

Accounting for CAM in Multifamily Leases

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September 29, 2017

Ms. Susan M. Cospers  
Technical Director  
Financial Accounting Standards Board  
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**Delivered Electronically**

**Subject: Treatment of Community Amenities and Maintenance Activities in Multifamily Residential Leases under ASC 606 and ASC 842**

Dear Ms. Cospers:

The purpose of this letter is to submit our collective views regarding the application of the new lease and revenue standards to community amenities and maintenance activities within multifamily residential leases for the Financial Accounting Standards Board's ("FASB") consideration.

Multifamily residential leases provide residents with a right to use an apartment home within a community over an average term of 12 months. Inherent in the lease contracts is the rental of both the apartment home and the requirement for the lessor to undertake some of the tasks of traditional homeownership necessary to support the general upkeep of the apartment community for a fixed monthly fee (base rent). Multifamily residential leases are structured as gross leases, where base rent is the consideration exchanged for the use of the apartment home, including the apartment unit, executory costs such as real estate taxes and insurance, and common area maintenance activities ("CAM") inclusive of the use of community amenities and other community maintenance activities undertaken by the lessor. Community amenities may include the use of the on-site fitness centers, pools, clubhouses or other gathering centers, dog parks, and playgrounds. Community maintenance activities may include such items as landscaping within the community, parking lot and walkway snow removal, and cleaning and maintenance of other community amenities. The lessor's obligation to provide and maintain the common areas and amenities is an integral component of the lease contract and is necessary to maintain the quality and desirability of our apartment communities.

As a standard practice, multifamily residential leases are generally standardized within a community and jurisdiction, with no provision to separately negotiate with residents for reimbursement of costs related to executory costs, community amenities, or maintenance activities. There is an inherent understanding between the lessor and the resident that such activities are necessary and inextricably linked components of the lease and are an obligation of the lessor, which does not transfer to the resident.

Under current GAAP, lease related executory costs in the multifamily industry such as real estate taxes and insurance, amenities, and maintenance are considered lease-related and included in rent. Under the new lease standard, granting a right to use an asset generates revenue for the lessor; therefore, the new lease standard refers to the guidance in the new revenue standard for purposes of identifying performance obligations and allocating consideration to lease and nonlease components of a lease contract. Lease components are the elements of the arrangement that provide the lessee/customer with the right to use the identified asset. Items that contribute to securing the outputs of the leased asset are lease components. In

## Accounting for CAM in Multifamily Leases

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the basis for conclusion in the new lease standard, the FASB affirms its expectation for entities to apply the guidance regarding separating components of a lease contract similarly to the guidance for identifying separate performance obligations found in the new revenue standard<sup>1</sup>. Under this interpretation of these new standards, the revenue earned from community amenities and other common maintenance activities would need to be accounted for, allocated, and disclosed separately from the use of the apartment unit within a multifamily residential lease<sup>2</sup>.

As a result, we are requesting the Board provide implementation guidance for lessors of multifamily residential leases which would: (1) not require the bifurcation of the CAM components on the face of the income statement and, (2) not require the disclosures required by ASC 606 – Revenue from Contracts with Customers ("ASC 606") for CAM to be reported as a non-lease performance obligation. We believe the information in the following paragraphs further supports our request.

### **Relevance to Investors**

The separate presentation, either on the face of the financial statements or as further disclosures in the footnotes, of an allocation of common amenity and other common maintenance activity components within the lease is not information sought or used by the investor or analyst community, and would provide no additional benefits to financial statement users as compared to current disclosures, while multifamily lessors would incur significant costs to generate and provide such information to conform to the new lease and revenue standards per the current interpretations. The financial statement users, investors, and analysts within our industry primarily rely on two metrics: monthly rental rate and monthly revenue per occupied home. The monthly rental rate metric is a company's rental rates for multifamily resident leases, inclusive of amenities and maintenance and related concessions, but excluding vacancies and bad debt. The monthly revenue per occupied home is the monthly rental rate including other income, divided by the average number of occupied homes for the period. We are not aware of any investor or analyst requesting information to bifurcate implied revenue of community amenities or reimbursement of maintenance activity amounts, or actual costs, with respect to those items for multifamily communities. Preparing and disclosing this detail to disaggregate revenue would not provide added benefits to financial statement users as total revenues for the period would remain unchanged, as shown in the hypothetical illustrations in Exhibit A.

