



The Real Estate CFO Playbook

Preparing for a Financial Statement Audit

The Real Estate CFO Playbook

As the CFO of a real estate company, preparing for your first financial statement audit can be daunting.

Understanding the relevant guidelines under U.S. generally accepted accounting principles (“U.S. GAAP”) and the impact those standards have on your company’s transactions is critical to a successful and seamless audit. In contrast, failing to do so can result in significant financial statement misstatements, the need for process changes, significant delays in report issuance, and increased audit costs.

To help you better prepare for your initial audit and mitigate some of the uncertainty and risk, we have summarized the **top 10 complex accounting topics commonly encountered by real estate companies**.

While further evaluation of your company’s transactions and the corresponding accounting guidance will be required to ensure compliance with U.S. GAAP, reviewing this publication should provide you with a better sense of areas where additional preparation and process improvements may be necessary before your audit begins.

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1 Revenue Recognition

1.1 Overview – Rental Revenue

Rental revenue is often the primary source of income for a real estate company. ASC 842-30, *Leases—Lessors*, establishes the principles that a lessor must apply for recognizing, measuring, presenting, and disclosing rental revenue earned under a lease.

1.1.1 Key Concepts

- **Classification:** Leases are classified as either operating, sales-type or direct financing leases. Classification considerations include transfer of ownership, purchase options, lease term, the present value of lease payments and alternative use of the leased asset.
- **Commencement Date:** The lease commencement date is when the lessee takes possession of or controls the leased asset.
- **Lease Term:** Lease term should include the non-cancellable period of the contract, adjusted for any period covered by an extension or termination option that is reasonably certain to be exercised.
- **Components:** A single lease agreement may have multiple lease components. For example, a lease may grant the lessee the right to use land, building, and a separate parking annex. In some cases, each lease component must be accounted for separately, while in other cases one or more lease components can be combined. Further, a reporting entity is required to separately account for lease and non-lease components (e.g., common area maintenance) to ensure accurate revenue recognition, unless the lessor is eligible for and elects the practical expedient to combine the lease and non-lease components.
- **Recognition:** Rental revenue under operating leases is recognized on a straight-line basis over the lease term. Differences between payments received and revenue recognized due to upfront payments fixed escalations or abatements specified in the lease agreement should be recorded as deferred rent receivable (asset) or deferred rental revenue (liability). Variable rental revenue, including rents tied to a lessee's sales or usage, as well as increases in rental rates from changes in price indices like the Consumer Price Index, are recognized in the periods when those variable amounts become fixed.
- **Modification:** A lease modification represents an amendment to the terms and conditions of a lease that results in a change in the lease scope or lease payments. Depending on the nature of the modification, it may be accounted for as a separate lease or a remeasurement of the existing lease. A modification is considered a separate lease only if it grants an additional right-of-use and the lease payments increase commensurate with the standalone price of the additional right-of-use. All other modifications will be treated as a remeasurement, typically requiring reassessment of the lease classification and adjustment to the rental revenue schedules.

1 Revenue Recognition

1.1.2 Best Practices

- **Classification and Recognition:** Formally evaluate and document judgments made when determining lease classification, including the likelihood of tenants exercising renewal options, estimated remaining useful life of the leased asset, and the leased asset's fair value. Also, carefully identify the lease commencement date.
- **Improvements and Tenant Allowances:** Identify whether the lessor or the lessee is the owner of any improvements performed in connection with a lease and identify whether any allowances granted to lessee are fixed or variable. See [section 2.4](#).
- **Modifications:** Carefully consider lease amendments (including changes in terms, payments, leased premises, etc.) as they may require reclassification or remeasurement of the lease. Ensure formalized accounting policy memorandums are prepared, documenting the accounting conclusions reached around significant modifications - accounted for as a separate lease or a remeasurement of the existing lease.
- **Components:** Evaluate whether various lease components must be accounted for separately, or whether they meet the principles for combination. Consider electing the practical expedient (if permitted) to combine lease and non-lease components for practicality purposes.
- **Data Maintenance:** Ensure that all lease agreements, amendments, and related documents are accurately recorded and maintained. This includes having a system to track the lease terms, rent commencement dates, payment schedules, and any changes to the lease agreements.
- **Documentation:** Keep detailed records of lease modifications, assessments, and the resulting accounting treatments.

1 Revenue Recognition

1.2 Overview – Service Revenue

Real estate companies often provide real estate adjacent services such as development, property, or construction management services to affiliates, related parties, or third parties. ASC 606, *Revenue from Contracts with Customers*, provides a comprehensive framework for recognizing revenue earned under contracts from customers. Revenue should be recognized as services are transferred to a customer, in an amount that reflects the consideration the reporting entity expects to receive in exchange for those services.

1.2.1 Key Concepts

- **Transaction Price:** The transaction price may consist of fixed and variable consideration. Variable consideration is measured using an expected value (probability-weighted) or most likely amount, and it is subject to a constraint.
- **Performance Obligations:** A promise to transfer a good or service that is "distinct" is referred to as a performance obligation. If a good or service is not distinct on its own, it must be combined with other promised goods or services to identify a bundle that is distinct, in which case the bundle is treated as a performance obligation.
- **Allocate Transaction Price:** The transaction price must be allocated to each performance obligation based on the relative standalone selling prices of each performance obligation.
- **Recognizing Revenue:** Revenue is recognized point in time or over time depending on when the goods or services are transferred to the customer.

