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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

Second Edition

Including
Statements of Position
Issued by the
Accounting Standards Division

AICPA

American Institute of Certified Public Accountants

Note: This volume includes both the industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*, as it was originally published in 1973 and statements of position, *Questions Concerning Profit Recognition on Sales of Real Estate* (75-6) and *Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate* (78-4), issued by the AICPA Accounting Standards Division. In using the guide, readers should refer to the additional material in the statements of position (pages 39 through 65), which were not available when the guide was issued.

PAUL ROSENFELD, *Director*
Accounting Standards Division

Accounting for Profit Recognition on Sales of Real Estate

Second Edition

Including
Statements of Position
Issued by the
Accounting Standards Division

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

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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.

CLARENCE D. HEIN, *Chairman*

MARVIN L. BARIS

JAMES J. GALLO

JAMES J. KLINK

RONN K. LYTLE

KENNETH A. MOUNCE

MELVIN PENNER

STAN ROSS

WILLIAM T. WARD

AICPA Staff:

JOE R. FRITZEMEYER, *Director,*
Auditing Standards

MYRON J. HUBLER, JR.
Manager, Special Projects

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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 lease-back 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-

summed 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

¹Usually, 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 lease-back 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 33 $\frac{1}{3}$ % 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

EXHIBIT A, contd.

*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
	<hr/> <u>\$ 875,000</u> <hr/>

Continued

EXHIBIT B, contd.

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
	\$ 861,000
Equivalent primary debt	\$ 861,000
Note receivable from buyer	93,000
	\$ 954,000
Total debt or equivalent	\$ 954,000
Down payment	125,000
	\$ 1,079,000
	\$ 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
	\$ 875,000
Represented by proceeds of:	
Cash down payment	\$ 165,000
Loan by Insurance Company: lien on lease- hold 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 in- stallments of principal and interest	53,000
	\$ 875,000

Continued

EXHIBIT B, contd.

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

EXHIBIT B, contd.

Subordinated Land Lease

3. *Land Owned by Seller—Qualifying:*

Assumptions:

Sales price of improvements	\$ 914,000
<hr/>	
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 month- ly installments of principal and interest . .	760,000
	<hr/>
	\$ 914,000
	<hr/> <hr/>

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
	<hr/>
Total debt or equivalent	\$ 854,000
Down payment	154,000
	<hr/>
Adjusted sales value	\$1,008,000
	<hr/> <hr/>

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
	<hr/>
Profit recognized at time of sale	\$ 58,000
	<hr/> <hr/>

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

Continued

EXHIBIT B, contd.

4. *Land Owned by Seller—Nonqualifying:*

Assumptions:

Sales price of improvements	\$ 875,000
<hr/>	
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 month- ly installments of principal and interest . .	743,000
	<hr/>
	<u>\$ 875,000</u>

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
	<hr/>
Total debt or equivalent	\$ 900,000
Down payment	132,000
	<hr/>
Adjusted sales value	<u>\$1,032,000</u>

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
	<hr/>
Anticipated profit on sale of improvements	<u>\$ 82,000</u>

Continued

EXHIBIT B, contd.

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
	<u>\$1,100,000</u>

Continued

EXHIBIT C, contd.

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

EXHIBIT C, contd.

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 1/3 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

EXHIBIT C, contd.

- 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	\$ 237,000	\$ 838,000
<u> </u> x projected profit	x <u>\$ 100,000</u>	<u>\$ 838,000</u> x <u>\$ 100,000</u>
Total costs	1,270,000	1,270,000
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						Total Profit
1972	1973	1974	1972	1973	1974	
\$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				
<u>\$ 100,000</u>	<u>\$ 100,000</u>	<u>\$ 100,000</u>				
\$ 968,000	\$1,119,000	\$1,270,000				
1,270,000	1,270,000	1,270,000				
x \$ 100,000	x \$ 100,000	x \$ 100,000				
\$ 76,221	\$ 88,110	\$ 100,000				
65,984	76,221	88,110				
<u>\$ 10,237</u>	<u>\$ 11,889</u>	<u>\$ 11,890</u>	<u>\$100,000</u>			

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	\$ 237,000	\$ 838,000
x projected profit	x \$ 100,000	x \$ 100,000
Total costs	1,270,000	1,270,000
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.

