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American Institute of Certified Public Accountants. Committee on Accounting for Real Estate

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An AICPA Industry Accounting Guide

Accounting for Profit Recognition on Sales of Real Estate

AICPA
American Institute of Certified Public Accountants

Notice to Readers

This AICPA industry accounting guide is published for guidance of members of the Institute in examining and reporting on financial statements of companies in the real estate industry and other companies involved in real estate transactions. It represents the considered opinion of the Committee on Accounting for Real Estate Transactions and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

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Accounting for Profit Recognition on Sales of Real Estate

Prepared by the Committee on Accounting for Real Estate
Transactions of the American Institute of Certified Public Accountants

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Introduction

1. In recent years, real estate transactions have become highly complex, and their legal form often obscures their economic substance. Increased public ownership of companies that deal in real estate and the creation of new types of investments in real estate have increased the need to reevaluate accounting for real estate transactions.

2. Accounting Series Release No. 95, issued by the Securities and Exchange Commission in 1962, included selected examples of real estate transactions in which the Commission deemed it inappropriate to recognize profit at the time of sale. However, the Release did not anticipate the diversity and complexity of real estate transactions of recent years.

3. The American Institute of Certified Public Accountants established the Committee on Accounting for Real Estate Transactions in August 1971 to appraise accounting practices in the real estate industry and to recommend changes in present practice to senior technical committees of the Institute. A separate Committee on Land Development Companies has issued an AICPA industry accounting guide, *Accounting for Retail Land Sales*, which is concerned with accounting for retail sales of lots. This guide therefore covers accounting for all other real estate sales transactions, including sales of lots to builders (other than a sale of a lot meeting the criteria of paragraph 9 of *Accounting for Retail Land Sales*) and sales of homes, buildings, and parcels of land to builders and others.

4. This guide covers primarily the timing of profit recognition on real estate sales. It does not cover other aspects of real estate accounting such as accounting for assets and liabilities, accounting for cost of real estate, imputing interest, or disclosing

real estate transactions in financial statements. Sale and leaseback transactions should be accounted for in accordance with the provisions of this guide and APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee* (particularly paragraphs 21 and 22). This guide does not cover exchanges of real estate for other real estate, the accounting for which is covered in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*.

5. The Committee believes that the matters with the greatest impact on the timing of profit recognition are (a) the extent of the buyer's investment in the property required to give reasonable certainty to collection of the seller's receivables and (b) continuing involvement of the seller with property sold. Therefore, after summarizing the general principles applicable to accounting for real estate transactions and defining the time of sale for purposes of recognizing profit on real estate transactions, the remainder of the guide discusses applying the general principles to specific aspects of those two areas.

General Principles

6. To narrow existing differences in practice in recognizing profit from real estate transactions, the Committee has considered in particular references in Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* to the principle of realization (paragraphs 148 through 153) and the importance of considering the substance rather than merely the form of business transactions (paragraph 127).

Recognizing Revenue and Profit

7. Revenue (and profit) is conventionally recognized at the time an asset is sold, provided (a) the amount of the revenue is measurable—that is, the collectibility of the sales price is reasonably assured or the amount uncollectible can be estimated—and (b) the earnings process is complete or virtually complete—that is, the seller is not obliged to perform significant activities after the sale in order to earn the revenue. Unless both conditions exist, recognition of all or part of revenue and/or profit on a sale transaction is postponed.

8. If no reasonable basis exists to estimate the collectibility of the sales price in a transaction, the installment or cost recovery method of accounting is appropriate. Both methods have the effect of basing profit recognition on collections: the installment method accounts for each collection as part recovery of cost and part profit realized; the cost recovery method accounts for all cash received as recovery of cost until cost is fully recovered and thereafter recognizes all cash received as realized profit (APB Opinion No. 10, paragraph 12).

9. Uncertainty about collectibility of the sales price may require another method of accounting in which the effective date of a sale is deferred until the uncertainty is satisfactorily resolved. No revenue or profit is recognized before the date the sale is considered to be effective, and all cash received before then is accounted for as a deposit on the sales price.

10. If the earnings process is incomplete, the basis of profit recognition shifts from the time of sale to the time of seller's performance. The occurrence of a sale is prerequisite to profit recognition, but profit is recognized only when the seller performs those acts that earn the revenue. Under rigid conditions, revenue may be recognized by a percentage of completion method before the earnings process is complete or virtually complete. When cash collections exceed the earned revenue (e.g., determined under the percentage of completion method), the excess should be deferred as unearned revenue to be recognized as income as the earnings process is completed.

Substance Over Form

11. Economic substance should determine the timing of recognition, amount, and designation of revenue if the economic substance of a transaction differs from its legal form. Economic substance of a transaction may differ from its legal form in several ways. For example, a transaction that is in the legal form of a sale (that is, title to or possession of a product or other asset is transferred in exchange for cash or a promise to pay cash) may be in economic substance (a) a construction contract, (b) a contract for services for a fee, (c) a lease for use of product or property, (d) an agreement to loan or borrow funds, (e) an agreement establishing a joint venture, (f) an agreement to divide profits in a specified ratio, (g) a deposit on or an option to purchase the asset, or (h) a sale of something (for example,

depreciation or other deductions for income taxes or a right to participate in profits from operating the asset) other than the asset that is the apparent object of the "sale." Thus, instead of recognizing revenue and profit on the sale of the product or other asset, the appropriate accounting may be to recognize revenue and profit during or after construction on the percentage of completion or completed contract method, as services are rendered, as rent accrues, as interest accrues, by consolidation or the equity method when earnings are reported, or by some other method that reflects the essence of the transaction. The substance of a single transaction may contain elements of two or more types of transactions.

12. Careful analysis of a transaction is necessary to determine the appropriate accounting for it. To be accounted for as a sale, a transaction should transfer from the seller to the buyer (a) the usual risks of ownership (for example, obsolescence, unprofitable operation, unsatisfactory performance, idle capacity, and dubious residual value) and (b) all or most of the rewards of ownership (for example, profitable operation and gain from appreciation in value). Any risk that is retained by the seller in the asset sold should be limited essentially to that of a secured creditor. Otherwise, accounting for a transaction other than as a sale is required. Examining the rights and obligations of the parties under the contract, the patterns of cash flows, the nature of the interest retained by the "seller," and the like should indicate the substance of the transaction and the method of accounting that should be applied.

13. If, at the time of sale, the terms of the transaction are such that the buyer may expect to recover his investment plus a return through assured cash returns, subsidies, and net tax benefits, even if he were to default on his debt to the seller, the transaction is probably not in substance a sale (paragraphs 11, 12, 42, and 56).

