Accounting and reporting update

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Revenue recognition
ASU 2014-09

- Replaces existing revenue guidance for virtually all industries and arrangements
  - ASC 360-20, *Real estate sales*, is superseded

- Delayed effective date (ASU 2015-14)
  - Public entities – annual periods beginning after 15 December 2017
  - Nonpublic entities – additional optional one-year deferral
    - Early adoption allowed for all US GAAP entities as of original public entity effective date (15 December 2016)
    - Early adoption allowed for IFRS entities upon initial issuance of standard

- Transition
  - Full retrospective – all periods presented using new guidance
  - Modified retrospective – new guidance applied only to existing and new contracts in most current period presented; cumulative catch-up recognized at beginning of most current period presented
  - SEC Staff provided relief on selected financial data table
Revenue recognition
Summary of the model

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

Step 1: Identify the contract(s) with the customer
Step 2: Identify the performance obligations in the contract
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to the performance obligations
Step 5: Recognize revenue when (or as) each performance obligation is satisfied
### Revenue recognition

**Real estate sales summary**

<table>
<thead>
<tr>
<th>Transaction: Real estate sales</th>
<th>Considerations</th>
</tr>
</thead>
</table>
| **Scope**                     | ► May be in the scope of ASC 606, ASC 610-20, or ASC 810  
► Customer vs. noncustomer; business and/or in substance nonfinancial asset |
| **Seller financing**          | ► Initial and continuing investment criteria in ASC 360-20 removed  
► Evaluation based on buyer’s intent and ability to pay transaction price |
| **Support obligations**       | ► Continuing involvement criteria in ASC 360-20 removed  
► Guarantees ‘carved-out’ and accounted for under ASC 460 |
| **Additional services**       | ► May represent separate performance obligation and generally would not limit recognition of gain on sale of real estate |
| **Partial sales**             | ► Limited guidance in new standard  
► FASB addressing as part of Definition of a Business project |
| ** Developers**               | ► May be able to recognize revenue over time if “no alternative use / right to present payment” criteria are satisfied  
► Criteria difficult to satisfy for most contracts in the US |
### Revenue recognition

#### Real estate sales - example

Developer P sells a hotel with a carrying value of $8m to Buyer Q. Developer P receives $1m of cash and provides seller financing of $9m in the form of a five-year amortizing note receivable.

<table>
<thead>
<tr>
<th>ASC 360-20</th>
<th>ASC 606 / 610-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Assuming a sale has been consummated, Developer P evaluates Buyer Q’s initial investment (10%) and determines that it is not sufficient to qualify for full accrual profit recognition (ASC 360-20 requires 15% investment for hotels)</td>
<td>► Developer P assesses whether it is probable that it will collect the consideration to which it will be entitled (i.e., the transaction price is collectible). See following slide.</td>
</tr>
<tr>
<td>► Developer P therefore recognizes profit using the cost recovery or installment method, depending on whether the cost of the property is reasonably assured</td>
<td>► If Developer P concludes the consideration is collectible, the sale and associated profit of $2m are recognized when control of the property transfers to Buyer Q</td>
</tr>
<tr>
<td>► Assuming all other criteria have been satisfied, Developer P may use the full accrual method in the future when payments received from Buyer Q satisfy both the initial and continuing investment tests</td>
<td>► When determining whether control has transferred, Developer P considers whether it has a present right to payment for the asset, as well as whether Buyer Q has legal title and physical possession of the property and has the risks and rewards of ownership</td>
</tr>
</tbody>
</table>
Revenue recognition
Real estate sales – example (cont.)

- The transaction price (i.e., amount assessed for collectibility) may be different than the stated contract price if an entity concludes it has offered or is willing to accept a price concession

  - Such concessions or discounts are forms of variable consideration that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated contract price</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Price concession - amount entity estimates it will offer (explicitly) or accept (implicitly) as a reduction to the contract price, unrelated to credit risk</td>
<td>$(2,000,000)</td>
</tr>
<tr>
<td>Transaction price assessed for collectibility</td>
<td>$ 8,000,000</td>
</tr>
</tbody>
</table>

- When an entity is not willing to accept less than the contract price, but is willing to accept the risk of default by the customer of contractually agreed-upon consideration (i.e., credit risk), the transaction price would not differ from the contract price. This amount would be assessed for collectibility
Revenue recognition
Real estate services and “other” summary

