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Application of the deposit, installment, and cost recovery methods in accounting for sales of real estate; a proposed recommendation to the Financial Accounting Standards Board; Statement of position 78-04;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position on

78-4

Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate

June 30, 1978

A Proposed Recommendation to the
Financial Accounting Standards Board

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTE

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 30, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying draft of statement of position, *Application of the Deposit, Installment, and Cost Recovery Method in Accounting for Sales of Real Estate,* has been prepared on behalf of the accounting standards division by the AICPA's committee on real estate accounting and approved by the accounting standards executive committee.

The statement is an interpretation of the AICPA accounting guide, *Accounting for Profit Recognition on Sales of Real Estate,* issued in 1973. It presents the division's recommendations on the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate. Diverse methods of application of those accounting methods have developed in practice, and the objective of the statement is to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

Accounting Standards Division

Accounting Standards Executive Committee

Committee on Real Estate Accounting

AICPA Staff

Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate

Questions have arisen about the application of the general principles and specific conclusions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate,* issued in 1973. The accounting standards division addressed some of those questions in Statement of Position 75-6 (December 29, 1975). This statement presents recommendations as a result of questions concerning the application of the deposit, installment, and cost recovery methods in accounting for sales of real estate, which are discussed in paragraphs 34 to 37 of the accounting guide. Diverse methods of application of those accounting methods have developed in practice. The division believes that narrowing the range of alternative practices is desirable.

The Deposit Method

General

Accounting under the deposit method is described in paragraph 35 of the accounting guide as follows:

> The deposit method postpones recognizing a sale until a determination can be made as to whether a sale has occurred for accounting purposes. Pending recognition of the sale, the seller records no receivable but continues to show in his financial statements the property and related existing debt and discloses the status of the property. Cash received from the buyer is reported as a deposit on the contract except that portions of cash received that are designated by the contract as interest and are not subject to refund may appropriately offset carrying charges (property taxes and interest on existing debt) on the property.

Except as indicated in the last sentence above, the seller's balance sheet should report all cash received from the buyer, including the initial down payment and subsequent collections of principal and interest, as a deposit (liability) on the contract. The seller's balance sheet should not report notes receivable arising from the transaction but should continue to report the property and any related mortgage debt assumed by the buyer and disclose that those items are subject to a sales contract. Nonrecourse debt assumed by the buyer should not be offset against the related property. Until the seller reports the sale, the buyer's principal payments on the mortgage debt assumed should be reported on the seller's balance sheet as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

Forfeiture of Nonrefundable Deposits

When a buyer defaults or otherwise forfeits a nonrefundable deposit, the seller should credit the deposit account to income. The seller should evaluate whether the circumstances underlying the forfeiture indicate a decline in the value of the property for which an allowance for loss should be provided.

Depreciation

Since, under the deposit method, the seller accounts for the property as if it were still owned, the accounting standards division believes a legal sale should not cause the seller to stop recording depreciation. While some believe that depreciation may be charged to the deposit account to the extent that the deposits are not refundable, the division believes that practice is not consistent with the concepts underlying the deposit method and that depreciation should continue to be charged to expenses as a period cost.

Provision for Losses

Under the deposit method, no sale is reported by the seller even if the terms of the transaction indicate that a loss has been incurred (for example, when the indicated sales value is less than the carrying amount of the property). The seller, however, should report the loss by a charge to income and as a valuation allowance against the property. The net carrying amount of the property, less the debt assumed by the buyer, should not exceed the sum of the recorded value of the consideration received and the fair value of the unrecorded note receivable.

If, at any time after the transaction, circumstances indicate that the buyer is likely to default and the property will revert to the seller, a provision for an additional loss may be required.

Sales Recognition

The seller does not report a sale and continues to use the deposit method until the conditions for recording a sale, as specified in the accounting guide, are met. Interest collected and included in the deposit account during the period before a sale is reported should be accounted for as additional sales proceeds at the time of recording the sale.[1]

The Installment Method

General

When the substance of a real estate transaction indicates that a sale has occurred for accounting purposes, but collectibility of the total sales price cannot be estimated reasonably, the installment method may be appropriate unless circumstances such as those described in paragraphs 28 and 36 of the accounting guide indicate that the cost recovery method is appropriate. The installment method apportions the down payment and each subsequent collection of principal between cost recovered and profit recognized in the same ratio as cost and profit are presumed to constitute the sales value.

Debt Assumed by the Buyer

In some real estate sales transactions, the buyer assumes an existing mortgage loan. If the seller is contingently liable for the assumed debt, the seller has a risk of financial loss that is similar to the risk the seller would have if the debt had not been assumed and the seller's receivable from the buyer had been increased by the amount of the debt assumed by the buyer. If the

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[1] See the section entitled "Cumulative Application of Tests When Recognition of Sale Is Delayed" in Statement of Position 75-6, *Questions Concerning Profit Recognition on Sales of Real Estate.*

seller is not contingently liable for debt assumed by the buyer (for example, if the buyer assumes a nonrecourse mortgage loan), some believe that, as cash payments are received by the seller, the portion of the profit recognized as earned under the installment method should be determined by the percentage of the cash received to the total cash to be received by the seller. The accounting standards division believes, however, that, for the purpose of applying the installment method, there should be no distinction between recourse and nonrecourse debt assumed by the buyer, because the seller may be motivated to honor the debt assumed by the buyer for various reasons, even though the seller is not contingently liable for the debt.