Time of Sale

14. Since an exchange transaction is generally a prerequisite to recognizing profit, the Committee concludes that a sale must be consummated before recognizing profit on a sale of real estate. That is, the sale must be consummated prior to the end of the accounting period in which it would be reported. A sale is con-

summated when the parties are bound by the terms of a contract, all consideration has been exchanged, and all conditions precedent to closing have been performed. Usually all of those conditions are met at the time of closing, not at the time of a contract to sell or a preclosing.

Buyer's Investment in Purchased Property

15. A real estate sale differs from most business transactions because a significant portion of the consideration is often a note or other receivable collectible over a relatively long period, and the receivable is normally not supported by the full faith and credit of the buyer. Thus, often the only recourse of the seller on default by the buyer is to recover the property sold. For legal and business reasons, sellers usually limit themselves to foreclosure to remedy defaults, even if the terms of the agreements provide for full recourse against the buyers. Cash equivalency of a note issued to a seller, which is supported by the full faith and credit of the buyer, can be clearly established, however, by (a) a sale of the note (without recourse to the seller) or (b) the buyer obtaining an irrevocable letter of credit for the amount of the note from an established lending institution. Unless its cash equivalency is thus established, a receivable supported by the full faith and credit of the buyer or other consideration is to be considered for the purposes of this guide to be the same as a receivable in which a seller has right of recourse only to the property sold.

16. Since uncertainty about collectibility of a receivable in a real estate sale may be greater than in other commercial transactions, recognizing profit at time of sale requires additional assurance that the sales price will be collected from the buyer. The Committee concludes that such additional assurance of collectibility depends on a significant investment in the property by a buyer. The investment must be large enough to give a buyer a stake in the property sufficient that the risk of loss through default motivates him to honor his obligation to a seller.

17. The Committee concludes that to recognize revenue and profit on a sale of real estate, a buyer's initial investment and his continuing investment should both be adequate to demonstrate his commitment to pay for the property. Paragraphs 18 through 33 set forth the Committee's meaning of an adequate initial investment and an adequate continuing investment by a buyer.

Buyer's Initial Investment

18. The Committee concludes that the factors to be evaluated in determining whether a buyer's initial financial investment to purchase real estate is sufficient to indicate a reasonable likelihood of the seller's collecting the receivable from the buyer are (a) the relative size of the buyer's down payment compared to the sales value (not necessarily the stated sales price) of the property and (b) the composition of the down payment. Sales value is a stated sales price increased or decreased for other consideration that clearly constitutes additional proceeds on the sale, services without compensation, imputed interest, and so forth.

Relative Size of Down Payment

19. The Committee believes that lending practices of institutions on various types of real estate provide a reasonable basis for assessing the degree of collectibility of receivables from buyers. Established lending institutions ordinarily loan between 50% and 95% of the value of real estate, depending on regulatory limitations and their own assessments of the reliability of the income from the property and other resources of the borrower to repay loans and interest. Loans in excess of those ordinary limits are more risky and less liquid than those within the limits.

20. Accordingly, the Committee concludes that recognizing the full profit at the time of sale is inappropriate unless a buyer has paid a down payment equal to a major part of the difference between usual loan limits and the sales value of the property. The Committee has developed minimum down payments (Exhibit A, page 22) based on usual loan limits for various types of properties. However, lenders' appraisals of specific properties may differ. Therefore, the Committee concludes that, if a newly placed permanent loan or firm permanent loan commitment for maximum financing of the property exists with an independent established lending institution, the minimum down payment needed to recognize profit on a sale of real estate should be the greater of (a) the amount derived from Exhibit A or (b) the amount by which the sales value of the property exceeds 115% of the amount of loan or commitment by the primary lender.[1]

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[1] Usually, a down payment equal to 60% of the difference between a lender's appraisal of the value of the property and a maximum first lien loan will also be equal to or greater than the difference between the sales value and 115% of the primary loan.

21. Notwithstanding the tests in paragraph 20, the Committee believes that in most instances a down payment of 25% of the sales value of the property is an initial financial investment by a buyer adequate to support recognizing profit at the time of sale. The Committee also recognizes that even if the required down payment is made, collectibility of the seller's receivable must be assessed in the context of other factors that affect the likelihood of a buyer paying his obligations to the seller, such as credit standing of the buyer, age and geographical location of the property, and adequacy of cash flow from the property.

Composition of Down Payment

22. The Committee believes that to recognize profit on the sale of real estate a seller should receive a down payment in cash on or before the time of sale. Buyer's notes supported by irrevocable letters of credit from an established lending institution also constitute satisfactory consideration to establish a buyer's initial investment. Other consideration received, including other notes of the buyer, constitute down payments only at the time they are sold or otherwise converted to cash without recourse to the seller. Funds that have been or will be loaned to the buyer or otherwise provided directly or indirectly by the seller cannot be included in determining the buyer's investment in the property.

23. A buyer may also invest in the property by paying third parties to reduce previously existing indebtedness on the property. Provided such additional investments can be verified, payments to third parties to reduce existing indebtedness may be included in a down payment to determine whether percentage requirements specified in this guide are satisfied. Payments by the buyer to third parties for improvements to the property should not be included.

24. A buyer may often pay amounts to a seller at the time of sale that do not apply against the stated sales price of the property under the terms of the contract. Although designated as management fees, points, etc., some payments may in substance be additional sales proceeds and therefore represent a financial investment in the property by the buyer. Or, a buyer may prepay interest or fees that by the terms of the contract are maintained in an advance status and are applied against principal at a later date. These types of payments and prepayments should be included in full in determining the amount of the down payment and

sales value of the property to determine whether the down payment satisfies requirements specified in this guide. If initial amounts of prepaid interest or fees are not maintained in an advance status, they should not be included in a down payment or sales value to determine whether requirements are met.

Buyer's Continuing Investment

25. The Committee concludes that a seller should recognize the profit on a sale of real estate at time of sale only if the buyer is required to continue to increase his investment in the property each year after he pays an adequate down payment. Accordingly, recognition of the full profit on a sale of real estate is appropriate at the time of sale only if (a) the buyer's initial investment is adequate (paragraphs 18 through 24) and (b) payments by the buyer each year on his total indebtedness for the purchase price of the property are by contract at least equal to the level annual payment that would be needed to pay the total indebtedness, including interest on the unpaid balance, over a specified maximum period. The specified maximum period is 20 years for indebtedness for land and the customary term of a first mortgage loan by an independent financial institution for receivables for other real estate. Payments (including lump sum payments) during the specified period that are in excess of those needed to meet the test of buyer's continuing investment do not affect the timing of profit recognition. Payments by the buyer on his indebtedness on the property should be in cash or other form specified in paragraphs 22 through 24 as acceptable for a down payment. Funds to be provided directly or indirectly by the seller cannot be included in buyer's investment for this test.