<table>
<thead>
<tr>
<th>Transaction: Real estate services and “other”</th>
<th>Considerations</th>
</tr>
</thead>
</table>
| Property management services                  | ► Evaluate whether services represent a “series of distinct services that are substantially the same and have same pattern of transfer to customer”  
  ► Variable consideration related to distinct service within series is allocated to the distinct service  
  ► Fixed fees or incentive fees may be recognized differently |
| Leasing services                               | ► Unclear whether services are single performance obligation or indeterminate number of separate performance obligations  
  ► Pattern of recognition may be the same for either conclusion |
| Development services                           | ► Considerations similar to those described in “property management services” above |
| Costs incurred to sell real estate projects    | ► Current guidance in ASC 970 removed  
  ► New guidance in ASC 340-40 for costs incurred to obtain a contract |
## Revenue recognition

### Real estate leases and other summary

<table>
<thead>
<tr>
<th>Transaction: Real estate leases</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease payments</strong></td>
<td>▶ Not within scope of revenue standard – refer to leases project</td>
</tr>
<tr>
<td><strong>Common Area Maintenance (CAM)</strong></td>
<td>▶ Still <strong>unclear</strong> whether CAM provides an additional service to the lessee and would therefore represent a “non-lease component” that is accounted for under the revenue standard</td>
</tr>
<tr>
<td></td>
<td>▶ If accounted for under revenue standard, pro-rata CAM may meet the criteria for recognizing variable consideration related to a “series of services”</td>
</tr>
<tr>
<td></td>
<td>▶ Under revenue standard, Fixed CAM arrangements would likely require over time recognition using a measure of progress</td>
</tr>
<tr>
<td><strong>Real estate taxes and insurance</strong></td>
<td>▶ Appears that real estate taxes and insurance will be lease components and not within scope of revenue standard</td>
</tr>
<tr>
<td><strong>Sale-leaseback transactions</strong></td>
<td>▶ ASC 360-20 will temporarily remain in codification for purposes of evaluating sale-leaseback transactions involving real estate</td>
</tr>
<tr>
<td></td>
<td>▶ Under proposed leases standard, seller-lessee would use “transfer of control” criteria in ASC 606 to determine whether buyer gained control of asset; real estate specific criteria eliminated</td>
</tr>
</tbody>
</table>
Recently completed projects
Consolidation (ASU 2015-02)

► New guidance makes targeted changes to ASC 810, Consolidation
  ► Effective for public entities in periods beginning after 15 December 2015
  ► Early adoption permitted; one year deferral for private entities

► Focus of project is rescinding FAS 167 deferral for investment companies, but amendments apply to all industries

► Key amendments include:
  ► Modification of criteria for determining whether fees paid to a decision maker represent a variable interest (focus on whether fees are at market)
  ► When assessing whether a partnership (or similar entity) is a VIE:
    ► No longer consider substance of a general partner’s investment
    ► Focus on whether a simple majority of limited partners have kick-out rights or substantive participating rights

► Determination of primary beneficiary
  ► Benefits criteria exclude fees at market and commensurate with services provided
  ► Consider direct and indirect interests held through related parties

► Voting model for partnerships (and similar entities)
  ► Eliminates presumption that general partner controls a limited partnership
Amendments are focused on limited partnerships (LPs) and similar entities (e.g., LLCs)

Changes impact determination of whether equity holders lack the power to direct the activities that most significantly impact the entity’s economic performance

- Evaluation previously focused on whether general partner’s at-risk equity investment was substantive

Analysis now based on existence of **substantive kick-out rights** or **substantive participating rights** held by the limited partners

- Rights are substantive if held by a single limited partner or a simple majority (or lower threshold) of limited partners
- Previously these rights must have been held by a single limited partner
**FAS 167:** Limited partnership is **not** a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, no party would consolidate.

**ASU 2015-02:** Limited partnership is **not** a VIE. Applying the amended voting model, no party would consolidate.
FAS 167: Limited partnership is not a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, REIT would consolidate.