1.2.2 Best Practices

- **Contracts:** Formally identify and document all services promised to the customer and determine which meet the definition of a performance obligation.
- **Recognition:** Leasing commissions are often recognized at the point in time when the binding lease contract is signed by the tenant. Otherwise, other types of real adjacent services are typically recognized over time. Develop methods to measure progress towards satisfying performance obligations (e.g., input methods like costs incurred or output methods like milestones achieved).
 - **Property Management Fees:** Property management fees are often determined to be a "series" recognized over time as the services are provided. Revenue is typically recognized based on the passage of time.
 - **Developer Fees:** Developer fees are typically recognized over time as the developer and construction management services are provided to the project owner. Either an input (time elapsed) or output (owner development costs) method of recognizing revenue may be appropriate, depending on facts and circumstances.
- **Data Maintenance:** Maintain thorough documentation of all contracts' payment terms, performance obligations, and methods used to recognize revenue. Track and validate the underlying data that best depicts the transfer of service to the customer such as owner project costs, developer time incurred, etc.

2 Real Estate

2.1 Overview – Acquisitions

For most real estate companies, property acquisitions are significant and frequent. As ASC 805-50, *Business Combinations—Related Issues*, provides limited guidance on asset acquisitions, companies also refer to other sources for guidance, such as i) ASC 805, *Business Combinations*, to the extent it does not conflict with the cost accumulation model and ii) other existing U.S. GAAP.

2.1.1 Key Concepts

- **Asset Acquisition vs. Business Combination:** Often, real estate acquisitions meet the screen test and are accounted for as an asset acquisition. However, there are exceptions, and the screen test must still be performed and documented for each significant acquisition.
- **Purchase Price Allocation:** When a real estate property is determined to be an asset acquisition, the total purchase price (cost) must be allocated to the identifiable assets acquired, which often include land, buildings, site improvements, in-place leases, and off-market leases, based on their relative fair values. Any assumed liabilities generally should be recorded at their fair value.
- **Qualifying Assets:** Assuming all assets have been recognized, in situations where there is excess cost, the excess costs typically are allocated to the long-lived, nonfinancial assets acquired.
- **Sales Leaseback Transactions:** Sales leasebacks are transactions in which the seller of a property immediately leases back the property from the buyer. The buyer in this transaction must determine whether the transaction qualifies as a purchase. If the transaction is determined to be a purchase, it is accounted for as either an asset acquisition or a business combination. If not, it is accounted for as a financing transaction, akin to a secured lending arrangement.

2.1.2 Best Practices

- **Contracts:** Carefully read and understand the purchase contract to ensure all assets acquired and liabilities assumed have been properly identified.
- **Recognition – Purchase Price Accounting:** Engage a valuation specialist to assist in determining the fair values of the assets acquired, liabilities assumed and/or any nonmonetary consideration transferred in exchange.
- **Recognition – Sales Leasebacks:** Pay careful attention to terms that may disqualify the transaction from being separated into the purchase and leaseback components, such as seller repurchase or extended lease term renewal options.

2 Real Estate

2.2 Overview - Impairment

As real estate is the largest asset on most real estate companies' balance sheet, regular monitoring and assessment of impairment is crucial. ASC 360, *Property, Plant, and Equipment*, provides guidance on the accounting for impairment of real estate properties.

2.2.1 Key Concepts

- **Impairment and Triggering Events:** Real estate assets should be tested for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. These triggering events may include, but are not limited to, a significant decrease in the fair value of a property, adverse changes in market conditions, or substantial changes in how the property is used.
- **Recoverability Test:** When a triggering event occurs, the reporting entity must estimate the future undiscounted cash flows expected to be generated by the asset (or asset group). If the sum of these future undiscounted cash flows is less than the carrying amount of the asset, the asset (or asset group) is considered nonrecoverable and has failed the recoverability test.
- **Impairment Loss:** If the asset (or asset group) fails the recoverability test, an impairment loss is recognized as the difference between the carrying amount and the fair value of the asset.

2.2.2 Best Practices

- **Monitor:** Conduct regular assessments of real estate assets for indicators of impairment. This may involve tracking market conditions, property performance, and changes in use.
- **Documentation:** Formally document all assumptions, methodologies, and judgments used in impairment testing to ensure transparency and support the conclusions reached. These cash flow estimates should be developed from and be consistent with other budgets and forecasts made by the company.

2 Real Estate

2.3 Overview - Capitalizable Costs

Construction activities are a fundamental aspect of real estate companies at various stages of their life cycle. ASC 970, *Real Estate—General*, provides guidance on accounting for the costs of real estate projects for sale or rental. Costs include acquisition, development, construction, selling and initial rental (up to the point of normal operations — as defined).

2.3.1 Key Concepts

- **Capitalization Period:** Holding costs can be capitalized during the period when activities necessary to get the property ready for its intended use are in progress. This period begins when construction or development activities commence and ends when the property is substantially complete and ready for use. Of note, a real estate project is considered substantially complete upon completion of tenant improvements, but no later than one year from cessation of major construction activity (typically meaning the building shell). Interest may be capitalized only on those units where tenant improvements are ongoing for up to one year after completion of the shell, even if lease commencement is delayed and interior development activities continue beyond 12 months. Major construction activity does not include routine maintenance and cleanup.
- **Capitalizable Costs:** Developers can typically capitalize real estate projects costs that are necessary to get the property ready for its intended use. There are various nuances to consider when determining what costs can be capitalized during the period. These include, but are not limited to, the following:
 - **Interest:** Many companies capitalize interest during the construction period using a weighted-average yield approach. Under this approach, the company will multiply qualifying construction costs by the weighted-average yield of all debt outstanding during the period. Reporting entities should be careful when using this approach since the accumulated cost of qualifying assets is often greater than the total outstanding debt balance; interest cost capitalized in an accounting period cannot exceed the total amount of interest cost incurred by the consolidated reporting entity during that period. Corporate level debt should be considered in determining the weighted-average yield and interest capitalized must be evaluated at the consolidated level.
 - **Net Incidental Revenue:** Incremental revenues from incidental operations in excess of incremental costs (net incidental revenues) are recognized as a reduction of capitalized project costs.