26. As indicated above, even though a buyer pays an adequate down payment, his debt on the property that by its terms will not be paid within the customary term of a first mortgage loan (or 20 years for a loan on land) raises questions about his commitment to pay fully his debt to the seller. If periodic payments on indebtedness by a buyer do not meet the test of continuing investment in paragraph 25, but payments by the buyer each year will be at least equal to annual level payments of principal and interest on the maximum first lien indebtedness that could be obtained on the property plus interest at an appropriate rate on the excess of aggregate actual indebtedness on the property over such maximum first lien indebtedness, the seller should recognize a reduced profit determined at the time of

sale. Such reduced profit should be determined by applying an appropriate rate (but not less than the stated interest or discount rate) to reduce the receivable from the buyer to its present value based on the lowest level of annual payments required by the contract over the maximum period specified in paragraph 25 without including requirements to pay lump sums. The result of the accounting described in this paragraph is to recognize profit on the sale of real estate only from level payments on the receivable over the maximum term referred to in paragraph 25 and to postpone recognition of other profits until lump sum or other payments are received.

Cumulative Application of Tests

27. Tests of adequacy of a buyer's initial and continuing investment described in paragraphs 18 through 26 should be applied cumulatively—at the closing date and annually afterwards. Thus, for example, if a down payment exceeds the minimum prescribed, the excess may be applied toward meeting the requirements for specified annual increases in buyer's investment.

Receivables Subject to Subordination

28. The effect of future subordination on collectibility of a receivable usually cannot be reasonably evaluated. Therefore, profit recognized at the time of sale should be limited to amounts determined under the cost recovery method (paragraph 36) if the seller's receivable is subject to later subordination. The restriction does not apply to (a) a receivable subordinate to a primary lien on the property existing at the time of sale, or (b) a future loan (including an existing permanent loan commitment) the proceeds of which must be applied first to the payment of the seller's receivable.

Release Provisions

29. An agreement to sell property, usually land, may provide that part or all of the property may be released from liens securing related debt if specified conditions are met, often including payment of a release price. Since payments by the buyer thus often apply first to released property, tests of a buyer's initial and

continuing investment apply primarily to the relation between sales value of unreleased property not subject to release and unpaid debt on the property. That is, to recognize profit at the time of closing, a buyer's investment should include payments sufficient both to pay release prices on released property and to constitute an adequate initial and continuing investment, as described in paragraphs 18 through 27, on property not released or not subject to release. Otherwise, profit should be recognized as if each release were a separate sale.

Sale of Improvements and Concurrent Lease of Land

30. If property improvements are sold subject to a lease of the underlying land to the buyer of the improvements, the computation of the relative size of a down payment in relation to the sales value of the property to determine the adequacy of the buyer's initial investment (paragraphs 18 through 24) should include the effect of the lease. That is, the sales value of the property (and the buyer's indebtedness on the property) should include the present value of the lease payments specified in the lease over the term of the primary indebtedness on the improvements or over the customary term of primary debt instruments on the type of improvements involved. Present value of the specified lease payments should be computed at an interest or discount rate appropriate for primary debt if the lease is not subordinated or for secondary debt if the lease is subordinated to loans with prior liens.

31. The lease affects only the tests of buyer's initial investment if the lease is between the buyer and a third party lessor (Exhibit B, Items 1 and 2). If the seller of the improvements is also the lessor of the land, however, the lease also affects the calculation of profit on the sale of the improvements.

32. Distinguishing between profit on sale of improvements and profit under the related lease is impracticable in a transaction in which there is a sale of property improvements and a concurrent lease of the underlying land to the buyer by the seller of the improvements because the results are interdependent. The Committee therefore concludes that in the typical situation (Exhibit B, Items 3 and 4) the profit to be recognized on sale of the improvements should be computed by deducting the sum of the cost of the improvements and the cost of the land from the sum of the sales value of the improvements and the present value of

the lease payments (but not in excess of the cost of land), determined as described in paragraph 30. The result is to defer recognizing profit from the residual value of the land or from rentals on the land after the maturity of the primary indebtedness on the improvements or other customary term (see paragraph 30) until the land is sold or the rental payments are received. Profit to be recognized on sale of the improvements should not be *increased* by profit inherent in the land lease since such profit is not realized until rentals are accrued under the lease.

33. The method of accounting prescribed in paragraph 32 is not appropriate if the term of the lease of land to the buyer from the seller of the improvement either (a) does not cover substantially all of the economic life of the property improvements (thus strongly implying that the transaction is in substance a lease of both land and improvements) or (b) is not of substantial duration, e.g., 20 years. The Committee concludes that if either circumstance exists, the transaction should be accounted for as a lease of the land and improvements.

Inadequate Buyer Investment

34. If the buyer's initial and continuing investment in the property in a real estate transaction fails to conform to the requirements specified in this guide, a method of recognizing revenue that is appropriate to the circumstances of the transaction should be selected. As already noted in paragraphs 8 and 9, inability to estimate reasonably the collectibility of sales price in a transaction normally leads either to methods that defer recognizing a sale until the uncertainty about collectibility is resolved or to methods that recognize profit as cash is collected, that is, to installment or cost recovery methods.

Deposit, Installment, and Cost Recovery Methods

35. 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.

36. The installment and cost recovery methods defer recognition of profit until collections are received. The cost recovery method accounts for all cash received as recovery of cost with no recognition of deferred profit until cost is fully recovered and thereafter accounts for all cash received as profit. The installment method apportions each cash receipt between cost recovered and profit recognized in the same ratio as cost and profit are presumed to constitute the sales value. Since default on loans secured by real estate usually results in recovery of the real estate sold, the installment method would usually be appropriate. Where there is (a) uncertainty as to whether all or even a portion of cost will be recovered upon default by the purchaser or (b) cost has already been recovered in the sale and collection of further proceeds is uncertain, the cost recovery method is appropriate rather than the installment method.

37. Under any of these methods of accounting for sales using deferred recognition, caution should be exercised that the recorded asset amounts less deferred profit, if any, do not exceed the depreciated values had the property not been sold. It would be inappropriate to avoid charging losses in value to income by accomplishing a thinly financed "sale" under which the risk of losses in value continue to rest with the seller. Under these circumstances, the transaction is probably not in substance a sale (paragraphs 11 through 13, 42, and 56).

Seller's Continued Involvement With Property Sold

38. A seller frequently continues to be involved over extended periods with property that he has legally sold. Continued involvement may include a seller's arranging financing; managing, developing, or constructing the property; guaranteeing a return to the investor (buyer); or initiating and supporting operations of the property after the sale, either through a single contract or a succession of contracts relating to the same property or project.

