

FASB Emerging Issues Task Force

Issue No. 07-6

Title: Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, *Accounting for Sales of Real Estate*, When the Agreement Includes a Buy-Sell Clause

Document: Issue Summary No. 1, Supplement No. 1*

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Previously distributed EITF materials: Issue Summary No. 1, dated August 28, 2007

References:

FASB Statement No. 66, *Accounting for Sales of Real Estate* (FAS 66)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

EITF Issue No. 86-6, "Antispeculation Clauses in Real Estate Sales Contracts" (Issue 86-6)

EITF Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities" (Issue 97-1)

International Accounting Standard 18, *Revenue* (IAS 18)

* The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.

Background

1. At the September 11, 2007 EITF meeting, the Task Force reached a consensus-for-exposure on this Issue that the determination of whether the terms of a buy-sell clause indicate that the seller of real estate has transferred the usual risks and rewards of ownership and does not have substantial continuing involvement is a matter of judgment. The Task Force directed the staff to pursue the issuance of a draft abstract for public comment. During its ratification meeting on September 26, 2007, the Board observed that the EITF's discussion and the comment letters received prior to the EITF meeting seem to indicate that there is not diversity in practice regarding this Issue. Given the apparent lack of diversity in practice, the Board questioned whether there was a need to proceed with this consensus-for-exposure. Additionally, the Board discussed whether the example factors included in the draft abstract were necessary for an entity to be able to properly apply the recognition principle of the consensus-for-exposure. Those questions notwithstanding, the Board ratified issuance of the consensus-for-exposure and directed the staff to specifically request that constituents provide comments on the following:

- a. Whether the proposed transition and effective date are appropriate?
- b. Should any specific disclosure be required and why?
- c. Whether any diversity exists between current practice and the consensus-for-exposure?
- d. Whether buy-sell clauses described in the draft abstract have been included in the constituent's real estate transactions and to what extent?
- e. How frequently constituents have invoked the buy-sell clause?
- f. Are the factors of significant continuing involvement included in the draft abstract necessary or beneficial for a proper understanding of the consensus-for-exposure?

2. The draft abstract was posted to the FASB website on October 1, 2007, with a comment period that ended October 22, 2007. Comment letters received on the draft abstract have previously been distributed to Task Force members and are analyzed below. At the November 29, 2007 EITF meeting, the Task Force will have the opportunity to consider these comment letters as it redeliberates the consensus-for-exposure. The Task Force will then be asked to affirm its consensus-for-exposure on this Issue as a final consensus. If the Task Force affirms its consensus-for-exposure, the staff will ask the Task Force whether it agrees with the staff

recommendations for the proposed changes to the draft abstract, including removal of the example factors and changes to the transition guidance.

Summary of Comment Letters

3. Five comment letters were received on the draft abstract, four from preparers and one from a real estate association. The staff has identified and analyzed the significant comments in the section that follows. While the staff believes the Task Force considered a majority of these comments during its initial deliberation of this Issue, the staff recommends that the Task Force consider these comments in conjunction with its redeliberation of this Issue.

Comment – Diversity and Frequency of Use

4. Respondents indicated that buy-sell clauses are included in most, if not all, of their joint venture real estate transactions and that such clauses are rarely, if ever, invoked. Four of the respondents further indicated that they currently evaluate the effect of a buy-sell clause consistent with the consensus-for-exposure. One respondent (CL #1) provided the results of a survey it performed that indicate that 28 of 30 companies surveyed evaluate the effect of a buy-sell clause on profit recognition consistent with the consensus-for-exposure. No information was provided as to how the two respondents with divergent practices accounted for the real estate transaction.

Comment – List of Factors

5. All respondents agreed with the consensus-for-exposure. However, all respondents recommended removing from the draft abstract the example factors that a seller should consider in its evaluation of whether the buy-sell clause constitutes a prohibited form of continuing involvement. Respondents expressed concerns that because of a lack of context to accompany the example factors, an entity may inadvertently make an assessment about whether a buy-sell clause constitutes a prohibited form of continuing involvement based simply on the example factors present in the entity's facts and circumstances. That is, while the example factors included in the draft abstract were not intended to be presumptive or determinative, an entity may look to the example factors as a roadmap, checklist, or weighting system without consideration of other factors that may exist.

6. For example, a selling entity may have a strategic necessity or an investment strategy that would indicate it cannot relinquish its ownership rights to the buyer (Factor 8(c) of the substantial continuing involvement examples in the draft abstract). While this factor may appear to indicate that the seller is compelled to reacquire full ownership of the real estate, without consideration of other factors (for example, whether the seller would have the ability to compel the buyer to sell its interest) the example factor provides no resolution of whether the buy-sell clause constitutes a prohibited form of continuing involvement.

7. In addition, some respondents expressed a concern that the example factors were not sufficiently detailed to allow an entity to appropriately apply them to its particular facts and circumstances. As a result, these respondents believe that the lack of specificity may also result in an entity making an incorrect assessment of whether a prohibited form of continuing involvement exists.