2 Real Estate

2.3.1 Key Concepts (*Continued*)

- **Common Costs:** Developers often incur project costs that are not specifically identifiable to one component of the project. These common costs include but are not limited to the following:
 - Land
 - Site improvements – roads, sidewalks, parking lots, etc.
 - Amenities – clubhouse, golf course, swimming pools, tennis courts, recreational facilitiesWhen a real estate project will be sold in parcels, these costs should be allocated to each land parcel benefited. Allocation shall be based on the land parcel's relative fair value before construction.
- **Pre-Acquisition Costs:** Payments to obtain an option to acquire real property shall be capitalized as incurred. Other costs incurred before the reporting entity acquires a property are capitalized if acquisition of the property is probable, the costs are directly identifiable with the specific property and the costs would be capitalized if the property were already acquired. These costs include expenses related to pre-acquisition activities such as permitting, zoning, and surveying the specific property, payroll for employees who work directly on these tasks, and payments made to obtain an option for acquiring additional property.

2.3.2 Best Practices

- **Policies:** Develop, formalize, and implement clear policies outlining criteria for cost capitalization.
- **Track:** Develop systems to capture costs and to assign them to components of each project.
- **Monitor:** Closely monitor the progress of construction or development activities to determine the appropriate start and end dates for capitalization. When a property is completed in phases, each phase should be accounted for as a separate project. Capitalization ceases for phases that have been completed. Consider the guidance around tenant improvements, especially when space is built to suit.

2 Real Estate

2.4 Overview - Improvements in Connection with Leases

Leases often contain provisions allowing or requiring improvements to be made to the leased asset, some or all of which may be paid for by the real estate company or by the tenant. ASC 842-10, *Leases—Overall*, provides guidance on accounting for lease incentives and determining the accounting owner of such improvements.

2.4.1 Key Concepts

- **Scope:** It is common for improvements or alterations to be made to a rental property to customize the space for the tenant, as agreed to between a lessor and lessee in a lease contract. These can include changes to the interior layout, installation of fixtures, as well as modifications or enhancements to the property's infrastructure.
- **Determining the Accounting Owner of Improvements:** It is important to determine whether the improvements are lessor or lessee improvements - in other words who is the "accounting owner." This determination affects recognition of the corresponding long-lived asset as well as timing and amount of rental revenue (i.e., when the lessee obtains control of the leased space). Considerations include:
 - The nature of the improvements.
 - If the lessee holds title to the improvements.
 - If the alterations/improvements must be removed at the termination of the lease.
 - If the lease requires that such improvements be made.
 - If the improvements are required to be completed before lease payments are contractually due.
 - If the improvements are unique to the tenant.
 - Which party is responsible for cost overruns.
- **Recognition:** Improvements for which the lessee is the accounting owner should not be recorded as real estate by the lessor. Instead, amounts paid towards lessee assets are accounted for as lease incentives, deferred and then amortized to rental revenue over the life of the lease (See [1.1 Rental Revenue](#)). If the improvements are determined to be lessor assets, amounts paid by the lessor and lessee are recognized as a long-lived asset and, correspondingly, the amounts directly paid by the tenant for such assets, should be recognized as a deferred rent liability, and amortized over the lease term.
- **Depreciation and Amortization:** Improvements associated with an operating lease for which the lessor is the accounting owner, should either be:
 - Amortized over the shorter of the lease term or their useful life if the improvements are customized to the point that they are usable only by the current tenant, or
 - Amortized over the improvement's useful life if the asset has economic value beyond the lease term.

2 Real Estate

2.4.2 Best Practices

- **Contracts:** Familiarize yourself with the agreement terms and conditions and identify patterns in your lease agreements around tenant improvement and allowance clauses. Standardize wherever possible to facilitate the accounting.
- **Documentation:** Maintain detailed documentation of the analyses performed and conclusions reached for all significant tenant improvements stipulated in a lease contract.

3 Investments

3.1 Overview – Consolidation

Real estate companies often partner with affiliates and third parties to form joint ventures and partnerships. Typically, these joint ventures and partnerships are also real estate and real estate adjacent companies. ASC 810, *Consolidation*, provides the guidance for determining if consolidation of these other entities is required based on the Variable Interest Entity (“VIE”) or Voting Interest Entity (“VOE”) models. Under both models, the investor with the controlling financial interest consolidates the investee.

3.1.1 Key Concepts

- **Variable Interest:** Variable interests are investments or other interests that will absorb portions of an entity’s expected losses or receive portions of the entity’s expected residual returns.
- **VIE Model:** An entity is considered a VIE if it meets certain conditions – for instance, if it lacks sufficient equity to finance its activities without additional subordinated financial support. In addition, a partnership or similar type of entity will be a VIE if the limited partners lack substantive participating rights or the ability to remove the general partner by a simple majority vote called at any time. The primary beneficiary is required to consolidate the VIE. A primary beneficiary is the party with the power to direct activities that most significantly impact the VIE’s economic performance and the obligation to absorb losses or receive benefits that could potentially be significant to the VIE.
- **VOE Model:** Under the VOE model, an entity is consolidated if the investor holds a controlling voting interest. The VOE model may only be used if the entity being evaluated for consolidation is not a VIE.

3.1.2 Best Practices

- **Scope:** Understand the guidance in U.S. GAAP around variable interests. Identify all significant variable interests held by the reporting entity.
- **Contracts:** Carefully read and understand the operating agreements governing the investment primarily focused on the decision-making rights and exposure to gains or losses of the investee.
- **Monitor:** Reassess VIE status upon certain events specified in U.S. GAAP. As applicable, reassess the primary beneficiary determination continuously as changes in facts and circumstances could alter consolidation conclusions.
- **Documentation:** Maintain detailed documentation of the analyses performed and conclusions reached regarding VIE and VOE determinations.

3 Investments

3.2 Overview – Equity Method Investments

When partnering with affiliates and third parties to form joint ventures and partnerships, ASC 323, *Investments—Equity Method and Joint Ventures*, provides guidance on accounting for investments in which the investor has significant influence, but not control.