Additionally, we believe the allocation of CAM and other portions of the lease would be highly judgmental and the potential cost to allocate the components within the lease would be substantial and outweighs any perceived benefit to the users of our financial statements. Many of the companies submitting this letter have in excess of 50,000 separate leases annually and each lease may have other perceived elements such as multiple roommates (i.e. separate leases) and varying occupancies and usage each month. These elements provide even greater complexity to the separate allocation of CAM activities within a multifamily residential lease. Each multifamily lessor and their independent registered public accounting firms will incur significant costs to document, test, and audit internal controls surrounding the allocation process and determining and auditing the fair value for each component. The hypothetical assignment of fair value of these CAM components, which are not core business streams of a multifamily residential lessor, may result in unnecessary scrutiny from federal, state, and local tax authorities as well as inquiries and audits regarding the qualification for Real Estate Investment Trust ("REIT") status under the Internal Revenue Code of 1986. Based on the factors noted above, we do not believe this information is relevant, meaningful, or useful to the users of our financial statements. We have included hypothetical illustrations of the potential changes to an income statement within Exhibit A.

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<sup>1</sup> ASU 2016-02 BC 146

<sup>2</sup> ASC 842-10-15-38

**Accounting Analysis**

To apply the new standards to multifamily residential leases, the lease and nonlease components of the contract must be identified. The new lease standard requires lessors to separately account for the right to use an underlying asset as a lease component if the lessee can benefit from the right of use and the right of use is neither highly dependent on nor highly interrelated with the other right(s) to use another underlying asset subject to the contract<sup>3</sup>. We believe the right to use community amenities within a multifamily residential lease is highly dependent on the right to use the apartment home subject to the lease because only residents can access these amenities. These amenities cannot be rented alone or used without a lease of an apartment home. We believe multifamily residential leases provide residents with access to common hallways, grounds and walkways within the community and use of these community assets is interrelated to the right to use the apartment home subject to the lease because the resident cannot access their apartment home without access to the community assets. Without proper maintenance of these assets, the resident's access to and egress from the leased apartment home could be restricted; however, the resident is not obligated to maintain these assets in the event the lessor is negligent in doing so. Therefore, we believe activities related to the use and maintenance of the community assets do not meet the two criteria of separate lease components and the use of the apartment home and related community assets and the maintenance thereof are considered a single lease component.

The nature and intent of a multifamily residential lease is to provide a home, including the enjoyment of amenities within the community. Most of the tasks necessary to provide the home within the community which meet the broad expectations of multifamily residents, include the upkeep and maintenance of the community at large, and do not provide a good or service to the specific resident. The resident does not have an option to decline these services even if they do not use the amenities of the community. Multifamily lessors incur costs for undertaking these activities, and the base rent charged to the customer includes the reimbursement of these costs similar to the insurance and real estate taxes on the community assets. As noted earlier, multifamily leases are structured as gross leases: reimbursement of executory costs and the costs of community asset maintenance are not separately identified from base rent; these activities are not mentioned in the lease contract; and, accordingly, there is no stand-alone pricing for these activities. As a result, we believe the costs related to the use and maintenance of community amenities and assets, including snow removal, landscaping and cleaning, are costs lessors incur as owners of the community, similar to real estate taxes and insurance related to the community assets. These activities do not provide a service to the residents separate from the right to use the apartment home or the community's amenities. Under the new lease standard, the reimbursement of a lessor's costs is not a component of the contract; therefore, consideration should not be allocated to these activities<sup>4</sup>.

We understand some may interpret Example 12, Case C – Common Area Maintenance<sup>5</sup> (“Case C”) in the new lease guidance to require all common area maintenance activities related to the leased space within a building to be considered a separate nonlease component. We, however, believe Case C is specific to commercial leases and is not intended to be analogous to multifamily residential leases. In the Case C example, common area maintenance is a nonlease component because the lessee “... would otherwise have to undertake itself or pay another party to provide (for example, cleaning the lobby for its customers, removing snow from the parking lot for its employees and customers, and providing utilities).”<sup>4</sup> The example clearly identifies a lessee's motivation to otherwise undertake maintenance costs itself are economically driven rather than access driven. In a multifamily residential lease, it is unreasonable to assume any individual resident would routinely undertake community maintenance activities or pay a third party to perform the maintenance of the underlying assets because they are not obligated to do so. A

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<sup>3</sup> ASC 842-10-15-28

<sup>4</sup> ASC 842-10-15-30

<sup>5</sup> ASC 842-10-55-144

## Accounting for CAM in Multifamily Leases

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resident rents an apartment with the reasonable expectation the landlord will perform these activities; these tasks are the sole responsibility of the lessor to maintain a functional, safe, and aesthetically appealing multifamily community in exchange for a base rent. Because of these expectations, community maintenance activities are not addressed within multifamily leases.