39. A relatively common example of a seller's continuing involvement with the property is a real estate syndication. Often real estate is sold to a group of passive investors who, in exchange for their investment, receive substantial tax benefits, perhaps some cash flow from operation of the real estate, and a potential future gain on resale of the property. Commonly, a lim-

ited partnership is formed to buy and hold the property, and the seller is often the general partner. Thus the seller may continue to be involved with the property in several ways: (a) as general partner responsible for operating the property and distributing profits to the limited partners and (b) as operator of the property for his own benefit not only for his share of profits, if any, but also because collection of the receivable he received from the partnership for the property depends significantly on successful operation of the property. In addition, the seller (general partner) may (c) be required to fund deficiencies in cash flow from operating the property or (d) guarantee to the limited partners a specified return on their investment or even return of their investment.

Effect of Seller's Continued Involvement

40. A seller's continued involvement with property he has sold complicates accounting for a real estate transaction. Since different kinds of continuing relations may affect the accounting differently, selecting appropriate accounting requires judgment. However, two major categories of effects are discernible based on general principles described in paragraphs 6 through 13.

41. First, recognition of all or part of the profit from a sales contract should be postponed to await performance by the seller if continued involvement by the seller includes obligations to perform specific significant parts of the contract after the time of sale. For example, an obligation to perform services without compensation, to develop land or construct facilities, or to initiate or support operations of the property sold requires an accounting method that recognizes profit primarily on the basis of performance rather than on sale.

42. Second, a sales contract should not be accounted for as a sale if the "seller's" continued involvement with the property carries in essence the same kinds of risks as does ownership of property. For example, an obligation by the "seller" to repurchase the property or to guarantee cash flow from the property or returns to investors ("buyers") for an extended period, or an arrangement by which the "seller" continues or is obligated for extended periods to continue to operate the property and may suffer directly or indirectly, most of the consequences of unprofitable operations usually prevent the transaction from being accounted for as a sale. The substance of the transaction should determine the accounting (paragraphs 11 through 13).

43. The following paragraphs describe the application of the principles of this guide to several common types of continuing involvement by sellers. Some transactions include two or more variations. In general, profit may be recognized at time of sale if the amount of the seller's loss of profit by reason of continued involvement with the property is definitely limited by the terms of the exchange contract. However, the profit recognized should be reduced by the maximum amount of exposure to loss specified unless a larger loss is apparent.

Participation Solely in Future Profit

44. A contract for sale of real estate may include or be accompanied by an agreement that provides for the seller to participate in future profit from the property without risk of loss. For example, the seller may participate in operating profits or residual values without further obligation. As long as the arrangement provides solely for a seller to participate in profits with no risk of loss, and the transaction otherwise qualifies as a sale under this guide, recognition of profit on the sale need not be postponed or deferred. However, no costs should be deferred to be recognized as expense when the riskless profit is recognized.

Permanent Financing

45. A contract for sale of real estate may include or be accompanied by an agreement that the seller is responsible for obtaining or providing permanent financing for the buyer. If so, the buyer's investment in the property cannot be evaluated until adequate permanent financing at an acceptable cost is available to the buyer; providing or obtaining the financing is prerequisite to a sale for accounting purposes (paragraph 14).

Services Without Compensation

46. A contract for sale of real estate may include or be accompanied by an agreement requiring the seller to provide management services relating to the property after sale without compensation or at compensation less than prevailing rates for the service required. Compensation for the service should be imputed at prevailing rates. The imputed compensation should be deducted from the sales price in measuring profit at time of sale and should be recognized over the term of the management contract.

Development and Construction

47. A contract for sale of undeveloped or partially developed land or other property may include or be accompanied by an agreement requiring the seller to develop the property in the future, to construct facilities on the land, or to provide offsite improvements. The Committee concludes that accounting for a seller's performance of development and construction work is not substantially different from accounting for long-term construction contracts in general. Therefore, recognizing profit on the basis of costs incurred or to be incurred in development or construction is appropriate, provided that uncertainties can be reliably quantified. A completed contract method should be used if total cost and total profit cannot be reasonably estimated from the seller's previous experience.

48. Only profit allocable to performance prior to the sale of the land should be recognized at time of sale; profit allocable to the work required after the time of sale should be recognized on performance of that work, as described in paragraph 47. The profit should be allocated to the sale and the later development or construction work on the basis of estimated costs of each activity, and the same rate of profit should be attributed to each activity. This method should also be used to allocate the total revenues and profit from syndication and support activities which are incidental to sales of real estate (paragraph 54).

49. However, no profit should be recognized at time of sale if future costs of development or construction cannot be reasonably estimated at the time of sale. Estimating costs may be impracticable if development or construction is not yet definitive, or for other reasons.

50. A seller's continuing involvement for future development or construction work may be presumed if a buyer is financially unable to pay amounts due for development or construction work or has the right under the terms of the arrangement to defer payment until the work is done.

Initiating and Supporting Operations

51. A contract for sale of real estate may include or be accompanied by an agreement (including short-term sale and leaseback agreements) requiring the seller to initiate or support operations of the property for a specified period of time or until a specified level of operations has been attained. For example, a

seller may agree to deliver to a buyer a rental property with rentals at a level sufficient to cover operating expenses and debt service. The seller may operate the property at his risk until a sufficient number of tenants are obtained to produce the level of rentals specified.

52. The Committee concludes that a seller should also be presumed to be obligated to initiate and support operations of property he has sold, even in the absence of specified requirements in the sale contract or related document, if any of the following conditions exist:

- A seller obtains an interest as general partner in a limited partnership that acquires an interest in the property sold.
- A seller retains an equity interest in the property, such as an undivided interest or an equity interest in a joint venture that holds an interest in the property.
- A seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable is dependent upon the operation of the property.
- A seller enters into a management contract with the buyer that provides for compensation on terms not usual for the services to be rendered and that is not terminable by either seller or buyer.

53. Since the types of arrangements that are described in paragraphs 51 and 52 may cast doubt that the transaction is in substance a sale, the first step is to analyze the transaction carefully to ascertain that it is in economic substance a sale of property (paragraphs 11 through 13, 42, and 56). For example, in a transaction in which the seller is (a) directly or indirectly a general partner in a limited partnership buying or holding the property (or has an extended noncancelable management contract requiring similar obligations), and (b) acquires or holds a significant receivable related to the property, the Committee believes that a sale has not occurred in economic substance. In such a transaction the Committee believes profit should be recognized in accordance with paragraph 56. For this purpose, a significant receivable is defined as a receivable in excess of 15% of the maximum first lien financing that could be obtained from an established lending institution for the property sold and would include the following:

i. A construction loan made or to be made by the seller to the extent that it exceeds the minimum funding commitment

for permanent financing from a third party on which the seller will have no personal liability,

ii. An all-inclusive or wrap-around receivable held by the seller to the extent that it exceeds prior lien financing for which the seller has no personal liability,

iii. Other funds provided or to be provided directly or indirectly (including liability on indebtedness) by the seller to the buyer or holder of the property, and

iv. The present value of a land lease when the seller is the lessor (determined as discussed in paragraph 30).