3.2.1 Key Concepts

- **Significant Influence:** This is defined as the ability to significantly influence the operating and financial policies of the investee. Indicators of significant influence include, but are not limited to, board representation, participation in policy-making processes, material transactions between the investor and investee, exchange of managerial personnel, and technological dependency.
- **Equity Method:** The method of accounting used to account for the investment when the investor can exert significant influence over the investee is referred to as “the equity method.” Under the equity method, the investment is initially recorded at cost, and the carrying amount is subsequently adjusted for the investor’s share of the earnings or losses of the investee. Basis differences between the fair value and carrying values of the investee’s assets and liabilities at the time of investment are identified and amortized over their respective useful lives.
- **Joint Ventures:** An investment in a joint venture, where a small group of businesses share control and participate in management, should be accounted for under the equity method. A common interpretation defines a joint venture as an entity for which all parties in the corporate joint venture must unanimously vote on all major decisions.
- **Impairment:** An equity method investment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment might not be recoverable and the impairment is other than temporary. A series of operating losses of an investee or other factors may indicate that an other than temporary decrease in value of the investment has occurred.

3.2.2 Best Practices

- **Contracts:** Evaluate the decision-making rights and level of influence over the investee as dictated by the governing agreements to determine whether the equity method of accounting is appropriate.
- **Recognition:** At the end of each reporting period, adjust and reconcile the carrying amount of the investment for the investor’s share of the investee’s earnings or losses and dividends received, as well as for the amortization of basis differences.
- **Monitor:** Regularly assess the investment for impairment and recognize any necessary losses if the fair value falls below the carrying amount and the decline is deemed other than temporary.
- **Documentation:** Keep comprehensive records of all analyses performed and how accounting conclusions were reached.

3 Investments

3.3 Overview – Equity Securities

ASC 321, *Investments—Equity Securities*, provides guidance on the accounting for investments in equity securities, including investments in common stock, preferred stock, and other ownership interests in entities that are not consolidated or accounted for under the equity method. Real estate companies often invest excess capital in equity securities.

3.3.1 Key Concepts

- **Equity Security (within scope of ASC 321):** This is defined as a security representing an ownership interest in an entity, or the right to acquire or dispose of an ownership interest in an entity at fixed or determinable prices (i.e., call or put options).
- **Readily Determinable Fair Value:** The fair value of an equity security is readily determinable if the security bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission or foreign market comparable to one of the U.S. markets.
- **Measurement Alternative Method:** If a readily determinable fair value is not available, U.S. GAAP permits nonpublic companies a measurement alternative wherein the equity interest is recorded initially at cost. The carrying amount should be subsequently remeasured to its fair value in accordance with the provisions of ASC 820, *Fair Value Measurement*, when either the investment is determined to be impaired or there are observable price changes in orderly transactions for a similar security issued by the same issuer.
- **Practical Expedient - NAV:** Equity investments in hedge funds and similar vehicles may qualify for a practical expedient, which allows the use of net asset value (“NAV”) per share when certain conditions are met. The NAV practical expedient calculates the fair value of certain equity securities by using the NAV provided by the investee as a substitute for fair value.

3.3.2 Best Practices

- **Policies:** Document the accounting policy for each type of equity security held by the reporting entity. If the measurement alternative method is available, consider taking the election.
- **Recognition – Measurement Alternative Method:** Identify observable price changes each reporting period. Consider any equity contributions for new or additional equity interests. Review the annual investee statements to identify any relevant equity transactions. Consider the performance and cash flows of the investee to identify potential impairment.
- **Recognition – NAV Practical Expedient:** Communicate frequently with the investee and create a process for obtaining and tracking annual investee statements reflecting the NAV as of period end.
- **Monitor:** Regularly assess the investees annual statements to identify impairment triggers.
- **Documentation:** Maintain comprehensive records of observable price changes, fair value adjustments, and impairment evaluations.

3 Investments

3.4 Overview – Notes Receivable

It is common for real estate companies to make loans to related parties as well as third parties, often collateralized by real estate. ASC 310, *Receivables*, provides guidance on the accounting for loans held for investment. Such receivables may be in the form of loans, notes, and other types of financial instruments and may be loans the reporting entity originated or purchased from another entity. Correspondingly, ASC 326, *Financial Instruments—Credit Losses* (“CECL”), provides guidance on the accounting for current expected credit losses, including the estimation and recognition of expected credit losses on financial instruments.

3.4.1 Key Concepts

- **Loan Origination Fees and Direct Loan Origination Costs:** Origination fees and costs should be offset and only the net amount deferred. The net amount is then recognized over the life of the loan as an adjustment to the yield using the interest method to arrive at a constant effective yield on the net investment.
- **Notes Receivable as a Result of a Sale of an Asset:** When an entity receives noncash consideration in exchange for a nonfinancial asset, the entity shall measure the estimated fair value of the noncash consideration (a note) at contract inception, when readily determinable. If the fair value of the noncash consideration is not readily determinable, it should be measured based on the standalone selling price of the assets transferred to the entity.
- **CECL Model**
 - **Recognition:** On initial recognition of the financial asset or contract inception and each reporting date thereafter, an entity recognizes an allowance for the estimated lifetime expected credit losses. The allowance is deducted from the amortized cost basis of a financial asset or a group of financial assets so that the balance reflects the net amount expected to be collected. If financial assets share similar risk characteristics, they should be grouped together, and expected credit losses should be measured for the entire group based on the associated risks.
 - **Scope Exceptions:** The CECL model does not apply to certain financial assets, including:
 - Financial assets carried at fair value, with changes in fair value reported through earnings.
 - Loans and receivables from entities under common control, including individuals holding a controlling interest in the reporting entity. Loans and receivables between related parties that are not under common control do not fall within this scope exception.