As further evidence a standard multifamily residential lease differs from the example in Case C, we understand commercial leases generally outline the specific roles and responsibilities with respect to common area maintenance, including the lessor's obligations to provide these services over the term of the lease. We believe this specificity is only necessary because the obligation could transfer to the lessees. Conversely, standard multifamily lease contracts do not guarantee access or maintenance to common areas during the lease term. In most instances, a standard multifamily residential lease acknowledges the lessor, at its discretion, may restrict access to, or permanently close access to a common area without an obligation to compensate the resident.

We believe, based on our interpretation of the basis for conclusion in the new lease standard regarding lessors, the guidance in the revenue standard regarding identification of performance obligations should also be considered in the identification of nonlease components to determine whether a nonlease component represents a separate good or service<sup>6</sup>. We believe the performance obligation analysis applied to a multifamily contract similarly results in the conclusion costs related to community maintenance within a multifamily residential lease would not represent separate performance obligations from the right of use asset in a contract with a customer.

Additionally, we acknowledge the new lease standard does not include the guidance regarding separate accounting for nonlease components of a contract if those components are distinct, and are able to separate those components<sup>7</sup>. The lease component within a multifamily residential lease provides the use of an apartment home which includes the use of the apartment unit, executory costs, community amenities, and other community maintenance activities. The nonlease components within a multifamily residential lease adhere to the new revenue standard.

The new revenue standard defines a performance obligation as “A promise in a contract with a customer to transfer to the customer either a) a good or service (or a bundle of goods or services) that is distinct; or b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.”<sup>8</sup> The standard further clarifies a good or service is “distinct” if it has both of the following characteristics:

- a) “The customer can benefit from the good or service on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct); and
- b) “The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is the promise is distinct within the context of the contract).”<sup>9</sup>

We acknowledge certain amenities may meet the first criteria by providing a service the resident would or could otherwise obtain from a third party, such as the use of a pool or fitness center. Accordingly, our analysis focuses on the second criterion. The revenue standard indicates the objective of evaluating whether the entity’s promise to transfer services is separately identifiable is “...to determine whether the

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<sup>6</sup> ASC 842-10-15-28, BC 146 Separate Lease Components

<sup>7</sup> ASU 2016-02 BC151a

<sup>8</sup> ASC 606-10-20 Glossary-Performance Obligation

<sup>9</sup> ASC 606-10-25-19

## Accounting for CAM in Multifamily Leases

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nature of the promise, within the context of the contract (emphasis added), is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs.”<sup>10</sup>

One factor to consider when determining if a service is not separately identifiable is if “...the entity is using the goods or services as inputs to produce or deliver the combined output...specified by the customer.”<sup>11</sup> We believe within the context of a multifamily residential lease contract the resident has been provided a home within a community, which represents the combined output for which the resident has contracted and not separate performance obligations for the use of the apartment unit, executory costs, common amenities, or the maintenance of such assets. Additionally, we acknowledge Example 12A – Series of Distinct Goods or Services<sup>12</sup> in the new revenue guidance which illustrates a series of distinct services meeting the criteria to be accounted for as a single performance obligation. We believe this example is more analogous to the promises in a multifamily residential lease. The nature of our promise to the resident in the multifamily residential lease contract is to provide an apartment home, inclusive of the use of the apartment unit, executory costs, community amenities, and maintenance activities of such assets. While these activities are not individually distinct, they are collectively necessary to provide the promise of an apartment home and are not separate promises in the contract. As such, we would recognize and disclose revenue from customers of multifamily residential leases gross as one single performance obligation.

