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REAL ESTATE **INSIGHTS**

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In This Issue

New Accounting Rule for Revenue Recognition

Real Estate Companies Must Exercise More Judgment

The Financial Accounting Standards Board (FASB) recently issued new guidance that standardizes when and how every type of company must recognize revenue. The guidance, found in Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers, supersedes existing revenue recognition rules and makes significant changes to the rules for accounting for real estate sales.

Because the new ASU focuses primarily on when the transfer of control of property occurs, revenue will likely be recognized sooner than it has been under the existing guidance.

5 Steps … and Their Issues

The guidance lays out five steps that a business must follow to determine when to properly recognize revenue on its financial statements. Here's a look at each step and its associated issues particular to real estate companies:

1. **Identify the contract.** The guidance applies to each contract that a company has with a customer. In some cases, two or more contracts might be combined for financial reporting purposes. A change order (a modification to the contract's scope, price or both) is an example of a contractual issue that could complicate matters. For example, should a change order be accounted for as a separate new contract or part of the existing contract? The ASU provides criteria for making this determination.

2. **Identify the company's performance obligations.** Sellers often remain involved in property that they've sold. For example, a seller might have agreed to provide property management services, improve roads or erect a building on the property sold. If a contract contains obligations to transfer more than one good or service to a customer, the company can account for each good or service as a separate performance obligation only if it is: 1) distinct, or 2) a series of distinct goods or services that are substantially the same.

   A good or service is "distinct" if:

   a) the customer can benefit from the good or service on either its own or together with other resources that are readily available to the customer, and
   b) the company's promise to transfer the good or service is separately identifiable from other promises in the contract.

3. **Determine the transaction price.** The company must determine the amount that it expects to be entitled to in exchange for transferring promised goods or services to a customer. Under the new rules, some or all contingent consideration (such as incentive payments) may be included in the transaction price and, therefore, recognized earlier than previously done. The transaction price also may require adjustment if the arrangement includes a "significant financing component."

4. **Allocate the transaction price to performance obligations under the contract.** The business will typically allocate the transaction price to each performance obligation based on the relative “standalone selling price” of each distinct good or service promised. A seller that will also provide management services, for example, generally must separately estimate the standalone selling prices of the property and the services and allocate the total transaction price proportionately.

5. **Recognize revenue as performance obligations are satisfied.** A company must recognize revenue when it satisfies a performance obligation by transferring the promised good or service to a customer. The amount recognized is the amount allocated to the performance obligation. If the performance obligation is satisfied over time (rather than at a single point in time) the company must similarly recognize revenue over time. Ways to measure progress include output methods (such as surveys or appraisals) and input methods (such as cost-to-cost or labor hours). These methods are generally expected to yield results similar to those of the existing percentage-of-completion method.

Implementing Changes

ASU 2014-09 will compel real estate companies to exercise more judgment than is required (or allowed) under the current, more prescriptive standards. It also requires enhanced financial statement disclosures regarding customer contracts.
Real estate businesses should start reviewing their accounting methods now to prepare for the changes. Fortunately, there is time. For nonpublic companies, compliance isn’t required until annual reporting periods beginning after Dec. 15, 2017.

Sale-Leaseback Rules Survive — For Now

Sale-leaseback transactions are used for large capital assets — including real estate, office buildings and improvements — to free up cash for the seller. After the property is sold, the seller leases the property back from the buyer for a period of time (typically 10 to 25 years) and the seller retains control of the property. Real estate entities will be relieved to hear that the current accounting rules for most sale-leaseback transactions involving real property were retained in the Financial Accounting Standards Board’s (FASB’s) new revenue recognition guidance. (See main article.)

Although the new revenue recognition standard generally supersedes all other industry-specific guidance, FASB decided that, if the sale of real property is part of a normal, arm’s-length sale-leaseback transaction, the transaction would continue to be evaluated under the existing guidance until FASB and the International Accounting Standards Board complete their joint project on leasing. Your financial advisors are monitoring the joint leasing project. They’ll let you know whether anything changes and can help you comply with the accounting rules for sale-leaseback transactions.

Should I Improve Energy Efficiency in My Industrial Properties?

