized in the income statement, which includes both interest and amortization on a straight-line basis.

- For lessors, Type A leases take a receivable and residual approach where the asset is removed from the balance sheet and a lease receivable and residual asset is recognized. The amortization of the discount on the assets is recognized as interest income over the term of the lease. The profit on the lease is allocated between the receivable and residual assets and the portion allocated to the receivable is recognized up-front. Type B leases take an operating approach where the asset is not removed from the balance sheet and the lease income is recognized on a straight-line basis.

105.5 The proposed changes are significant and would affect nearly all entities. Entities will need to be prepared not only for the effect the changes will have on their balance sheets but also on the resulting financial ratios. The FASB is aware of the implications of the standard and has indicated

they will consider this in determining the effective dates. At the date this *Guide* was completed, the FASB expected to issue a final ASU in the fourth quarter of 2015, but had not announced an expected effective date.

Financial Instruments

105.6 In 2013, the FASB issued exposure drafts of two proposed ASUs on accounting for financial instruments, one on classification and measurement and one on impairment. The authors believe both would have limited effects on small and midsize nonpublic entities, as the following summarizes:

a. The proposed ASU on classification and measurement would likely only affect small and midsize nonpublic entities that have marketable equity securities. Under the proposed ASU, those securities would be measured at fair value, with changes in fair value recognized in net income.

b. The proposed ASU on impairment would likely not affect small and midsize nonpublic entities. The proposed ASU appears to be designed for entities with large portfolios of receivables.

105.7 At the date this *Guide* was completed, the FASB expected to issue final ASUs in the fourth quarter of 2015, but had not announced an expected effective date.

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