Therefore, under the installment method, profit should be recognized on cash payments including principal payments by the buyer on the debt assumed and should be based on the percentage of total profit to total sales value (including the first mortgage debt assumed by the buyer). The following illustrates the calculation.

Assumptions:

Cash down payment	$ 150,000
Second mortgage payable by buyer to seller (10-year amortization of principal plus interest)	350,000
Total cash to be received by seller	500,000
First mortgage assumed by buyer (20-year amortization of principal plus interest)	500,000
Total sales price and sales value	1,000,000
Cost	600,000
Total profit	$ 400,000

The down payment is assumed to be inadequate for full profit recognition, and the installment method of accounting is assumed to be appropriate. It is also assumed that, subsequent to the down payment, the buyer pays $25,000 of principal on the first mortgage and $35,000 of principal on the second mortgage.

Profit recognition attributable to down payment:

Under the installment method, profit recognition attributable to the down payment is $60,000, representing 40 percent ($400,000 ÷ $1,000,000) of $150,000.

Profit recognition attributable to the principal payments on the first and second mortgages:

Under the installment method, profit recognition attributable to the principal payments by the buyer on the first and second mortgages is $24,000, representing 40 percent of $60,000 ($25,000 + $35,000).

Financial Statement Presentation

The form of financial statement presentation under the installment method is illustrated in exhibit II, pages 31-33 of the AICPA industry accounting guide, *Accounting for Retail Land Sales* (1973). At the time of sale, the income statement should present the total sales value, from which the deferred gross profit should be deducted, and the total cost of the sale. Deferred gross profit should be presented on the balance sheet as a deduction from the related receivable. Deferred gross profit subsequently recognized as earned should be presented as a separate item of revenue on the income statement.

The Cost Recovery Method

General

When the substance of a real estate transaction indicates that a sale has occurred for accounting purposes but that no profit should be recognized until costs are recovered because of the requirements of paragraphs 28 or 36 of the accounting guide, the cost recovery method must be used. In addition, the cost recovery method may be elected initially to report transactions for which the installment method is permitted.

Under the cost recovery method, no profit is recognized until cash collections, including both principal and interest, and existing debt assumed by the buyer exceed the cost of the property sold.[2]

[2] For an all-inclusive or "wrap-around" receivable held by the seller, interest collected may be recognized as income to the extent of, and as an appropriate offset to, interest expense on prior lien financing for which the seller remains responsible.

Financial Statement Presentation

At the time of sale, the income statement should present the total sales value, from which the deferred gross profit should be deducted, and the total cost of the sale. Deferred gross profit should be presented on the balance sheet as a deduction from the related receivable. Principal collections should be used to reduce the related receivable. Interest collections on such receivable should be used to increase the deferred gross profit on the balance sheet. Deferred gross profit subsequently recognized as earned should be presented as a separate item of revenue on the income statement.

Change From Installment or Cost Recovery Method to Full Accrual Method

When developments subsequent to the adoption of the cost recovery or installment method provide evidence that collectibility of the sale price is reasonably assured, a change should be made to the full accrual method. In the absence of other conditions requiring deferral of profit (such as the seller's continued involvement with the property sold or a decline in its value), the remaining deferred profit should be recognized in income at that time. For example, even though a nonrecourse debt assumed by the buyer having a prior lien on the property sold is not fully paid, a seller should ordinarily change from the installment or cost recovery method to the accrual method no later than the time the seller's receivable from the buyer is collected. Another circumstance that might ordinarily, but not necessarily, provide reasonable assurance that the remaining uncollected balance of the sales price is collectible would be collection, on a cumulative basis from the date the sale was first recorded on the installment or cost recovery basis, of the aggregate cumulative amounts contemplated by paragraphs 20, 21, and 25 of the accounting guide (for this purpose collections should be in cash or the other forms of payment specified in paragraphs 22 through 24 of the guide), with the buyer's continuing investment thereafter meeting the guide's requirements.

The accounting standards division believes that a change from the cost recovery or installment method of reporting profit on a sale of real estate to the full accrual method as a result of changed conditions is not a change in accounting principles. However, if the change has a material effect on the seller's financial position or results of operations, the seller's financial statements should disclose the effect of, and the reason for, recognizing as income the profit on the uncollected portion of the sales value.

Transition

The accounting standards division recommends the application of the provisions of this statement prospectively to transactions consummated in fiscal years beginning after June 30, 1978. Earlier application is encouraged for transactions consummated in fiscal years beginning before July 1, 1978, for which financial statements have not previously been issued.