Comment – Disclosure

8. Respondents agreed that additional disclosures are not necessary.

Comment – Transition and Effective Date

9. Respondents agreed that the proposed transition and effective date are appropriate.

10. Subsequent to the September 11, 2007 EITF meeting, the staff received an informal comment related to transition. Specifically, the respondent questioned whether an entity should be precluded from applying the consensus in this Issue to transactions accounted for prior to the effective date under the deposit, profit sharing, leasing, or financing methods for reasons other than the existence of a buy-sell clause, if subsequent to the effective date of the Issue and before consideration of the buy-sell clause the transaction would meet the criteria to be accounted for as a partial sale. For example:

On January 2000, Company A recorded the sale of real estate into a joint venture under the deposit method due to a lack of initial investment (paragraph 5(b) of FAS 66) on the part of

the buyer. The transaction included a buy-sell clause; however, because of the lack of initial investment, Company A did not assess whether the buy-sell clause constituted a form of prohibited continuing involvement. Subsequent to the effective date of this Issue as proposed in the draft abstract, Company A performs a reassessment of the seller's continuing investment because of the receipt of a sufficient initial and continuing investment and concludes that, prior to consideration of the buy-sell clause, the transaction would meet the requirements for being accounted for under the full accrual method. Because this Issue as proposed in the draft abstract would be effective only for new arrangements entered into after the effective date, Company A would be required to make its initial assessment of whether the buy-sell clause constitutes a prohibited form of continuing involvement based on the Company's policy in place prior to the effective date of this Issue as proposed in the draft abstract.

11. As originally drafted, an entity would be precluded from considering the guidance in this Issue when a reassessment is performed after the effective date if the related transaction occurred prior to the effective date.

Staff Recommendations

List of Factors

12. The staff believes that the recognition principle in the draft abstract is clear that all of the relevant facts and circumstances of an arrangement should be considered in making an assessment as to whether the terms of the buy-sell clause constitute a prohibited form of continuing involvement. The staff acknowledges that there is benefit in providing example factors. However, because of the multitude of facts and circumstances that may exist for a given transaction, the staff believes it is impractical to provide a comprehensive list of example factors that should be considered in making the assessment of whether a prohibited form of continuing involvement exists. Furthermore, the staff believes that without a comprehensive list of example factors or a mechanism for evaluating the interaction of those factors, an entity may incorrectly look to the example factors as a roadmap or checklist in making its assessment.

13. Because of the principle nature of the Issue, the staff acknowledges that entities with similar circumstances may reach different conclusions regarding continuing involvement. However, the staff is concerned that inclusion of the example factors would lead to less evaluation of the facts and circumstance than what would be performed if the example factors were not included. Therefore, the staff recommends that the draft abstract be modified to remove the example factors. Suggested changes to the wording in the draft abstract are reflected in the marked draft abstract included in Appendix 07-6A.

14. In addition to the formal comments received from respondents, the staff also received several informal comments recommending that the example factors be combined into one list. Because the staff has recommended removal of the example factors, no changes were made to the draft abstract as a result of this comment.

15. The staff believes that there are no additional issues or comments that warrant consideration by the Task Force at the November 29, 2007 EITF meeting.

Transition

16. The staff believes that the intention of the transition guidance was to not require a reassessment of all existing transactions containing buy-sell clauses. However, the staff believes that the Task Force did not intend to preclude assessments of transactions that would be necessary absent the issuance of this abstract. Accordingly, the staff recommends that the draft abstract be modified to permit an entity to consider the guidance in this Issue under the circumstances contemplated above. Revisions to the draft abstract are reflected in the marked draft abstract included in Appendix 07-6A.

EITF Issue No. 07-6, Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66 When the Agreement Includes a Buy-Sell Clause

Dates Discussed: September 11, 2007; [November 28-29, 2007]

Objective

1. The objective of this Issue is to establish considerations for determining whether a buy-sell clause is a prohibited form of continuing involvement that would preclude partial sales treatment under Statement 66.

All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.

Background

2. When investors enter into an arrangement to create a jointly owned entity and one investor sells real estate to that entity, a buy-sell clause often is included in the agreement between the investors. The buy-sell clause is a contractual term that gives both of the investors of the jointly-owned entity the ability to offer to buy the other investor's interest. In some cases the buy-sell clause may be executed at any time or in other cases only at some specified future date. When an offer is made pursuant to the buy-sell clause, the recipient of the offer can elect to sell its interest for the offered amount or buy the offeror's interest at the offered amount. Generally, once an offer is made, the offeror is contractually required to buy the other investor's interest or sell its interest at the offered amount depending on the other investor's election. A buy-sell clause can specify that the offer be at fair value, at a contractually specified amount, or at an amount determined by the offeror, which is the most common type.

3. Statement 66 includes guidance on the accounting for sales of real estate and criteria that must be met to recognize profit by the full accrual method. One of those criteria is that the seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property. For the purpose of this Issue, the seller is the investor who sold the real estate to the jointly owned entity. The buyer is the other investor in the jointly owned entity. If the seller has complied with all the provisions of Statement 66 to use the full accrual method but retains an equity interest in the real estate or has an equity interest in the buyer, Statement 66 requires the seller to account for the sale as a partial sale.