ASU 2015-02: Limited partnership is a VIE because LP’s have no substantive kick-out or participating rights. REIT would consolidate as Primary Beneficiary.
## Selected FASB simplification projects
### Current status

<table>
<thead>
<tr>
<th>Project</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eliminating extraordinary items (ASU 2015-01)</td>
<td>Completed</td>
</tr>
<tr>
<td>Presentation of debt issuance costs (ASU 2015-03)</td>
<td></td>
</tr>
<tr>
<td>Measurement date of defined benefit pension plan assets (ASU 2015-04)</td>
<td></td>
</tr>
<tr>
<td>Customer accounting for fees paid in a cloud computing arrangement (ASU 2015-05)</td>
<td>Final standard – Q4</td>
</tr>
<tr>
<td>Subsequent measurement of inventory (ASU 2015-11)</td>
<td></td>
</tr>
<tr>
<td>Accounting for measurement period adjustments in a business combination</td>
<td>Final standard – Q4</td>
</tr>
<tr>
<td>Accounting for equity method basis differences</td>
<td>Redeliberations</td>
</tr>
<tr>
<td>Intra-entity asset transfers and balance sheet classification of deferred taxes</td>
<td></td>
</tr>
<tr>
<td>Share-based payments</td>
<td>Exposure draft</td>
</tr>
<tr>
<td>Balance sheet classification of debt as current or noncurrent</td>
<td>Exposure draft - Q4</td>
</tr>
</tbody>
</table>
Equity method investments
FASB simplification proposal

<table>
<thead>
<tr>
<th>Current GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocate difference between cost and share of net assets (basis difference) similar to a business combination</td>
</tr>
<tr>
<td>Consider basis differences when recording share of income</td>
</tr>
<tr>
<td>When investment (e.g., cost method) first qualifies for equity method, apply retrospectively as if equity method always applied</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>No accounting for basis difference at initial recognition (i.e., not required to determine fair value of investee’s assets/liabilities)</td>
</tr>
<tr>
<td>Record share of net income without adjustment</td>
</tr>
<tr>
<td>Prospectively adopt equity method when investment first qualifies for equity method</td>
</tr>
</tbody>
</table>

Board is currently redeliberating
Clarifying the definition of a business

Project overview

► The FASB is currently working on a project that would result in changes to the definition of a business
► Potential changes, which would affect accounting at both acquisition and disposition, include evaluation of certain criteria:

<table>
<thead>
<tr>
<th>Proposed criteria</th>
<th>Comments</th>
</tr>
</thead>
</table>
| To be a business, the set of acquired activities and assets must include inputs and **one or more substantive processes** that **together** contribute to the ability to create outputs | ► The standard will include a framework for determining whether a substantive process is included in the acquired set  
► Existence of continuing revenues (i.e., an in-place lease) would not indicate on its own a substantive process was acquired |
| The Board also decided that if **substantially all of the fair value** of the gross assets acquired is concentrated in a **single** tangible or identifiable intangible asset (or group of similar tangible or identifiable intangible assets), the set is not a business |
|                                                                                   | ► The Board directed the staff to develop indicators and examples to describe what constitutes “similar assets”  
► For example, land and building would be combined into a single asset and a portfolio of buildings would constitute similar assets |
Clarifying the definition of a business
Project overview (continued)

► As part of the project the Board may also address the following:

► Accounting for partial sales
  ► Tentative decisions:
    ► Gain or loss on partial sale only recognized if seller does not consolidate the legal entity (i.e., ASC 810 “overlay”)
    ► Any retained noncontrolling interest measured at carrying value

► Definition (or removal) of the term “in-substance nonfinancial asset” from ASC 606 and ASC 610
  ► If removed, accounting treatment would be based on meeting definition of asset or business; no requirement to consider both as currently written

► Differences in accounting for assets vs. businesses
  ► Accounting for acquisition costs, initial measurement, contingent consideration, bargain purchases, etc.
  ► May also result in reconsideration of tentative partial sales decisions
Lessees – The FASB decided to use a dual on-balance sheet model using the classification criteria in IAS 17 (similar to US GAAP but without the bright lines)

- The IASB decided all recognized leases would be Type A
- Short-term leases (12 months or less) would not be recognized on the balance sheet (accounting policy election)
- The IASB is considering an exemption for leases of “small assets”