**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.

**Statement of
Position**

75-6

**Questions Concerning
Profit Recognition on
Sales of Real Estate**

December 29, 1975

**Proposal to the Financial Accounting Standards
Board to Clarify AICPA Industry Accounting Guide
*Accounting for Profit Recognition on Sales of
Real Estate***

**Issued by
Accounting Standards Division**

**American Institute of
Certified Public Accountants**

AICPA

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The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA committees, subcommittees, or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee, subcommittee, or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the committee, subcommittee, or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee, subcommittee, or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee, subcommittee, or task force believes would be in the public interest.



American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying statement of position has been prepared by the AICPA Accounting Standards Task Force on Real Estate Accounting to clarify the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate.

Numerous questions have arisen in practice with respect to the application of the general principles and specific conclusions set forth in the guide. Questions as to the applicability of the guide to specific transactions and to companies other than real estate companies have also been raised. The task force has identified certain key questions and has recommended appropriate responses to them in this statement of position.

Members of the task force will be glad to meet with you or your representatives to discuss this proposal. The task force would also appreciate being advised as to the board's proposed action on the recommendations set forth in this statement of position.

Sincerely,

MELVIN PENNER, Chairman
Accounting Standards Task Force
on Real Estate Accounting

cc: Securities and Exchange Commission

**Accounting Standards Task Force
on Real Estate Accounting**

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JAMES J. KLINK	
KENNETH A. MOUNCE	

THOMAS P. KELLEY, *Director*
Accounting Standards

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Questions Concerning Profit Recognition on Sales of Real Estate

Buyer's Investment in Purchased Property

Funds Provided (Loaned) by Seller

Question. With respect to paragraph 22 of the guide,* what is the effect on the test of the adequacy of the down payment in a sale of real estate if the seller has made or will be making loans to the buyer/builder/developer for acquisition, construction, or development purposes? What is the effect of the existence of a permanent loan commitment by an independent third party?

Answer. Under paragraph 22, *any* funds that have been loaned or will be loaned, directly or indirectly, to the buyer by the seller must first be deducted from the down payment in determining whether the down payment test has been met. Paragraph 22 does not require that the funds loaned by the seller be specifically identified with the funds composing the down payment. As an example, if A sells unimproved land to B for \$100,000, received a down payment of \$50,000 in cash, and plans to loan B \$35,000 at some future date for installation of water and sewer lines, the down payment test has not been met ($\$50,000 - \$35,000 = \$15,000 \div \$100,000 = 15\%$; fails test because at least 20% is required).

Funds provided directly or indirectly by the seller include loan guarantees, collateral provided by the seller, and any other situation where the seller is subject to loss as a result of funds loaned to the buyer.

Existence of a permanent loan commitment by an independent third party for replacement of the construction or development loan made by the seller does not eliminate the need to deduct the seller's loan from the down payment under paragraph 22. The guide did not intend that consideration be given to such commitments, and construction or development

*The paragraph and exhibit references throughout are to appropriate sections of the AICPA Industry Accounting Guide, *Profit Recognition on Sales of Real Estate*, hereinafter referred to as the "guide."

loans by the seller to the buyer must be deducted from the down payment whether or not a permanent loan commitment exists.

Acceptable Letters of Credit

Question. Paragraph 22 of the guide requires that a buyer's down payment be composed of cash or notes supported by irrevocable letters of credit from an established lending institution. What constitutes an "established lending institution"? If the letters of credit are obtained subsequent to the period in which the transaction takes place but prior to the issuance of the financial statements, is it appropriate to include them for purposes of determining compliance with the down payment criteria in the earlier period?

Answer. An "established lending institution" refers to institutions, usually commercial banks, that issue letters of credit in the normal course of business.

Buyer's notes, unless and until supported by irrevocable letters of credit covering the period of the notes, do not constitute cash equivalency (see paragraph 15) in a real estate transaction. Accordingly, the down payment criteria are not met for accounting purposes until the period in which letters of credit are obtained.

Cumulative Application of Tests When Recognition of Sale Is Delayed

Question. Paragraph 27 of the guide states that the "tests of adequacy of a buyer's initial and continuing investment . . . should be applied cumulatively—at the closing date and annually afterwards." What date should be used for the purpose of these tests when the transaction is not recorded as a sale for accounting purposes on the closing date and the proceeds are accounted for as a deposit?

Answer. The guide indicates that under certain conditions the effective date of the sale for accounting purposes is required to be deferred (see paragraphs 9, 34, 35, 42, 45, and 54). When a transaction is recorded under the deposit method, the date from which the cumulative test would begin to apply would be delayed until the sale is recorded for accounting purposes.