Energy costs associated with industrial properties — such as warehouse, distribution or storage facilities — can add up fast, making a significant dent in your bottom line. According to the Building Owners and Managers Association (BOMA), energy accounts for about 15% of operating costs for the industrial property sector, with an average cost of $0.68 per square foot. So, many industrial property owners are taking a new look at energy efficiency measures.

Bundle of Benefits

Improved energy efficiency comes with a bundle of benefits. In addition to the obvious environmental positives, it can slash operating costs, extend the life of building systems and boost asset values by maximizing performance. Certain energy improvements may also produce significant tax breaks.

Enhanced energy efficiency can also make an industrial property more attractive. Properties with improved lighting, upgraded HVAC systems and similar improvements tend to draw new tenants and encourage existing ones to renew their leases.

Improvement Measures

According to BOMA, the top five measures for improving industrial property energy efficiency are:

- Upgrading parking lot and exterior lighting to highly efficient fixtures,
- Installing occupancy sensors and lighting controls,
- Reviewing temperature setpoints and making seasonal adjustments,
- Installing dock shields or dock shelters to reduce outside air infiltration, and
- Using high-efficient motors for material-handling conveyors and installing controls to run only when needed.

BOMA also recommends the Environmental Protection Agency's (EPA's) ENERGY STAR Portfolio Manager®. This interactive management tool can help you manage water and energy consumption, benchmark your energy performance rating against similar companies, and earn EPA recognition. An energy performance rating of 50 indicates that a property performs better than 50% of all similar buildings nationwide, and buildings with ratings of 75 or more can qualify for the ENERGY STAR label for superior energy performance.

Portfolio Manager can also help you set investment priorities. For example, it allows you to evaluate the relative costs associated with a given level of performance, your cumulative investments in upgrades and your annual energy costs. A built-in financial tool makes it easy to compare savings across the properties in your portfolio and calculate cost savings for particular projects, too.

Within Your Grasp

When it comes to the value of industrial property in today’s market, many aspects are beyond your control. Energy performance, however, is firmly within your grasp. Taking steps to improve that performance can produce benefits now and for many years down the road.

Property Tax Assessments

Court of Appeals Weighs in on Tax Assessment

Property taxes often represent a significant chunk of an owner's annual expenses. Yet many taxpayers simply accept the billed amounts calculated by their assessors.

That might not be wise, as a recent case in California illustrates. In SHC Half Moon Bay, Inc. v. County of San Mateo, the California Court of Appeals, applying property tax laws similar to those in some other jurisdictions, found that a county's assessment improperly inflated a hotel's value — in turn improperly inflating the hotel's property taxes.

Hotel Owner Challenges Property Tax

In 2004, SHC Half Moon Bay purchased the Ritz-Carlton Half Moon Bay Hotel for about $124 million. The purchase price included real and personal property (furniture, fixtures and equipment), as well as intangible assets and rights. As part of an income valuation approach, the San Mateo County assessor assessed the hotel at its purchase price and deducted the value of personal property. It ultimately reached a total value of about $117 million.

SHC challenged the property tax assessment, asserting that it erroneously included the value of over $16 million in nontaxable intangible assets — specifically, the hotel's assembled workforce, leasehold interest in the employee parking lot, agreement with the golf course operator and goodwill. It argued that simply deducting the hotel's management and franchise fee of $1.6 million wasn't enough to exclude intangible assets from the assessment, as required by state law. Instead, SHC contended, the assessor was required to identify, value and exclude the value of the intangible assets from the calculation.

The county Assessment Appeals Board upheld the assessment. SHC then sued for a property tax refund, but the trial court also sided with the county. SHC appealed.

Court Sides with Owner

The Court of Appeals began its review by noting that California law mandates that the quantifiable fair market value of intangible assets that directly enhance a property's income stream — such as goodwill, customer base and favorable franchise terms or operation contracts — be deducted from an income stream analysis prior to taxation. (Many county laws similarly provide that property tax valuations should be based on the value of the real estate only.)

The court concluded that the assessor's deduction of the management and franchise fee from the hotel's projected revenue stream didn't identify and exclude intangible assets. It pointed out that the assessor's expert had conceded to the appeals board that the assessor's methodology didn't remove all intangible assets and rights.