Lessors – The Boards agreed to limit changes to lessor accounting

- Lessors would follow IAS 17 classification criteria
- Incremental real estate specific lease criteria (e.g., classification, sale-leaseback criteria) eliminated
- Other decisions may affect lessor accounting
Leases project
Impacts for real estate companies

- Core lessor accounting model remains consistent, but...
- Classification criteria:
  - Bright lines removed
  - Real estate-specific guidance removed
- Leases of land may be classified as “Type A” leases
- New lessee model for arrangements where real estate company is the lessee
- Specific criteria removed for sale-leasebacks involving real estate
- Lease modifications:
  - Separate, new lease when additional right-of-use is priced commensurate with standalone price
- Non-lease component:
  - Activity or lessor cost that provides additional good or service to lessee. Lessor would recognize using ASC 606
- New disclosure requirements
- Transition:
  - Modified retrospective
  - Package of relief available
- Initial direct costs:
  - Only costs incurred as a result of obtaining a lease may be capitalized

2015 REIT CFO and Tax Director Roundtables
## Financial instruments

### Classification & measurement

<table>
<thead>
<tr>
<th>Changing (from current US GAAP)</th>
<th>Same (as current US GAAP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Equity investments measured at fair value through net income (no more available-for-sale category)</td>
<td>► Classification and measurement for loans and debt securities</td>
</tr>
<tr>
<td>► Practicability exception for equity investments lacking readily determinable fair values (current cost method investments)</td>
<td>► Bifurcation of embedded derivative features</td>
</tr>
<tr>
<td>► One-step impairment test for equity investments lacking readily determinable fair values</td>
<td>► Ability to elect FVO</td>
</tr>
<tr>
<td>► Changes in entity’s own credit recorded in other comprehensive income (OCI) when applying fair value option (FVO) to financial liability</td>
<td></td>
</tr>
</tbody>
</table>
### Financial instruments

#### Impairment

<table>
<thead>
<tr>
<th>Type of security</th>
<th>Proposed impairment model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Held-to-maturity (HTM)</td>
<td>Current expected credit loss (CECL)</td>
</tr>
<tr>
<td>Available-for-sale (AFS)</td>
<td>Modified other-than-temporary impairment (OTTI)</td>
</tr>
<tr>
<td></td>
<td>► Use allowance instead of direct write-down</td>
</tr>
<tr>
<td></td>
<td>► Would allow for reversal of credit loss</td>
</tr>
<tr>
<td></td>
<td>► When assessing OTTI, no longer consider:</td>
</tr>
<tr>
<td></td>
<td>► Length of time fair value below amortized cost basis</td>
</tr>
<tr>
<td></td>
<td>► Recoveries or additional declines in fair value after balance sheet date</td>
</tr>
</tbody>
</table>
Conclusion
Thank you

Building a better working world
Appendix A
Available resources – Revenue recognition


► Technical Line, *Applying the new revenue recognition standard to sales of real estate* (BB3023)

► Technical Line, *A closer look at the new revenue recognition standard* (BB2771)

http://www.ey.com/accountinglink
Appendix A
Available resources – Consolidation

► To the Point, New consolidation guidance will affect entities in all industries (BB2932)

► Technical Line, New consolidation guidance will require many entities to re-evaluate their conclusions (BB2973)

► Technical Line, Consolidation considerations for asset managers – FIN 46(R) to ASU 2015-02 (BB2972)

http://www.ey.com/accountinglink
Appendix A
Available resources – Leases project

► Technical Line, Final standard on leases is taking shape (BB2952)
► The publication discusses how the FASB’s new leases standard would be applied. Also, refer to the following appendices therein:
► Appendix A: Summary of lessee and lessor reassessment requirements
► Appendix B: US GAAP guidance the FASB plans to eliminate
► Appendix C: Key differences between US GAAP and IFRS

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Appendix A
Available resources – other topics

► To the Point, *Simplifying the presentation of debt issuance costs* (BB2963)

► To the Point, *FASB proposes simplifying equity method accounting* (BB2997)

► To the Point, *FASB proposal would change how companies account for employee share-based payments* (BB2985)

► To the Point, *FASB poised to make significant changes to credit impairment model* (BB2942)

► To the Point, *New guidance on classifying and measuring financial instruments is coming soon* (BB2921)

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