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Accounting for real estate transactions where circumstances indicate that profits were not earned at the time the transactions were recorded

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SECURITIES ACT OF 1933
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ACCOUNTING SERIES
Release No. 95

ACCOUNTING FOR REAL ESTATE TRANSACTIONS WHERE CIRCUMSTANCES INDICATE THAT PROFITS WERE NOT EARNED AT THE TIME THE TRANSACTIONS WERE RECORDED

A number of recent cases have come to the attention of the Commission in which the gross profits on certain real estate transactions were taken into income under circumstances which indicate that they were not realized in the period in which the transactions were recorded.

The recognition of profit at the time of sale, in accordance with generally accepted accounting principles, is appropriate if it is reasonable to conclude, in the light of all the circumstances, that a profit has been realized. "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." 1/ Thus, recognition of profit is appropriate only when a bona fide sales transaction has taken place, and then only to the extent that the consideration received in the transaction can be reasonably evaluated.

In some of the situations coming before us it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for the sale of securities. Moreover, even in bona fide transactions the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition of gain at the time of sale. Circumstances such as the following tend to raise a question as to the propriety of current recognition of profit:

1. Evidence of financial weakness of the purchaser.

2. Substantial uncertainty as to amount of costs and expenses to be incurred.

3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement; e.g., nonrecourse notes, non-interest-bearing notes, purchaser's stock, and notes with optional settlement provisions, all of indeterminable value.

1/ Accounting Research Bulletin No. 43, Chapter 1, Section A, American Institute of Certified Public Accountants.

4. Retention of effective control of the property by the seller.

5. Limitations and restrictions on the purchaser's profits and on the development or disposition of the property.

6. Simultaneous sale and repurchase by the same or affiliated interests.

7. Concurrent loans to purchasers.

8. Small or no down payment.

9. Simultaneous sale and leaseback of property.

Any such circumstance, taken alone, might not preclude the recognition of profit in appropriate amount. However, the degree of uncertainty may be accentuated by the presence of a combination of the foregoing factors. In the following illustrative cases, taken from recent filings, the Commission deemed it inappropriate to recognize gross profit as recorded as having been realized at the time of sale.

Case No. 1

On the last day of its fiscal year a registrant engaged principally in the development of real estate sold a block of 1,000 lots to a nonaffiliated construction company for $1,100,000, receiving a cash payment of $100,000 and a nonrecourse note of $1,000,000 due in one year, secured only by the lots transferred. Interest was limited to 6% for one year or $120 per house. A profit of $500,000 before taxes was recorded on the transaction.

The transaction was subject to, among others, the following conditions and arrangements:

a. Each lot was to be released upon payment of $1,000 plus interest at the time of closing the sale of a house and lot.

b. The registrant was to make the determination of when the houses were to be constructed and to arrange the construction loans.

c. The registrant was to be exclusive sales agent for the construction company, arrange financing and conduct closings with the home buyers.

d. The construction company was to be paid a maximum of $500 profit and an additional $100 to cover overhead expenses on each house sold. Profits to be received by the construction company were to be applied against the note owed to the registrant.

Case No. 2

In September 1961 a registrant sold a block of improved properties to another corporation for consideration of $3,500,000 in cash, a $3,500,000 non-interest-bearing note, and 50,000 shares of the Class A stock of the purchaser which had a current market price of $15 per share. This sale was recorded at these amounts and showed a gain of $2,000,000 after provision of $500,000 for possible loss and $1,000,000 for Federal income taxes. The non-interest-bearing note is payable during the period from 1970 to 1980. Until 1968 the purchaser has the option of liquidating the note by the issuance of capital stock, the number of shares to be determined by dividing the face amount of the note, $3,500,000, by the lesser of $15 per share or 125% of the then current market price. After 1968 registrant may call for payment of the note in stock at $17 per share, and, if such call is made, the purchaser may elect to pay the note in full in cash.

Case No. 3

In September 1961 a registrant acquired approximately 500 acres of undeveloped land for $300,000 in cash and a mortgage of $900,000 and immediately sold the property to an affiliate of the original seller for $2,200,000. The purchaser paid $300,000 in cash, issued a $1,000,000 non-interest-bearing deed of trust note maturing in 18 months, and assumed the $900,000 mortgage. Simultaneously the registrant loaned $1,000,000 to the purchaser on a 6% note maturing in 18 months and made a commitment to loan an additional $1,000,000. Registrant recorded a gross profit of $1,000,000 against which a reserve for possible loss in the amount of $260,000 was provided.

Case No. 4

In June 1961 a registrant purchased 20,000 acres of undeveloped land for $1,000,000 cash and a 5% note for $3,000,000. Simultaneously, the registrant sold the property to another company for a $2,000,000 non-interest-bearing deed of trust note payable in installments of $1,000,000 in June 1962, $500,000 in June 1963, and $500,000 in June 1964, and for the assumption by the purchaser of the $3,000,000 first lien note. A gross profit on the sale of $1,000,000 was recorded and a reserve of $400,000 was provided for a possible loss.

Case No. 5

A registrant purchased a tract of land for a cash payment of $100,000 and a 10-year nonrecourse non-interest-bearing note in the amount of $800,000 with annual maturities of $80,000. On the same date the land was sold to a non-affiliated group for a cash payment of $15,000 and a nonrecourse non-interest-bearing purchase money note for $1,785,000. The latter obligation requires annual payments of approximately $100,000 for seven years and a payment of approximately $1,100,000 at the end of the eighth year. At the time of the sale the registrant also advanced to the purchaser $350,000 for use in advertising. The proceeds from the sales of land by the purchaser are assigned to the registrant until the $350,000 advance is paid. The registrant recorded a profit of $900,000 at the date of sale.

Case No. 6

Shortly before the close of its fiscal year a registrant recorded the sale of a block of 150 lots for a total consideration of $375,000. Cash of $75,000 was paid on the settlement date and the purchaser then took title to 30 lots. The balance of the consideration consisted of four notes of $75,000 each bearing interest at 5% per annum, due 6, 12, 18, and 24 months after settlement. The purchaser was to take title to 30 lots at the time of settlement of each note. The notes were secured only by a mortgage on the property, and there was no personal liability on the purchaser to complete the payments. In a registration statement filed shortly after the close of the fiscal year this transaction was recorded as a sale in the total amount of $375,000 with an indicated gross profit of $44,000 on the uncollected portion after provision for deferred taxes of $47,000.

Case No. 7

In early 1960 a registrant sold to an unaffiliated purchaser a manufacturing plant and another building used in its operations for a total consideration of $1,500,000 reflecting a profit of $600,000 after taxes. The consideration was realized in the form of cash and assumption of an existing mortgage. The seller simultaneously leased these same properties back at an annual rental of $160,000 for a period of 25 years. The registration statement as effective reported the profit as deferred and to be amortized against rental payments over the life of the leases.

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