His report stated that only "the majority of the property's business value" was removed by deduction of the fee. The report also acknowledged that the capitalized value of necessary preopening expenses (for example, the cost of assembling and training a workforce, preopening marketing expenses and working capital) is frequently deducted as an intangible value of a hotel. According to the court, the expert's report and testimony demonstrated that the assessor's methodology failed to attribute a portion of the hotel's income stream to the enterprise activity that was directly attributable to the value of the intangible assets and deduct that value prior to assessment. Therefore, the methodology was "legally incorrect."

The court did, however, uphold the Assessment Appeals Board's finding that the fee largely captured the goodwill. Although there may be situations where a taxpayer can establish that the deduction of a management and franchise fee doesn't capture goodwill, it said, SHC failed to do so here.

Appeal Leads to Savings

As a result of the appellate court's ruling, the board was required to recalculate the value of the property, applying the income method consistently with the court's findings. In other words, it will have to exclude the value of the hotel's assembled workforce, leasehold interest in the employee parking lot and agreement with the golf course operator — which should produce substantial tax savings.

Should You Challenge Your Property Taxes?

Unlike the property taxes at issue in SHC Half Moon Bay (see main article), which were the result of an individually tailored assessment, property taxes are often based on estimates derived from mass appraisal techniques. These techniques might prove accurate overall, but the individual estimates don't necessarily reflect specific properties' characteristics.

So don't just blindly pay your tax bill. Take a close look at the factors that were applied to your property and determine whether they actually do apply. For example, you might find errors in the property description, such as square footage, age, condition and construction materials. To contest an assessment, you can present testimony from a professional appraisal, financial data for the property (such as income and cash flow statements), current leases and assessments for similar properties.

If you decide to appeal your assessment, pay attention to the relevant jurisdiction's deadlines. While some jurisdictions have a "rolling" appeals process, many observe strict deadlines.

How Can I Benefit from Carbon Credits?

As more building owners have begun to explore the advantages of pursuing energy-efficient or "green" initiatives in their properties, some might wonder how carbon credits come into play. Although these credits have received a lot of attention over the past decade or so, many business owners don't understand how they work and how they can benefit owners.

How the Credit Works

Carbon credits are generally earned by offsetting carbon dioxide (CO_2) emissions through conservation, alternative energy and other technologies. A single carbon credit represents a metric ton of CO_2 or CO_2-equivalent gases removed or reduced from the atmosphere.

The credits represent transferable rights to emit greenhouse gases and can be traded (or sold) on voluntary and "compliance" carbon markets. Compliance markets include legally binding mandatory emission-trading mechanisms established under, for example, the Kyoto Protocol. Regional compliance markets can also be found in areas of the United States and Australia.

Businesses purchase the credits to offset their own emissions, whether to meet their corporate social responsibility goals or external carbon reduction goals. Increasing numbers of companies are experiencing stakeholder pressure to improve their emissions.

To earn credits, a property owner would first need to set verifiable audit baselines through an investment-grade audit (a type of audit used to justify investment in a capital-intensive energy-efficient initiative). The audit would identify opportunities to improve energy efficiency and generate credits that can be traded on a market. Such opportunities can range from behavioral changes, such as powering down computers overnight, to capital projects, such as installation of solar panels. Credits generated in the United States typically can be traded domestically or abroad.

Benefits of Carbon Credits

Carbon credits produce favorable financial results on several fronts. A building with energy-efficient features will obviously reap savings on energy costs and could trigger tax breaks. That, in turn, would reduce operating expenses while increasing net operating income and internal rates of return. Increasingly, such buildings come with a competitive edge, as growing numbers of potential tenants consider sustainability when selecting their spaces. Moreover, trading or selling credits on a voluntary or compliance market provides an owner with additional revenues.

Win-Win?

Carbon markets aren't yet commonplace, and an eventual mandatory cap-and-trade system in the United States isn't a given. But the bottom-line benefits of energy-efficient efforts have been clear for some time now, and the potential of carbon credits to build revenues can be a bonus.