3 Investments

3.4.2 Best Practices

- **CECL Considerations:**
 - **Scope:** Identify all financial instruments within the scope of CECL.
 - **Pooling Assets:** Consider characteristics like term, size, credit rating of the borrower, collateralization, etc. of the financial assets when aggregating based on similar risk characteristics.
 - **Recognition:** Establish estimation techniques that are applied consistently at each period end to recognize allowances for credit losses on financial assets. These techniques should provide reliable estimates of collectability. For notes receivable that are sufficiently collateralized or guaranteed, consider using the loss given default model when calculating the allowance for credit losses.
- **Recognition – Nonmonetary Consideration:** Ensure all noncash consideration has been recognized at fair value, when readily determinable.
- **Documentation:** Maintain thorough documentation of any fair value calculations as well as the analysis and determinations made when calculating the allowance for credit losses.

4 Long-Term Financing

4.1 Overview – Embedded Derivatives

Real estate is often highly leveraged, and lenders deploy various features to mitigate risk that may need careful evaluation. ASC 815, *Derivatives and Hedging*, establishes the principles for recognizing, measuring, presenting, and disclosing derivatives and hedging activities. A debtor must carefully evaluate the terms of outstanding debt arrangements to determine whether they contain any features that must be accounted for as derivatives separately from their debt host contracts (including call/put options, prepayment amounts, exit fees, etc.).

4.1.1 Key Concepts

- **Embedded Redemption Features:** These features provide the issuer or holder the right to redeem the debt before its maturity date. They must be evaluated to determine if they should be bifurcated and accounted for separately.
- **Penalties:** Some debt agreements contain make-whole provisions or require penalty interest upon the occurrence (or nonoccurrence) of certain events.

4.1.2 Best Practices

- **Contracts:** Assess all debt agreements for embedded features and determine if they should be separated from the host contract. This analysis is complex and may require engaging specialists.
- **Recognition:** Measure the fair value of any embedded derivatives at inception and subsequently at each reporting date, recognizing changes in fair value in earnings. Again, valuation specialists are often necessary to perform these calculations.
- **Documentation:** Maintain thorough documentation of the evaluation process, assumptions used in fair value measurements, and changes in value.
- **Fair Value Election:** Consider making a fair value election to record the entire debt instrument at fair value, with changes in fair value recorded in earnings. Except for the portion of fair value change due to movements in the creditworthiness of the reporting entity, which are recorded to other comprehensive income within equity, it may be easier and less costly to measure the entire instrument at fair value rather than just the embedded derivatives. This election can only be made at the time the debt is issued or substantially modified, and it is irrevocable.

4 Long-Term Financing

4.2 Overview – Debt Covenants

Lenders use debt covenants to ensure borrowers maintain financial stability and adhere to agreed-upon limits, thereby reducing the risk of default. Debt instruments commonly include covenants and other provisions that require the debtor to perform in a certain manner or prohibit it from conducting certain activities. A debtor must present callable debt as a current debt obligation in a classified balance sheet and necessary disclosures must be made. In addition, ASC 205-40, *Presentation of Financial Statements—Going Concern*, requires a formal going concern assessment during the financial statement preparation process.

4.2.1 Key Concepts

- **Classification:** Covenant violations can often trigger the lender's call right, which can cause the obligation to be current within a classified balance sheet.
- **Going Concern Consideration:** Debt covenants are often integral to the assessment of an entity's ability to continue as a going concern. Violations or the inability to meet a covenant requirement may trigger clauses that allow lenders to demand immediate repayment, potentially jeopardizing the reporting entity's operations.
- **Disclosure:** Material covenants should be disclosed within the financial statements. In cases of significant violations of the covenants, these should be clearly disclosed within the financial statements. Moreover, the potential impact of covenant breaches on the reporting entity's ability to continue as a going concern should be explicitly disclosed in the footnotes.

4.2.2 Best Practices

- **Loan Agreements – Covenants:** Borrowers should regularly assess covenant compliance based on the provisions of their debt agreement. Thoroughly review all debt agreements to identify and understand both financial and non-financial covenants. Ensure that the borrower's obligations under these covenants are fully recognized and monitored.
- **Loan Agreements – Events of Default:** All debt agreements specify activities that would cause the borrower to be in default with its obligations under a loan agreement. Common events of default include declaring bankruptcy, failing to make timely principal and interest payments when due, or failing to maintain certain financial covenants.

4 Long-Term Financing

4.2.2 Best Practices (*Continued*)

- **Perform Testing:** Consider performing “pro forma” debt covenant testing in the months leading up to the required calculation dates to determine the amount of “cushion” available to meet the covenants. Negotiate with lenders if a covenant violation may be likely.
- **Documentation:** Maintain thorough documentation of the compliance analysis and any related correspondence with the lender. Conduct a formal going concern assessment during the financial statement preparation process. This assessment should focus on liquidity and cash flow projections. Ensure that any potential risks to the reporting entity’s ability to continue as a going concern are identified early, documented, and communicated to stakeholders.

4 Long-Term Financing

4.3 Overview - Leases

Real estate companies occasionally find themselves on the other side of a lease agreement, leasing an asset from another company. In these transactions the real estate company is the lessee leasing an asset from a lessor. The most common and significant of these transactions involve ground leases. ASC 842-20, *Leases—Lessee*, establishes the principles for recognizing, measuring, presenting, and disclosing lease expenses and lease liabilities incurred under a lease.