Multifamily communities frequently provide residents with exclusive access to on-site fitness centers, pools, clubhouses or other gathering areas, dog parks and playgrounds. The amenities in the complex are integral to the resident’s community experience. Furthermore, we believe these amenities provided for particular multifamily communities are important differentiating factors in competitive markets. We note leases for some luxury apartment communities may provide more detailed components of base rent, which include an “amenity fee,” which some might interpret as an indication the provision of amenities in these communities is a separate service from the right to use an apartment unit within the community. However, these “amenity fees” are not optional to the resident and are included in the monthly consideration regardless of whether the resident uses the amenity, if at all, or how frequently the resident may use the amenity. Multifamily lessors of very high-end communities incur costs for undertaking these activities, and the “amenity fees” charged to the resident factors the reimbursement of costs for operating the amenities, similar to the reimbursement of executory costs. We believe the existence of these non-negotiable fees in leases for very high-end communities further supports our view amenities are used by landlords to differentiate communities from competing communities, but are not the provision of a service to the residents because each resident may have different motivations for selecting a home to lease.

We believe providing a home within a community as a combined item is substantially different from providing only the right to use an apartment unit with separate promises to provide access to the amenities within the community and to perform maintenance tasks, such as landscaping, snow removal and cleaning services. We consider these components to be “highly interdependent”<sup>13</sup> in the context of a multifamily residential lease contract because the residents’ enjoyment of their homes would be significantly affected if the lessor did not maintain community assets. Furthermore, an individual resident may not opt out of receiving the benefit of community maintenance activities or access to amenities. Based on this analysis, we do not believe the maintenance of community areas represents a separately identifiable service from other promises in the contract.

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<sup>10</sup> ASC 606-10-25-21

<sup>11</sup> ASC 606-10-25-21(a)

<sup>12</sup> ASC 606-10-55-157B:157E

<sup>13</sup> ASC 606-10-25-21(c)

## Accounting for CAM in Multifamily Leases

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The new revenue standard also requires separate recognition and disclosure of revenue from customers for distinct services, unless the distinct services have the same pattern of transfer<sup>14</sup>. In multifamily residential leases, some may view the rights to use the apartment unit, related executory costs, the use of community assets, and community maintenance to have the same pattern of transfer and revenue should be recognized on a straight-line basis over the term of the lease. However, others may conclude access to community amenities should have a usage-based pattern of recognition, which differs from the straight line recognition of rent and a stand ready performance obligation. The latter interpretation would result in volatility in revenue recognition between otherwise similar communities solely based on the mix of amenity users. To further illustrate this point, please refer to the hypothetical examples within Exhibit A.

We believe our position is further supported by our common business practices, which include:

- Multifamily residential leases do not have a mechanism for the lessors to recover cost fluctuations associated with community amenities and maintenance activities such as is the case in commercial leases;
- Rent is not contingent upon whether the resident uses an amenity, nor are they contingent upon the actual cost of community maintenance activities (there is no standalone market for these services);
- Multifamily lessors are generally not obligated, pursuant to the leases, to provide specific amenities;
- During the voluntary (e.g. redevelopment) or involuntary (e.g. casualty or maintenance) circumstance that renders a specific amenity unavailable to residents, the lease does not provide for a rent concession or reduction; and
- Residents may not transfer access to community amenities to non-residents for economic benefit.

Based on the above analysis, we believe community maintenance activities do not represent a separate and distinct promise to deliver services to our residents when evaluated in the context of a multifamily residential lease. Accordingly, we believe it is inappropriate to account for these services as nonlease components of the lease as they do not represent the provision of services or a performance obligation separate from the right of use asset. Furthermore, we believe this accounting and reporting (presentation of a single revenue item for rent) continues to present relevant information to users of our financial statements, as our analysts and investors focus on gross revenues rather than components that comprise our revenues.

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<sup>14</sup> ASC 842-10-15-30, BC 153 Allocating Consideration in the Contract

Accounting for CAM in Multifamily Leases

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**Conclusion**

We thank the Board for the opportunity to seek additional implementation guidance as it pertains to the lessor's treatment of CAM within multifamily residential leases. We are requesting the Board provide separate implementation guidance for lessors of multifamily residential leases which would: (1) not require the bifurcation of the CAM components on the face of the income statement and, (2) not require the disclosures required by ASC 606 for CAM to be reported as a non-lease performance obligation and would like to request a meeting with the FASB to discuss.

Sincerely,



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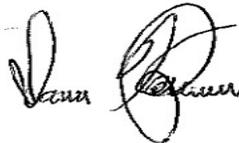
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Accounting for CAM in Multifamily Leases

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**EXHIBIT A**

The following cases are hypothetical illustrations to show the subjectivity of separation and allocation of the estimated fair value to each component. Please note each of the estimated fair values do not have stand-alone pricing in a multifamily lease contract and will pose challenges for documenting, testing, and auditing of these values. The financial statement users and investors within our industry will continue to rely on the two main metrics, monthly rental rate and monthly revenue per occupied home, as described earlier in this memorandum.