**Applicability of the Alternative
115% Test for Down Payment**

Question. Does the alternative 115 percent test for down payment under paragraph 20 of the guide apply if (a) the seller takes a receivable, collateralized by a first mortgage on the property sold, for the entire difference between the sales value and the down payment, or (b) if the buyer assumes, or takes the property subject to, a primary loan that is not a newly placed permanent loan for a portion of the difference between sales value and the down payment?

Answer. No. The 115 percent test for down payment in paragraph 20 does not apply if a newly placed permanent loan or firm loan commitment from an independent lender is not involved.

**Down Payment Requirements on
Single Family Residential Housing**

Question. Footnote (b) to exhibit A (minimum down payment requirement) calls for a higher down payment on sales of single family residential property if collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience. Do the provisions of footnote (b) apply when independent first mortgage financing is utilized?

Answer. No. The provisions of footnote (b) are applicable when independent first mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the down payment. When independent first mortgage financing is utilized, the minimum down payment on sales of single family residential property should be determined in accordance with paragraph 20 of the guide.

Seller's Continued Involvement With Property Sold

Time of Sale Considerations

Question. Are paragraphs 47–48 and 60 of the guide in conflict with the closing requirements in paragraph 14 of the

guide? Paragraphs 47–48 and 60 permit income recognition during a development or construction phase assuming all other conditions of the guide are met. On the other hand, paragraph 14 includes as a prerequisite to income recognition the criterion that “. . . all conditions precedent to closing have been performed.” One major condition precedent to closing on such properties as buildings, condominiums, and so forth, is that the structure be ready or certified for occupancy. Which of these paragraphs prevails? If an exception to paragraph 14 is intended with respect to completion, then are exceptions intended with respect to any other requirements of paragraph 14?

Answer. Because of the length of the construction period of office buildings, condominiums (especially high rise), shopping centers, and similar structures (excluding single family homes), the guide was written to permit income recognition during the process of construction even though the fact of completion is usually a “condition precedent,” and thus this exception to paragraph 14 is an exception to this condition only.

Calculation of Safety Factor

Question. In applying exhibit C, paragraph 55 of the guide states “that estimated rent receipts should be reduced by a safety factor of 33⅓ percent unless signed lease agreements have been obtained to support a projection higher than the rental level thus computed.” Should the 33⅓ percent reduction be applied to the *total* estimated future rent receipts (including the amount resulting from signed lease agreements) or only to the estimated future rent receipts that are not yet subject to signed lease agreements?

Answer. The 33⅓ percent reduction should be applied to the *total* estimated future rent receipts for each period unless the amount so computed is less than the actual amount of rent receipts resulting from signed lease agreements. In this event, the actual amount would be substituted for the computed amount.

As an example, A sells an office building under development to B together with an agreement to support operations of

property for a period of three years. The projected annual rent roll is \$1 million of which \$350,000 is supported by signed lease agreements. The *projected* rental income for the first year of operation of the office building is \$600,000, the second year \$750,000, and the third year \$1 million. *At the time of sale*, the amounts includible in the exhibit C calculation would be computed as follows.

<i>Year</i>	<i>Projected Rental Income</i>	<i>Safety Factor (33⅓%)</i>	<i>Adjusted Projected Rental Income</i>
1	\$ 600,000	\$200,000	\$400,000
2	750,000	250,000	500,000
3	1,000,000	333,333	666,667

In the example, if at the time of sale there were signed lease agreements in the amount of \$450,000, then the \$450,000 would be used in year 1 since it is greater than the adjusted projected rental income. The adjusted projected rental income for years 2 and 3 would remain \$500,000 and \$666,667, respectively.

Sales of Condominiums

Question. Paragraph 60 of the guide with respect to sales of condominium units states that “profit should not be recognized . . . 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.” What do each of the above criteria for profit recognition mean?

Answer.

Construction is beyond a preliminary stage.

Actual construction of buildings usually must be preceded by engineering and design work, execution of construction contracts, site clearance and preparation, excavation, and completion of the building foundation. Ordinarily, if any one of these required phases is incomplete, the work is not beyond a preliminary stage.

The buyer is committed to the extent of being unable to require a refund.

The buyer cannot have the right under the terms of the agreement or by law to receive a refund, except for nondelivery of the unit. Examples where a sales contract may not be binding and therefore voidable may include but are not limited to the following:

- Certain states require a minimum status of completion of the project.
- Certain states require that a “declaration of condominium” be filed. (In some states, however, the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable.)
- Some sales contracts include a provision that permanent financing at an acceptable cost must be available to the buyer at the time of closing.
- Certain condominium units must be registered with either the Office of Interstate Land Sales Registration of the Department of Housing and Urban Development or the Securities and Exchange Commission.