4.3.1 Key Concepts

- **Classification:** Leases are classified as either operating leases or financing leases. Classification is based on a variety of factors including whether the lease transfers ownership of the leased asset to the lessee, whether purchase options are reasonably certain to be exercised, the relationship of the lease term to the remaining economic life of the leased asset, the present value of lease payments relative to the fair value of the leased asset, and whether the leased asset has any alternative use to the lessor.
- **Commencement Date:** The lease commencement date is when the lessee takes possession of or controls the leased asset. This date is crucial as it triggers recognition of the lease liability and right-of-use asset.
- **Lease Term:** Lease term should include the non-cancellable period of the contract as well as any period covered by an extension or termination option that is reasonably certain to be exercised. The term reasonably certain represents a higher level of likelihood than “probable”, as discussed in [section 6.2.1](#). Often ground lease extensions are reasonably certain of being exercised as the improvements (buildings) developed on the ground are a major commitment and source of revenue for a real estate operator.
- **Recognition:** At the commencement date of a lease, a lessee recognizes a lease liability for the future lease obligations and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset). The lease liability and right-of-use asset will be reduced throughout the life of the lease as lease payments are made based on the classification determined at inception.
- **Modification:** A lease modification represents an amendment to the terms and conditions of a lease that results in a change in the lease scope or lease payments. Depending on the nature of the modification, it may be accounted for as a separate lease or a remeasurement of the existing lease. A modification is considered a separate lease only if it grants an additional right-of-use and the lease payments increase commensurate with the standalone price of the additional right-of-use. All other modifications will be treated as a remeasurement, requiring reassessment of the lease classification and adjustment of the lease liability, right-of-use asset, and lease related expenses.

4 Long-Term Financing

4.3.1 Key Concepts (*Continued*)

- **Practical Expedients:** Practical expedients can be elected to simplify the accounting:
 - **Risk-Free Rate:** A reporting entity may elect a policy to use the risk-free rate for determining the lease liability versus the incremental borrowing rate.
 - **Lease and Non-Lease Components:** A reporting entity may elect to account for the non-lease components as part of the lease components to which they relate. Thus, the combined component is accounted for as a single lease component.
 - **Leases between Entities under Common Control:** The written terms between the parties are deemed to be legally enforceable and used in the calculation of the lease liability and right-of-use asset.
- **Lease Remeasure:** If a modification results in a change in the lease term or payments, generally remeasure the lease liability using the discount rate at the modification date.

4.3.2 Best Practices

- **Recognition:** Formally evaluate and document considerations made when determining inputs to the lease models, such as the lease commencement date. The lease commencement date can be difficult to determine. Carefully evaluate leases containing renewal, extension or termination options and formally document the evaluation of whether it is reasonably certain that options to renew, extend, or early terminate the lease will be exercised by the lessee. If the risk-free rate practical expedient is applied, the risk-free rate is determined using a period comparable with the lease term. Risk-free rate should be applied to each class of underlying asset rather than for all leases.
- **Data Maintenance:** Ensure that all lease agreements, amendments, and related documents are accurately recorded and maintained. This includes having a system to track the lease terms, rent commencement dates, payment schedules, and any changes to the lease agreements.
- **Modifications:** Carefully consider lease amendments (including changes in terms, payments, leased premises, etc.) as they may require reclassification or remeasurement of the lease. Ensure formalized accounting policy memorandums are prepared documenting the accounting conclusions reached around significant modifications - accounted for as a separate lease or a remeasurement of the existing lease. Adjust the lease liability and right-of-use asset accordingly.
- **Documentation:** Keep detailed records of lease modifications, assessments, and the resulting accounting treatments.

4 Long-Term Financing

4.4 Overview – Equity

To finance new projects, real estate companies often issue various forms of equity instruments, which can include instruments granting the investor preferred rights and special redemption features. ASC 505, *Equity*, and ASC 480, *Distinguishing Liabilities from Equity*, provide principles for recognizing, measuring, presenting, and disclosing equity interests, preferred interests, and financial instruments with characteristics of both liabilities and equity.

4.4.1 Key Concepts

- **Classification:** Preferred interests must be classified as a liability if they are mandatorily redeemable on a specific date. Otherwise, preferred interests are classified or a component of equity. Although not required, it is strongly encouraged for redeemable (or contingently redeemable) legal equity instruments to be presented as mezzanine equity.
- **Complex Equity Structures:** An equity waterfall refers to the allocation structure used in real estate partnerships and joint ventures to distribute cash flows or profits among investors based on predefined thresholds and priorities. Waterfall structures often include hurdle rates that must be met before additional profits are distributed.
- **Presentation:** The equity section of a partnership's and limited liability company's balance sheet or, alternatively, the statement of changes in equity should distinguish between amounts ascribed to each ownership class. This means that partnership or membership interests that grant significantly different rights to the holders should be presented separately, accompanied by disclosures detailing the specific variations in these rights.

4.4.2 Best Practices

- **Contracts:** Carefully read and understand the structure of the various real estate deals and reporting entities' operating agreements. Analyze each class of equity, including review of the offering documents and governing documents, to determine the proper presentation in the balance sheet. Ensure that all cash is distributed to the owners in accordance with the governing operating agreements (follow the waterfall structure).
- **Recognition:** Allocate profits and losses to the owners to reflect what each owner is economically entitled to based on the ending book value of equity.
- **Data Maintenance:** Track initial capital contributions and distributions by individual owner or class of ownership units/interests.

5 Derivatives

5.1 Overview – Interest Rate Swaps and Caps

As interest is a large component of a real estate company's cost of doing business, interest rate swaps and caps are often used to manage interest rate risk, while stabilizing cash flows and protecting against rising interest rates. Interest rate swaps and caps are considered derivative instruments and are accounted for under ASC 815, *Derivatives and Hedging*.

5.1.1 Key Concepts

- **Recognition:** Derivative instruments representing rights or obligations that meet the definitions of assets or liabilities should be reported in the balance sheet at fair value. The accounting for subsequent changes in the fair value (that is, gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship.
- **Statement of Cash Flows – Presentation:** Cash receipts and payments in connection with a derivative are classified as operating, financing, or investing based on the instrument's nature.
 - **Operating:** Derivative acquired or originated for all other purposes
 - **Financing:** Derivative with an other-than-significant financing element at inception (for the party acting as borrower)
 - **Investing:** Derivative with an other-than-significant financing element at inception (for the party acting as lender)
- **Income Statement – Presentation:** Presentation of gains and losses on derivative instruments in the income statement depends on the type of hedge and the effectiveness of the hedging relationship.
- **Hedge Accounting:** Consider hedge accounting if the embedded features qualify and hedge documentation requirements are met. Unless the entity meets the requirements for the simplified hedge accounting method described below, the requirements for designating and maintaining hedge accounting are extensive and rigorous. It is almost always the case that an entity seeking hedge accounting – and not qualifying for the simplified hedge accounting method – will need to engage experts to prepare the quarterly analyses and documentation required.