54. If a transaction is in economic substance a sale, the Committee believes that substantial continued involvement by the seller requires appropriate deferrals of profit for the risks and potential additional costs which may be incurred. Such involvement may exist as a result of contractual guarantees as specified in paragraph 51 or obligations presumed to exist as indicated in paragraph 52. Exhibit C illustrates the method of accounting that the Committee considers appropriate in such circumstances. Under the exhibit, all profits on sales of income-producing properties (see paragraph 48) should be recognized on the basis of performance of the services required which is measured essentially by the costs incurred and to be incurred. If the seller's involvement results from obligations presumed to exist as explained in paragraph 52, or if the seller has contractual obligations which do not include returns on investment, profit recognition under Exhibit C should commence (see paragraph 55) when rentals on underlying leases attain levels that assure coverage of operating expenses and debt service (including payments due the seller under the terms of the transaction) unless objective information regarding occupancy levels and rental rates in the immediate area provides reasonable assurance that rental income will be sufficient to meet those expenses and cash flow requirements. However, if the seller is contractually obligated, under short-term sale and leaseback agreements or otherwise, to guarantee returns on investment to the buyer for limited periods, the Committee believes that a sale should not be recognized and therefore Exhibit C should not be applied until such time as actual rental operations are at a level sufficient to cover all obligations, such as operating expenses, debt service, and other contractual payments, including payments to the seller.

55. Exhibit C illustrates the accounting for a sale of rental property to a limited partnership under an agreement obligating

the seller to construct multi-family units and is based on the presumption that the seller will support operations of the property. As illustrated in the exhibit, all profits on sales of income-producing properties (see paragraph 48) should be recognized on the basis of performance of the services required measured essentially by the costs incurred and to be incurred. The potential additional cost to be incurred by the seller during the presumed support period should be estimated by reducing projected rent receipts by a reasonable safety factor. The Committee believes that estimated future rent receipts should be reduced by a safety factor of 33⅓% unless signed lease agreements have been obtained to support a projection higher than the rental level thus computed. Rent receipts should commence with the initial rent-up period and be appropriately adjusted to reflect the time required to attain projected occupancy levels. Further, if the contract provides for deferring payment of fees to a seller for managing the property sold, the total projected fees for the period of deferral should be included in costs of support in applying the method illustrated in Exhibit C. In instances in which the sales contracts do not stipulate the period that the seller is obligated to support operations of the property sold, the Committee believes that, in applying the accounting illustrated in Exhibit C, support should be presumed for at least two years from the time of initial rental unless actual rental operations are able earlier to cover all obligations, such as operating expenses, debt service, and other contractual commitments including payments to the seller. Where the seller is contractually obligated for a longer period of time, profit recognition under Exhibit C should continue until the expiration of the contractual period.

Financing, Leasing, and Profit-Sharing Arrangements

56. A contract for sale of real estate may be in substance a financing, leasing, or profit-sharing arrangement rather than a sale. The Committee concludes that the following contractual provisions, as well as those specified in paragraph 53, require accounting for the transaction as a financing, leasing, or profit-sharing arrangement:

- A seller has an obligation or an option to repurchase the property. (A right of first refusal based on a bona fide offer by a third party is ordinarily not an obligation or an option to repurchase.)
- A buyer has an option to compel the seller to repurchase the property.

- A seller guarantees the return of the buyer's investment (see paragraph 13).

No sale is recognized if the transaction is in substance a financing, leasing, or profit-sharing arrangement. Payments from "buyer" to "seller" are accounted for as funds loaned, rental payments, or transfers needed to effect division of profits as the substance of the transaction indicates the parties have agreed.

Partial Sales

57. A contract for sale of an interest in real estate may have features of several kinds of real estate transactions already discussed. In many ways, a sale of a partial interest in real estate is similar to a sale of a whole interest in an asset. The Committee believes that recognizing profit is appropriate as long as the sale is to an independent buyer, collection of the sale price is reasonably assured, and there is reasonable assurance that the seller will not be required to support the property, its operations, or related obligations to an extent greater than his proportionate interest. However, profit should be recognized by other methods if the buyer is not independent of the seller, collection of the sales price is uncertain, or the seller assumes obligations to perform after sale. The following paragraphs give some examples.

58. A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit should be recognized if the seller controls the buyer (APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 19, and Interpretation No. 1 of APB Opinion No. 18) until realized from transactions with outside parties through sale or operations of the property.

59. If a seller retains an interest in the property sold and the buyer receives preferences as to profits, cash flow, return on investment, etc., the transaction should be examined to determine its economic substance. Assuming the substance is that of a sale, the seller should recognize profit only to the extent that proceeds from the sale exceed all his costs.

60. Single-family units in condominium projects are often sold individually. Recognizing a profit on the sale of individual units is often appropriate, provided the transaction meets all conditions for profit recognition at time of sale as to collectibility

of sales price and ability to estimate costs not yet incurred. Profit should not be recognized, however, unless construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund, sufficient units have already been sold to assure that the property will not revert to rental property, and aggregate sales proceeds can be estimated reasonably. The profit to be recognized should be calculated on the basis of the percentage of completion of the project times the gross profit on the units sold. For this purpose, the project may be defined as a building, a group of buildings, a single structure or a complete project, depending on the circumstances.

Effective Date

61. The provisions of this guide shall be effective for real estate transactions which the parties commit to (the final terms have been agreed to and are enforceable by the buyer and seller) on or after July 1, 1973. However, earlier application is recommended in financial statements for a fiscal year for which financial statements have not been issued. Real estate transactions that have been previously reported in annual financial statements for fiscal years ending on or before June 30, 1973 should generally not be retroactively adjusted. However, the Committee recognizes that comparability of year-to-year operating results may be materially distorted for those companies that enter into real estate transactions of a similar nature with a relatively high degree of frequency and the terms of the transaction have not substantially changed. In these circumstances, the Committee believes that the provisions of this guide may be applied retroactively.

Exhibits

Exhibit A—Minimum Down Payment Requirements

Exhibit B—Illustration of Effect of Land Lease—New Multi-Family Residential Property

Exhibit C—Illustration of Profit Recognition—Sale of Property With Construction and Support Obligations by Seller
Schedule 1—Example of Profit Calculation
Schedule 2—Example of Profit Calculation

EXHIBIT A

Minimum Down Payment Requirements

This schedule of minimum down payments of various types of real estate property has been developed by the Committee to help determine whether a buyer's initial investment in the property is adequate to recognize profit at time of sale. Use of the schedule is described in paragraphs 18 to 24 and illustrated in Exhibit B.