**Case 1**

Lessor owns a 200-apartment home multifamily community occupied by 300 residents and is 95% leased. The community contains a pool and fitness facility, which are open year-round and all residents actively utilize. The average monthly rent per apartment home is \$2,000 per month and the lease does not detail explicit rights to use the amenities nor assigns an implied value to the community amenities. The cleaning of all sidewalks, pool area, fitness facility, etc., is performed by the on-site maintenance team.

The hypothetical fair value of the non-rent items, based on a sample of fitness facilities near the multifamily community, value the use of the pool and fitness facility at \$20 and \$30 per month per resident, respectively. Revenue is recorded on an as-used basis and all residents are assumed to use both the pool and fitness facility daily. Associated common area maintenance is estimated to cost \$30 per month per apartment home. The costs to provide these services are fixed, and are not dependent upon usage occupancy levels. The potential changes in the recognition of annual revenues from current practice to a detailed composition are illustrated below.

	<u>Currently</u>	<u>As Described</u>	<u>Difference</u>
Rental income	\$ 4,560,000	\$ 4,311,600	\$ (248,400)
Pool income	-	72,000	72,000
Gym income	-	108,000	108,000
Maintenance fees	-	68,400	68,400
Annual revenue	<u>\$ 4,560,000</u>	<u>\$ 4,560,000</u>	<u>\$ -</u>

Accounting for CAM in Multifamily Leases**Case 2**

Assume the same facts as Case 1, with the following exceptions:

- 10% of the residents use the pool daily, 25% twice per week, 40% every two weeks, and 25% do not use the pool.

The potential changes in the recognition of annual revenues from current practice to a detailed composition are illustrated below.

	<u>Currently</u>	<u>As Described</u>	<u>Difference</u>
Rental income	\$ 4,560,000	\$ 4,369,680	\$ (190,320)
Pool income	-	13,920	13,920
Gym income	-	108,000	108,000
Maintenance fees	-	68,400	68,400
Annual revenue	<u>\$ 4,560,000</u>	<u>\$ 4,560,000</u>	<u>\$ -</u>

**Case 3**

Assume the same facts as Case 2, except the pool is closed from September – April each year. The potential changes in the recognition of annual revenues from current practice to a detailed composition are illustrated below.

	<u>Currently</u>	<u>As Described</u>	<u>Difference</u>
Rental income	\$ 4,560,000	\$ 4,378,960	\$ (181,040)
Pool income	-	4,640	4,640
Gym income	-	108,000	108,000
Maintenance fees	-	68,400	68,400
Annual revenue	<u>\$ 4,560,000</u>	<u>\$ 4,560,000</u>	<u>\$ -</u>

Accounting for CAM in Multifamily Leases

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**Case 4**

Assume the same facts as Case 3, with the following exception:

- 10% of the residents use the fitness facility daily, 20% twice per week, 10% once per month, and 60% do not use the fitness facility.

The potential changes in the recognition of annual revenues from current practice to a detailed composition are illustrated below.

	<u>Currently</u>	<u>As Described</u>	<u>Difference</u>
Rental income	\$ 4,560,000	\$ 4,470,040	\$ (89,960)
Pool income	-	4,640	4,640
Gym income	-	16,920	16,920
Maintenance fees	-	68,400	68,400
Annual revenue	<u>\$ 4,560,000</u>	<u>\$ 4,560,000</u>	<u>\$ -</u>

**Case 5**

Assume the same facts as Case 4, with the following exceptions:

- The community is 95% leased in each of the months January – April, 93% leased during May – August, and 94% leased during September – December.
- There are 300 residents in each of the months January – April, 284 in May, 287 in June, 289 in July, 281 in August, 289 in September, 292 in October, 294 in November, and 291 in December.

The potential changes in the recognition of annual revenues from current practice to a detailed composition are illustrated below.

	<u>Current</u>	<u>As Described</u>	<u>Difference</u>
Rental income	\$ 4,512,000	\$ 4,423,425	\$ (88,575)
Pool income	-	4,412	4,412
Gym income	-	16,483	16,483
Maintenance fees	-	67,680	67,680
Annual revenue	<u>\$ 4,512,000</u>	<u>\$ 4,512,000</u>	<u>\$ -</u>