5 Derivatives

5.1.1 Key Concepts (*Continued*)

- **Simplified Hedge Accounting:** A private company may elect the simplified hedge accounting method for pay fixed, receive floating interest rate swaps, provided criteria is met. If all the criteria for applying the simplified hedge accounting approach are satisfied, a private company may assume the hedging relationship is perfectly effective and elect to recognize the interest rate swap at its settlement value instead of fair value. The primary difference between settlement value and fair value is that nonperformance risk (the risk that the counterparty will not fulfill their obligations) is not considered in the measurement of settlement value. This also allows the mark-to-market adjustment to be pushed through other comprehensive income and for the income statement to effectively reflect interest expense based on the fixed rate in the swap.

5.1.2 Best Practices

- **Monitor:** Regularly review and adjust the fair value (or settlement value, if applicable) for subsequent accounting periods.
- **Presentation:** Do not ignore the cash flow classification considerations. Consider and evaluate the nature of the instrument to determine proper classification in the statement of cash flow.
- **Data Maintenance:** Separately track and reconcile the amounts paid and collected in connection to all swaps and caps, which can be accomplished through maintaining separate general ledger accounts for these transactions.
- **Documentation:** Maintain thorough documentation of the hedging relationship and changes in value. If seeking to qualify for hedge accounting, engage experts to assist with the extensive initial and ongoing effectiveness testing and documentation.

6 Loss Contingencies

6.1 Overview – Asset Retirement and Environmental Obligations

Unfortunately, a real estate company may encounter property damage from tenants or natural disasters. Other events such as those that arise from change in legislation, tenant’s improper disposal of hazardous waste or other environmental violations, or tenant litigation may create contingent obligations that the real estate company might have to settle.

ASC 410, *Asset Retirement and Environmental Obligations*, provides guidance on accounting for legal obligations associated with the retirement of tangible long-lived assets. ASC 410-20, *Asset Retirement Obligations*, specifically addresses asset retirement obligations (“AROs”), detailing how to account for the costs related to the retirement of tangible long-lived assets. ASC 410-30, *Environmental Obligations*, on the other hand, covers environmental remediation obligations, focusing on the recognition and measurement of liabilities associated with environmental cleanup and restoration.

6.1.1 Key Concepts

- **Environmental Remediation:** Typically, these are costs associated with the cleanup of hazardous waste or pollutants. These costs must be recognized when it is probable that a liability has been incurred and the amount can be reasonably estimated.
- **Asset Retirement Obligations:** Typically, these are legal obligations associated with the retirement of long-lived assets. AROs are recognized at fair value in the period the obligation is incurred if a reasonable estimate of fair value can be made. For example, an entity may be required to demo and reforest a job site at the end of the property’s expected useful life. The anticipated costs of those activities are accrued as the project is being completed. Increases in expected cash flows are considered new AROs (or a new layer) and are measured at fair value, whereas decreases in expected cash flows are discounted using the credit-adjusted risk-free rate that existed when the original liability was recognized. A downward revision does not consider current market interest rates and credit spreads and, therefore, is not a fair value measurement.

6 Loss Contingencies

6.1.2 Best Practices

- **Scope:** Assess all properties and operations for potential environmental and asset retirement obligations. Determine whether the obligations are within the scope of ASC 410-20 or 410-30.
- **Recognition – AROs:** Develop reasonable estimates of the costs associated with AROs. Recognize a liability for the fair value of the obligation in the period it is incurred, with a corresponding increase in the carrying amount of the related long-lived asset or expense depending on the facts and circumstances. The liability must be recorded at a discounted amount, considering a credit-adjusted risk-free interest rate. Determining this rate can be challenging in practice.
- **ARO Monitoring:** Regularly review and adjust the liability for changes in the estimated costs or timing of the remediation or retirement activities.
- **Recognition – Environmental Remediation:** Develop reasonable estimates of the costs associated with environmental remediation. Recognize a liability at the estimated costs of remediation in the period it is determined to be probable and estimable, with a corresponding increase in the carrying amount of the related long-lived asset or expense depending on the facts and circumstances.
- **Environmental Remediation Monitoring:** Regularly review and adjust the liability for changes in the estimated costs. Changes in estimates of the reporting entity's remediation liability shall be accounted for as changes in estimates.
- **Documentation:** Maintain comprehensive documentation of identified obligations, cost estimates, recognized liabilities, and subsequent changes to ensure financial statement disclosures are complete.

6 Loss Contingencies

6.2 Overview - Litigation

Loss contingencies arising from litigation are common in the real estate space. The most common area that litigation arises is in connection to properties under construction, where disagreements between the real estate company and a general contractor, subcontractor or other party may arise. In addition, properties with embedded homeowners' associations are often subject to legal claims. ASC 450-20, *Loss Contingencies*, provides guidance on accounting for potential losses that might arise from existing conditions involving uncertainty as to possible loss that will ultimately be resolved when one or more future events occur or fail to occur.