Sufficient units have already been sold to assure that the property will not revert to rental property.

In determining whether or not this condition has been met, the following should be considered:

- Economic conditions.
- Developer’s history.
- State laws may require that a specified percent of units be sold.
- Sales contract may provide buyer with right of rescission until a specified percent of units are sold.
- Seller may retain right to convert to rental basis.
- Construction loans may require that a specified percent of units be sold before the lender will release any units.
- End loan financing commitments may provide that a specified percent of units be sold before closing of any sale.

The guide intended to preclude recognition of profit on sales of condominium units that can later be rescinded because

the *entire* property reverts to a rental project. Technically, this provision of the guide may be satisfied when the number of units sold meets the requirements of the state law (or relevant jurisdiction), the condominium contract, and the financing agreement, so that such sales are not legally voidable either by the buyer or the seller. Nevertheless, there is a presumption that at least 50 percent of the individual units should be sold before any profit is recognized on the percentage-of-completion method. The reason for this presumption is that profit attributed to units sold may not be subject to reliable estimates until a substantial number of units are sold, because of uncertainties concerning either the ultimate number and sales value of units to be sold (see below) or the costs to be incurred.

Aggregate sales proceeds can be reasonably estimated.

Consideration should be given to sales volume, trends of unit prices, developer's experience, geographical location, and environmental factors. Sometimes certain units in a condominium project are difficult to sell, indicating that the pricing structure may not reflect realizable sales value. For example, certain units may have been designed in a manner that does not reflect changes in market demand, or certain units may not be as desirable as others because of location or aesthetic factors. In these cases, consideration should be given to the possibility that some of the remaining units may not be sold or may have to be sold at substantially reduced prices.

Applicability of the Guide

Applicability to Companies Other Than Real Estate Companies

Question. Paragraph 3 states that the guide was prepared to appraise accounting practices in the real estate industry. Are the principles in the guide applicable to manufacturing, distribution, and other companies that are not real estate companies?

Answer. Yes. The guide was meant to apply to all sales of real estate, except retail lot sales covered by the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales*, without regard to the nature of the seller's business.

Sale of Corporate Stock

Question. The guide primarily covers the timing of profit recognition on real estate sales. Does the guide apply to the sale of corporate stock of a company with substantial real estate?

Answer. If the sale is in economic substance a sale of real estate, provisions of the guide would apply.

Sale of Partnership Interests

Question. The guide contains provisions for the timing of profit recognition if a person sells to a limited partnership in which the seller is the general partner. Is the guide applicable if a person forms a partnership, arranges for the partnership to acquire the property directly from third parties, and sells a portion of his interest in the partnership to persons who then become limited partners?

Answer. The guide is applicable. In particular, see paragraphs 57 to 59 of the guide with respect to partial sales.

Sale of an Option

Question. The guide primarily covers the timing of profit recognition on real estate sales. Does the guide apply to the sale of options to purchase real estate?

Answer. The guide is applicable. In particular, see paragraphs in real estate and, accordingly, the principles in the guide apply.

For purposes of evaluating the buyer's commitment when an option is sold by an option holder, the initial and continuing investment by the buyer of the option (which would exclude amounts that are subject to refund by the seller) should be related to the total of the exercise price of the option and the sales price of the option. For example, if the option is sold for \$150,000, (\$50,000 cash and a \$100,000 note) and the exercise price is \$500,000, the sales value against which the buyer's down payment and continuing investment is measured is \$650,000. If the buyer's investment is inadequate, income may

be recorded on the cost recovery method to the extent non-refundable cash proceeds exceed the seller's cost of the option.

Proceeds from the issuance of a real estate option by a property owner should be accounted for as a deposit as set forth under paragraph 35 of the guide. It is not appropriate to recognize income before the option either expires or is exercised because the sale of the option cannot be evaluated independently from the sale of the real estate to which the option relates. If the option is exercised, cash proceeds from the issuance of the option should be accounted for as a down payment and included in sales value.

APPENDIX B

**Statement of
Position**

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**

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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,

A handwritten signature in cursive script that reads "Arthur R. Wyatt".

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

Accounting Standards Division

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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, in-

cluding 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

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	<u>\$ 400,000</u>

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 ($\$400,000 \div \$1,000,000$) 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.