	Minimum Down Payment Expressed as a Percentage of Sales Value
Land:	
Held for commercial, industrial, or residential development to commence within two years after sale	20%[a]
Held for commercial, industrial, or residential development after two years	25%[a]
Commercial and Industrial Property:	
Office and industrial buildings, shopping centers, etc.:	
Properties subject to lease on a long-term lease basis to parties having satisfactory credit rating; cash flow currently sufficient to service all indebtedness	10%
Single tenancy properties sold to a user having a satisfactory credit rating	15%
All other	20%
Other Income-Producing Properties (hotels, motels, marinas, mobile home parks, etc.):	
Cash flow currently sufficient to service all indebtedness	15%
Start-up situations or current deficiencies in cash flow	25%
Multi-Family Residential Property:	
Primary residence:	
Cash flow currently sufficient to service all indebtedness	10%
Start-up situations or current deficiencies in cash flow	15%

[a] Not intended to apply to volume retail lot sales by land development companies.

Continued

	Minimum Down Payment Expressed as a Percentage of Sales Value
Secondary or recreational residence:	
Cash flow currently sufficient to service all indebtedness	15%
Start-up situations or current deficiencies in cash flow	25%
Single Family Residential Property (including condominium or cooperative housing):	
Primary residence of the buyer	5% [b]
Secondary or recreational residence	10% [b]

[b] If collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience, a higher down payment is indicated and should not be less than 60% of the difference between the sales value and the financing available from loans guaranteed by regulatory bodies, such as FHA or VA, or from independent financial institutions.

* * * * * *

This schedule cannot cover every type of real estate property. To evaluate down payments on other types of property, analogies can be made to the types of properties specified, or the risks of a particular property can be related to the risks of the properties specified.

EXHIBIT B

Illustration of Effect of Land Lease—New Multi-Family Residential Property

This exhibit illustrates the effect of loan characteristics of long-term land leases on evaluating the adequacy of a buyer's initial investment if improvements on land are sold separately. In addition, it demonstrates the limit that a lease places on profit recognition if the leased land is owned by the seller of the improvements, making the lease of land and sale of improvements interdependent transactions.

Recognizing profit on sale of new multi-family residential property requires a down payment of the larger of (a) 15% of the sale value (Exhibit A) or (b) the excess of the sales value over 115% of the loan by the primary lender (paragraph 20). The present value of the lease payments discounted over the term of the primary loan should be added to both sales value and primary debt in applying the test to sale of improvements concurrently with lease of underlying land (paragraphs 30 through 33). The test of initial investment is illustrated for four sets of assumptions.

Primary Land Lease

1. *Land Owned by Third Party Lessor—Nonqualifying:*

Assumptions:

Sales price of improvements	$ 875,000
Represented by proceeds of:	
Cash down payment	$ 125,000
Loan by Insurance Company: lien on leasehold improvements, 28-year term, 8½%, payable in equal monthly installments of principal and interest	657,000
Note received by seller from buyer: 12-year term, 9½%, payable in equal monthly installments of principal and interest	93,000
	$ 875,000

Continued

Land lease for 99 years @ $19,000/year, net, payable monthly in advance
Cost of constructing improvements—$750,000
No continuing involvement by seller

Computations:

Present value of 336 monthly payments of $1,583.33 discounted at 8½% (interest rate on loan from Insurance Company) ($1,583.-33 plus $1,583.33 x 127.9071)	$ 204,000
Loan from Insurance Company	657,000
Equivalent primary debt	$ 861,000
Note receivable from buyer	93,000
Total debt or equivalent	$ 954,000
Down payment	125,000
Adjusted sales value	$1,079,000

Since 15% of the adjusted sales value of the improvements is $161,850, the down payment of $125,000 (about 12% of adjusted sales value) is inadequate to recognize profit on the sale of improvements. The second test is therefore irrelevant.

2. *Land Owned by Third Party Lessor—Qualifying:*

Assumptions:

Sales price of improvements	$ 875,000
Represented by proceeds of:	
Cash down payment	$ 165,000
Loan by Insurance Company: lien on leasehold improvements, 28-year term, 8½%, payable in equal monthly installments of principal and interest	657,000
Note received by seller from buyer: 12-year term, 9½%, payable in equal monthly installments of principal and interest	53,000
	$ 875,000

Continued

Land lease for 99 years @ $17,880/year, net, payable monthly in advance
Cost of constructing improvements—$750,000
No continuing involvement by seller

Computations:

Present value of 336 monthly payments of $1,490 discounted at 8½% (interest rate on loan from Insurance Company) ($1,490 plus $1,490 x 127.9071)	$ 192,000
Loan from Insurance Company	657,000
Equivalent primary debt	$ 849,000
Note receivable from buyer	53,000
Total debt or equivalent	$ 902,000
Down payment	165,000
Adjusted sales value	$1,067,000

Since 15% of the adjusted sales value of the improvements is $160,050, the down payment of $165,000 (15+% of the sales value) is adequate to recognize profit on the sale of improvements. However, the second test must also be applied.

The down payment required by the second test is $90,650 (sales value of $1,067,000 less 115% of equivalent primary debt—115% of $849,000 = $976,350). The down payment of $165,000 exceeds the amount required, so recognition of profit on sale of improvements is appropriate.

The second test may alternatively be applied as the ratio of total debt or equivalent to the equivalent primary debt: $902,000/$849,000 = 106%. Since 106% is less than 115%, the down payment exceeds the difference between the adjusted sales value of the property and 115% of the equivalent primary debt.

Profit recognition:

Sales price of improvements	$ 875,000
Less: Cost of improvements	750,000
Profit recognized at time of sale	$ 125,000

Continued

Subordinated Land Lease

3. *Land Owned by Seller—Qualifying:*

Assumptions:

Sales price of improvements	$ 914,000
Represented by proceeds of:	
Cash down payment	$ 154,000
Loan by Insurance Company: first lien on the fee or on subordinated leasehold, 28-year term, 8¼ %, payable in equal monthly installments of principal and interest	760,000
	$ 914,000

Land lease for 99 years @ $11,580/year, net, payable monthly in advance, and 5% of gross rents
Cost of land—$200,000
Cost of constructing improvements—$750,000
No continuing involvement by seller

Computations:

Present value of 336 monthly payments at $965 discounted at 12% (imputed interest for a second lien receivable) ($965 plus $965 × 96.432696)	$ 94,000
Loan from Insurance Company (Primary debt)	760,000
Total debt or equivalent	$ 854,000
Down payment	154,000
Adjusted sales value	$1,008,000

15% of $1,008,000 is $151,200.