4. Paragraph 26 of Statement 66 indicates that if the seller has an obligation to repurchase the real estate or if the terms of the transaction allow the buyer to compel the seller or give an option to the seller to repurchase the real estate, the seller is considered to have a prohibited form of

[†] ~~This draft abstract is being exposed for a public comment period that will end on October 22, 2007.~~

continuing involvement that would preclude profit recognition. Some have questioned whether a buy-sell clause would be considered a prohibited form of continuing involvement under paragraph 26 of Statement 66 and therefore preclude partial sale and profit recognition.

Scope

5. This Issue applies to a real estate sale transaction subject to the requirements of Statement 66 when the transaction includes a buy-sell clause.

6. The scope of this Issue includes sales of real estate to an entity that is partially owned by the seller and the arrangement between the seller and the other investor of the jointly owned entity includes a buy-sell clause. Except for the potential effect of the buy-sell clause, the seller of the real estate as contemplated in this Issue has met the criteria in Statement 66 to recognize a partial sale. This Issue does not apply to transactions that are outside the scope of Statement 66.

Recognition

7. Determining whether the terms of the buy-sell clause indicate that the seller has transferred the usual risks and rewards of ownership and does not have substantial continuing involvement is a matter of judgment and requires consideration of all relevant facts and circumstances of the transaction at the time the real estate is sold.

8. A buy-sell clause, in and of itself, does not constitute a prohibited form of continuing involvement that would preclude partial sales treatment under Statement 66. However, a buy-sell clause may constitute a prohibited form of continuing involvement if:

- a. The buyer has an economic incentive to sell and the ability to compel the seller to acquire the buyer's interest in the jointly owned entity or
- b. The seller has an economic incentive to acquire and the ability to compel the buyer to sell its interest in the jointly owned entity.

~~A buy-sell clause, in and of itself, does not constitute a prohibited form of continuing involvement that would preclude partial sales treatment under Statement 66. However, a buy-sell clause may constitute a prohibited form of continuing involvement if the buyer cannot act independently from the seller or if the seller is economically compelled to reacquire the other investor's interest in the jointly owned entity (thereby reacquiring the real estate). Determining whether the terms of the buy-sell clause constitutes a prohibited form of continuing involvement is a matter of judgment and all of the relevant facts and circumstances of the arrangement should be considered. Examples of factors that the seller should consider in its evaluation of whether the buy-sell clause constitutes a prohibited form of continuing involvement are included below. These examples are not intended to be presumptive or determinative.~~

~~*Factors that may indicate that the seller has substantial continuing involvement in the real estate:*~~

- a. ~~The price specified in a buy-sell clause may indicate that the parties have already negotiated for the seller to acquire the buyer's interest. For example, a fixed price is specified in the buy-sell clause.~~
- b. ~~The seller has a strategic necessity or an investment strategy that indicates that it cannot relinquish its ownership rights to the buyer and therefore compel the seller to reacquire full ownership of the real estate.~~

- e. ~~The seller has arrangements with the jointly owned entity, such as management or third party leasing arrangements, that may economically compel the seller to reacquire the real estate in order to retain the economic benefits (for example, leasing commissions from lessees) or escape the negative economic consequences (for example, below market contract with the entity) of such arrangements.~~
- d. ~~Tax implications economically compel the seller to acquire the buyer's interest in the entity (thereby reacquiring the real estate).~~

Factors that may indicate that the buyer can compel the seller to repurchase the property:

- a. ~~The buyer is financially unable to acquire the seller's interest. A requirement for an appraisal or for the offer price to be at fair value may provide protection to the buyer in such circumstances and provide evidence that the buyer is financially unable to acquire the seller's interest. However, a requirement for an appraisal may not be evidence of compulsion in other situations.~~
- b. ~~The buy-sell clause stipulates a specified rate of return to the buyer (or seller), indicating that the buyer may not fully participate in the rewards of ownership from the real estate.~~
- e. ~~The buyer has a strategic necessity or an investment strategy that requires that it sell its interest to the seller.~~
- d. ~~The buyer is legally restricted from acquiring the seller's interest.~~
- e. ~~If the real estate is integrated into the seller's business, the buyer may not have alternative means available, such as sale to an independent third party, to realize its economic interest.~~
- f. ~~Tax implications economically compel the buyer to sell its interest in the entity to the seller.~~

Transition

9. This Issue shall be effective for new arrangements entered into and assessments performed in fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted

10. For purposes of the transition guidance, assessments are any assessment performed pursuant to Statement 66 after the effective date of this Issue for arrangements accounted for under the deposit, profit-sharing, leasing, or financing methods for reasons other than the existence of a buy-sell clause.

The provisions of this Issue need not be applied to immaterial items.
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References:

FASB Statement No. 66, *Accounting for Sales of Real Estate*