6.2.1 Key Concepts

- **Recognition:** A loss contingency should be accrued if it is both (1) probable of occurrence and (2) reasonably estimable. ASC 450-20-20 defines "probable" as "likely to occur," which is generally considered a 75% or better threshold. "Reasonably estimable" refers to the ability to make a reasonable estimate of the amount of a loss.
- **Disclosure:** The nature of a loss contingency must be disclosed when it is at least reasonably possible a loss has occurred. Reasonably possible is defined as a more than remote chance of occurrence.
- **Insurance Recoveries:** Receipts from insurance up to the amount of the loss recognized are considered recoveries. Recoveries may occur when the receipt of payment is considered probable. Insurance recoveries should not be recognized before the related loss is recognized. Anticipated proceeds in excess of the recognized loss are considered a gain and are subject to the guidance in ASC 450-30, *Contingencies—Gain Contingencies*. Anticipated proceeds in excess of a loss recognized in the financial statements may not be recognized until all contingencies related to the insurance claim are resolved.
- **Unasserted claims:** An entity should consider if an event has occurred in which a claim is judged probable however the potential claimant is unaware of the matter or has not yet pursued it (e.g., known construction defect).

6.2.2 Best Practices

- **Scope:** Identify all pending or threatened litigation as well as asserted and unasserted claims through discussions with in-house and outside legal counsel.
- **Recognition:** Evaluate the corresponding levels of probability of loss in connection with each claim and determine if recognition or disclosure is required – any disclosures should be reviewed and approved by appropriate executives and legal counsel given the sensitivities involved. Ensure all loss contingencies are estimated and recognized at the end of each reporting period when certain thresholds are met.
- **Documentation:** Request that the in-house legal counsel or accounting team, with support from external attorneys if in-house legal counsel is not available, maintain a detailed list of all claims, including relevant facts, stage of litigation, and other pertinent information.

6 Loss Contingencies

6.3 Overview – Guarantees

In the real estate industry, guarantees often arise in construction projects or financing arrangements, where a guarantee of the obligations of another party, often a related party in which the real estate company (guarantor) has a variable interest, is provided. ASC 460, *Guarantees*, requires recognizing a liability for the fair value of the guarantee at its inception. Correspondingly ASC 326, *Financial Instruments—Credit Losses*, provides guidance on the accounting for current expected credit losses, including the estimation and recognition of expected credit losses on financial guarantees.

6.3.1 Key Concepts

- **Recognition:** A guarantee obligation is initially recognized at fair value, defined as the price to transfer a liability in an orderly transaction between market participants.
- **Classification:** At the inception of a guarantee, a guarantor must recognize a liability in its financial statements. However, the corresponding offsetting entry is not explicitly prescribed by the guidance and depends on the nature of the transaction in which the guarantee was issued.
- **CECL Consideration:** Guarantees (contingent aspect) in the scope of ASC 460 that create off-balance sheet credit exposure for the guarantor are also in the scope of CECL. The reporting entity is required to forecast the amount of losses that will be incurred and the likelihood of those losses occurring based on historical information and market conditions.

6.3.2 Best Practices

- **Scope:** Identify all financial guarantees that must be accounted for at fair value at inception.
- **Recognition:** Determine if engaging a valuation expert is necessary. Determine which model will be used to calculate the guarantee related CECL reserves.
- **Documentation:** Maintain comprehensive records for each guarantee entered into, including the calculation of its fair value at inception.

7 Other

7.1 Overview – Related Party Transactions

A real estate company's connections and relationships are vast; consequently, transactions with related parties are extensive. ASC 850-10-50, *Related Party Disclosures*, requires all related party transactions to be disclosed. This includes, but is not limited to:

- a) Guarantees of a reporting entity's debt by its principal stockholders or other related parties.
- b) Certain information about each guarantee, or group of similar guarantees for which the reporting entity is the guarantor.
- c) A general description of any leasing arrangements, including a description of leasing transactions with related parties (as lessor or lessee).
- d) Certain information on sales, purchases, and transfers of real and personal property.
- e) Certain information on advances to and receivables from related parties.

In addition, the following transactions often require special consideration when the counterparty is a related party:

- a) ASC 470-50, *Debt-Modification and Extinguishments*, provides guidance on whether it is appropriate to recognize any associated gain or loss in the income statement in connection with a debt restructuring.
- b) ASC 460, *Guarantees*, provides guidance on the accounting (recognition and measurement) around guarantees provided by the reporting entity in connection with equity method investee debt.
- c) ASC 805, *Business Combinations*, provides special considerations when accounting for sales, purchases, and transfers of real and personal property between a specific type of related party – entities under common control.

7.1.1 Key Concepts

- **Recognition:** Related party transactions often require special presentation and disclosure that deviates from how a similar transaction with third parties would be recorded in the financial statement.
- **Disclosure:** Information about the related party transactions must be disclosed in the financial statements under ASC 850. Other areas of U.S. GAAP may require disclosure of related party balances on the face of the financial statements, such as amounts owed to or from related parties, and revenues generated from sales to related parties.

7 Other

7.1.1 Key Concepts (*Continued*)

- **Common Control Transactions**

- **Definition:** Although no official definition within the codification, common control is generally expected to exist when:

- An individual or entity owns more than 50 percent of the voting interests in both the reporting entity and the legal entity.
- Immediate family members (which includes a married couple, their children, and their grandchildren) own more than 50 percent of the voting interests in both the reporting entity and the legal entity and there is no evidence to suggest they will not vote their shares in concert.
- A group of shareholders own more than 50 percent of the voting interests in both the reporting entity and the legal entity and there is contemporaneous written evidence that this group has agreed to vote a majority of the voting interests in a block.

- **Transfers:** Transfer of a business or a combination of businesses between entities under common control typically result in a change in the reporting entity. For real estate companies, transfers of real estate assets typically do not meet the definition of a business and in turn do not result in a change in the reporting entity. Special consideration is required for real estate sales between entities under common control as step up in basis to fair value is typically not allowed.

7.1.2 Best Practices

- **Scope:** Familiarize yourself with the definitions of a related party and common control in U.S. GAAP. ASC 850-10-20 defines a related party and provides examples.
- **Recognition:** For all transactions with related parties, ensure that any relevant U.S. GAAP has been evaluated that may require special accounting considerations.
- **Data Maintenance:** Have a system in place to track related party transaction to ensure the financial statement disclosures are complete.

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