$1,008,000 less $874,000 (115% of $760,000) is $134,000.

Therefore, the down payment of $154,000 is adequate, and recognizing profit on the sale of the improvements is appropriate.

Profit Recognition:

Adjusted sales value		$1,008,000
Less: Cost of improvements	$750,000	
Cost of land	200,000	950,000
Profit recognized at time of sale		$ 58,000

The effect of including the present value of the lease is to reduce profit recognized by $106,000 ($94,000 – $200,000).

Continued

4. *Land Owned by Seller—Nonqualifying:*

Assumptions:

Sales price of improvements	$ 875,000
Represented by proceeds of:	
Cash down payment	$ 132,000
Loan by Insurance Company: first lien on the fee or on subordinated leasehold, 28-year term, 8¼%, payable in equal monthly installments of principal and interest	743,000
	$ 875,000

Land lease for 99 years @ $19,332/year, net, payable monthly in advance.
Cost of land—$200,000
Cost of improvements—$750,000
No continuing involvement by seller

Computations:

Present value of 336 monthly payments of $1,611 discounted at 12% (imputed interest for a second lien receivable) ($1,611 plus $1,611 × 96.432696)	$ 157,000
Loan from Insurance Company (Primary debt)	743,000
Total debt or equivalent	$ 900,000
Down payment	132,000
Adjusted sales value	$1,032,000

Since 15% of $1,032,000 is $154,800, the down payment of $132,000 (about 13% of adjusted sales value) is inadequate to recognize profit on sale of improvements. Profit recognized at time of sale should not exceed that recognizable under the installment method as if the subordinated lease were an installment receivable.

Profit Recognition on Installment Method:

Adjusted sales value		$1,032,000
Less: Cost of improvements	$750,000	
Cost of land	200,000	950,000
Anticipated profit on sale of improvements		$ 82,000

Continued

Cash received or to be received by the seller, other than the proceeds of the primary loan, totals $289,000, the sum of the down payment of $132,000 and the present value of the lease payments of $157,000. The percent of profit in each collection is therefore:

$$\frac{\$82{,}000}{\$289{,}000} = 28.37\%$$

Profit recognizable in the period of sale is 28.37% of the down payment of $132,000 or $37,450. The remaining profit of $44,550 will be recognized at the rate of 28.37% of the portion of each lease payment that is equivalent to a reduction of principal on a loan of $157,000 for 28 years at 12%.

The effect of including the present value of the lease in the sales value of the improvements is to reduce the profit recognized on the improvements by $43,000 ($157,000 − $200,000) to $82,000.

EXHIBIT C

Illustration of Profit Recognition—Sale of Property With Construction and Support Obligations by Seller

This exhibit illustrates the method of accounting recommended by the Committee for a sale of property including the seller's obligation to construct multi-family units and where cash flow deficits are anticipated. The example applies to presumed obligations of the seller as specified in paragraph 52.

Assumptions

1. Company X is engaged in developing and selling multi-family residential projects. The company performs directly all activities in developing its projects from initial planning to site acquisition, obtaining financing, and physical construction of the project.
2. During the year ended December 31, 1971 the Company had a project of 100 units. The project was planned and substantial activity had been performed in 1971, but physical construction had not started as of December 31, 1971. However, all contracts had been let, and the Company had obtained construction financing.
3. On December 31, 1971, the Company sold the project to a limited partnership syndication (fully formed) in which it is the sole general partner:

Sales price	$1,100,000
Represented by proceeds of:	
Cash down payment	$ 165,000
Permanent financing assumed by the buyer, consisting of a 28-year 8½% fully amortizing first mortgage loan by a conventional lender, payable in equal monthly payments of principal and interest to maturity	825,000
Second mortgage note received by the Company payable in equal monthly installments including interest at 9½% over 12 years	110,000
	$1,100,000

Continued

4. The closing occurred on December 31, 1971 and included delivery and/or performance of the following:
   a. The Company delivered to the buyer a legal title to the land and all existing improvements.
   b. The Company delivered to the buyer a firm commitment from an outside lender for permanent financing, and the buyer assumed permanent financing formerly in the name of the Company.
   c. The Company received from the buyer $165,000 cash and a second mortgage note for $110,000.
   d. The Company signed a contract to deliver the completed project for a single price of $1,100,000.

5. Cost incurred by the Company and total costs estimated to complete the project, as of December 31, 1971, were:

	Costs to Date	Estimated Costs to Complete	Total Estimated Costs
Land	$117,000	$ -0-	$117,000
Feasibility, zoning, architectural	35,000	-0-	35,000
Finance and other	85,000	10,000	95,000
Site improvements	-0-	20,000	20,000
Building construction	-0-	571,000	571,000
Total	$237,000	$601,000	$838,000

6. The Company has completed an extensive market research and feasibility study analyzing its cost estimates, the rent-up incubation period and subsequent rent levels. The initial rent-up commenced in 1972. Accordingly, a support period of two years is presumed for 1973 and 1974.

Continued

7. Based on its market analysis the projected results are as follows:

	1972	1973	1974
Rental expense	$ 37,000	$ 58,000	$ 58,000
Debt service	93,000	93,000	93,000
Total	$130,000	$151,000	$151,000
Rental revenue	(75,000)	(150,000)	(180,000)*
Anticipated net deficit in cash flow	$ 55,000	$ 1,000	($ 29,000)
Safety factor of ⅓ of rental revenue	25,000	50,000	60,000
Adjusted anticipated net deficit in cash flow	$ 80,000	$ 51,000	$ 31,000

* $180,000 equals 95% of gross scheduled rents.

8. Initial cost estimates by the Company on previous projects have never varied from final costs by more than one-half of 1% of total costs.

Calculations of Profit to Be Recognized

Schedules 1 and 2 illustrate calculations of profit to be recognized in the period of sale, in the period of construction, and in each period in which the seller is presumed to be required to support operations. The following features should be noted:

a. The percent of estimated total profit to be recognized each period is determined by the ratio of gross costs incurred to the end of the period to total estimated gross costs of the project, including gross costs during the period of support of operations (construction costs should be included even if construction is performed by parties other than the seller).

b. The estimated total profit that is the basis of the calculation in each period (that is, the profit to which the percent in (a) is applied) is determined by adding the sales value and two-thirds of the projected revenue during the period of support of

Continued

operations and deducting the estimated total costs of the project, including costs of operating the property and debt service.

(i) Actual amounts of revenue and costs are substituted for estimated amounts in the calculation as the actual amounts are known. However, in this illustration, remaining estimates of future revenue and expense are not changed because of actual results even though experience might indicate that projections of future amounts should be revised.

(ii) Projected and actual revenues in the calculation should exclude amounts that accrue to the buyer, for example, revenue in excess of the sum of operating expenses and debt service.

(iii) The Committee believes that one-third of projected revenue should be excluded from the estimate of profit to provide a margin of safety (Assumption 7). Actual results incorporated in the calculation need not be reduced by a safety factor.

(iv) The calculation illustrated should be applied only if objective information is available regarding occupancy levels and rental rates for similar property in the immediate area to provide reasonable assurance that rent revenue from the project will be sufficient to cover operating expenses and debt service, including payments due to the seller under the terms of the transaction. Unless that evidence is available, no profit should be recognized on the transaction until rent revenue actually reaches levels that assure coverage of those costs.

c. Schedule 1 shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in Assumption 6 adjusted for the safety margin of one-third of revenue.

d. Schedule 2 shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in Assumption 6 before adjustment for safety margin.

Example of Profit Calculation

(Assuming actual outcome of rental revenue equals adjusted projection)

	Income Recognized in Period of Sale		Income Recognized in Periods of Construction	
REVENUES				
Sales price	$1,100,000		$1,100,000	
Adjusted—projected rental income[a]				
1972	50,000		50,000	
1973	100,000		100,000	
1974	120,000		120,000	
		$1,370,000		$1,370,000
COSTS				
Total estimated costs of project (assumption 5)	838,000		838,000	
Estimated rental expenses and debt service				
1972	130,000		130,000	
1973	151,000		151,000	
1974	151,000		151,000	
		1,270,000		1,270,000
TOTAL PROJECTED PROFIT		$ 100,000		$ 100,000
Profit to be recognized				
Cost to date / Total costs x projected profit	$ 237,000 / 1,270,000	x $ 100,000	$ 838,000 / 1,270,000	x $ 100,000
Total profit to date		$ 18,661		$ 65,984
Less profit previously reported		-0-		18,661
Current profit recognition		$ 18,661		$ 47,323

[a] Two-thirds of projected revenue during periods of support of operations; can also be calculated as projected rental expenses plus projected debt service less projected deficit cash flow.
[b] Actual rental revenue.

EXHIBIT C
Schedule 1

Income Recognized During Support Period						
1972		1973		1974		Total Profit
$1,100,000		$1,100,000		$1,100,000		
50,000[b]		50,000[b]		50,000[b]		
100,000		100,000[b]		100,000[b]		
120,000		120,000		120,000[b]		
	$1,370,000		$1,370,000		$1,370,000	
838,000		838,000		838,000		
130,000		130,000		130,000		
151,000		151,000		151,000		
151,000		151,000		151,000		
	1,270,000		1,270,000		1,270,000	
	$ 100,000		$ 100,000		$ 100,000	
$ 968,000 / 1,270,000	x $ 100,000	$1,119,000 / 1,270,000	x $ 100,000	$1,270,000 / 1,270,000	x $ 100,000	
	$ 76,221		$ 88,110		$ 100,000	
	65,984		76,221		88,110	
	$ 10,237		$ 11,889		$ 11,890	$100,000

Example of Profit Calculation

(Assuming actual outcome of rental revenue equals unadjusted projection)

	Income Recognized in Period of Sale		Income Recognized in Periods of Construction	
REVENUES				
Sales price	$1,100,000		$1,100,000	
Adjusted—projected rental income[a]				
1972	50,000		50,000	
1973	100,000		100,000	
1974	120,000		120,000	
		$1,370,000		$1,370,000
COSTS				
Total estimated costs of project (assumption 5)	838,000		838,000	
Estimated rental expenses and debt service				
1972	130,000		130,000	
1973	151,000		151,000	
1974	151,000		151,000	
		1,270,000		1,270,000
TOTAL PROJECTED PROFIT		$ 100,000		$ 100,000
Profit to be recognized				
Cost to date / Total costs x projected profit	$ 237,000 / 1,270,000	x $ 100,000	$ 838,000 / 1,270,000	x $ 100,000
Total profit to date		$ 18,661		$ 65,984
Less profit previously reported		-0-		18,661
Current profit recognition		$ 18,661		$ 47,323

[a] Two-thirds of projected revenue during periods of support of operation; can also be calculated as projected rental expenses plus projected debt service less projected deficit cash flow.
[b] Actual rental revenue.
[c] Actual rental revenue excluding amounts not needed to meet cash flow requirements of the property.
[d] Since the property has attained a level of occupancy in excess of the original adjusted projection, and there is no reason to believe that such occupancy level cannot be sustained, the projected 1974 rental revenue should be adjusted to 1973 actual rental revenue.

EXHIBIT C
Schedule 2

Income Recognized During Support Period						Total Profit
1972		1973		1974		
$1,100,000		$1,100,000		$1,100,000		
75,000[b]		75,000[b]		75,000[b]		
100,000		150,000[b]		150,000[b]		
120,000		150,000[d]		151,000[c]		
	$1,395,000		$1,475,000		$1,476,000	
838,000		838,000		838,000		
130,000		130,000		130,000		
151,000		151,000		151,000		
151,000		151,000		151,000		
	1,270,000		1,270,000		1,270,000	
	$ 125,000		$ 205,000		$ 206,000	
$ 968,000	x $ 125,000	$1,119,000	x $ 205,000	$1,270,000	x $ 206,000	
1,270,000		1,270,000		1,270,000		
	$ 95,276		$ 180,626		$ 206,000	
	65,984		95,276		180,626	
	$ 29,292		$ 85,350		$ 25,374	$206,000

Comments of Those Who Qualify Their Approval or Who Disapprove of the Publication of This Accounting Guide

Mr. Ross consents to issuance with qualification. He disagrees with the statement that notes with full recourse against the buyer are indistinguishable from non-recourse notes and that only cash or notes supported by irrevocable letters of credit constitute an acceptable form of down payment. Mr. Ross is of the opinion that the acceptability of recourse notes is an audit problem and not an accounting principle issue. Accordingly, the requirements for income recognition should allow for the acceptance of recourse notes as part of the buyer's initial investment where the negotiability, underlying value and ultimate collectibility of the notes can be demonstrated as required in other commercial transactions.

Mr. Penner approves publication with qualification. He is in agreement with the broad, general principles underlying the specific rules and believes that, on balance, application of the rules will improve accounting for profit on sales of real estate. However, he believes that it has not been satisfactorily demonstrated that down payments which are smaller than those specified are always inadequate to initially commit the buyer to the purchase of real estate, that cash and notes supported by irrevocable letters of credit constitute the only appropriate types of consideration for compliance with down payment requirements, or that no distinction should ever be made between recourse and non-recourse notes receivable for the purpose of evaluating a buyer's investment. Mr. Penner believes the rules should allow for consideration of all relevant factors and the exercise of judgment.