

FASB Emerging Issues Task Force

Issue No. 06-8

Title: Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66, *Accounting for Sales of Real Estate*, for Sales of Condominiums

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FASB Staff: Akinlade (ext. 284)/ Beswick (ext. 453)

EITF Liaison: Mark Bielstein

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Previously distributed EITF materials: None

References:

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

AICPA Statement of Position 04-2, *Accounting for Real Estate Time-Sharing Transactions* (SOP 04-2)

International Accounting Standard No. 11, *Construction Contracts* (IAS 11)

International Accounting Standard No. 18, *Revenue* (IAS 18)

EITF Issue No. 86-7, *Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts* (Issue 86-7)

*** The alternative views presented in this Issue Summary 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. Many homebuilders and lodging companies are entering into the condominium development market. Since condominium projects are generally long-term in duration, individual units of the condominium are often sold during the construction phase. FAS 66, provides guidance on the accounting for real estate sales and states, in paragraph 5:

Profit on real estate transactions shall not be recognized by the full accrual method until all of the following criteria are met:

- a. A sale is consummated (paragraph 6).
- b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (paragraphs 8-16).
- c. The seller's receivable is not subject to future subordination (paragraph 17).
- d. 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 (paragraph 18).

Paragraphs 19-43 describe appropriate accounting if the above criteria are not met. [Footnote reference omitted.]

FAS 66 provides specific guidance on the application of the consummation of a sale (paragraph 5(a) of FAS 66) and the seller's continuing involvement (paragraph 5(d) of FAS 66) for condominium projects. These two criteria may not be met for individual condominium units sold during the construction phase of the project because of the long-term nature of condominium development projects.

2. First, in evaluating whether a sale has been consummated (under paragraph 5(a)), entities determine whether the conditions precedent to the closing on a sale have been achieved. One condition, a certificate of occupancy, is not typically obtained for condominium development projects until the entire project has been completed. Paragraph 20 of FAS 66 does not require a certificate of occupancy for a sale to be consummated due to the length of the construction period for certain types of projects, including condominium projects. Specifically, paragraph 20 of FAS 66 states:

The deposit method of accounting described in paragraphs 65-67 shall be used until a sale has been consummated (paragraph 6). "Consummation" usually

requires that all conditions precedent to closing have been performed, including that the building be certified for occupancy. However, because of the length of the construction period of office buildings, apartments, condominiums, shopping centers, and similar structures, such sales and the related income may be recognized during the process of construction, subject to the criteria in paragraphs 41 and 42, even though a certificate of occupancy, which is a condition precedent to closing, has not been obtained.

3. Second, since the risks and rewards of ownership have not been fully transferred to the buyer during the construction period, the continuing involvement that a developer has during construction is addressed in paragraph 37 of FAS 66, and as long as certain criteria are met, profit can be recognized during the construction phase under the percentage of completion method. Specifically, paragraph 37 of FAS 66 states:

If individual units in condominium projects or time-sharing interests are being sold separately and all the following criteria are met, profit shall be recognized by the percentage-of-completion method on the sale of individual units or interests:

- a. Construction is beyond a preliminary stage.
- b. The buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest.
- c. Sufficient units have already been sold to assure that the entire property will not revert to rental property. In determining whether this condition has been met, the seller shall consider the requirements of state laws, the condominium or time-sharing contract, and the terms of the financing agreements.
- d. Sales prices are collectible (paragraph 4).
- e. Aggregate sales proceeds and costs can be reasonably estimated. Consideration shall be given to sales volume, trends of unit prices, demand for the units including seasonal factors, developer's experience, geographical location, and environmental factors.

If any of the above criteria is not met, proceeds shall be accounted for as deposits until the criteria are met. [Footnote references omitted.]

4. FAS 66 does not, however, provide guidance on the application of the continuing investment criterion in paragraph 5(b) of FAS 66 specific to condominium projects. Both the initial and continuing investment requirements in paragraph 5(b) of FAS 66 are intended to demonstrate that collectibility of the sales price is reasonably assured through the buyer's stake in the property, which is sufficient enough that the risk of loss through default motivates the buyer to honor its obligations to the seller. Unless the sales price is collectible, a seller cannot

recognize profit under the full accrual method. Diversity exists on whether the continuing investment test in paragraph 12 of FAS 66 should be applied in order to conclude that the sales price is collectible and to recognize profit under the percentage of completion method.

5. Some have questioned whether SOP 04-2 would be applicable to these types of arrangements since SOP 04-2 provides guidance on the application of FAS 66 to terms typically encountered in time-sharing arrangements and establishes standards for accounting issues not addressed in FAS 66. However, SOP 04-2 was not intended to promulgate new revenue recognition guidance. Due to the different characteristics of condominium and time-share sales, SOP 04-2 does not directly address whether the continuing investment test should be applied in order to recognize profit under the percentage of completion method for projects with long construction periods.

6. As an example, a condominium project that commences on March 1, 2006, is expected to be completed in June 2009. The condominium developer has a history of meeting the expected completion date. One condominium unit is sold on May 1, 2006, and the buyer, who will be using the property as a secondary residence, makes a non-refundable 10 percent down payment. The initial investment criterion is met by the down payment (paragraph 54 of FAS 66). The condominium project is beyond the preliminary stage of construction, sufficient units have been sold such that the project will not revert to rental property, and the developer can reasonably estimate the sales proceeds and costs. The condominium developer will not receive the certificate of occupancy until the project is complete.

Accounting Issues and Alternatives

Issue 1: Whether an entity needs to evaluate the adequacy of the buyer's continuing investment pursuant to paragraph 12 of FAS 66 in order to recognize profit under the percentage of completion method.

View A: An entity should not evaluate the adequacy of the buyer's continuing investment in determining whether to recognize profit under the percentage of completion method.

7. Proponents of View A believe that the continuing investment test is only applicable once the sale has been consummated. That is, the continuing investment test is a post-closing assessment. Pursuant to paragraph 5(a) of FAS 66, the consummation of a sale is one of the general criteria that must be met before profit may be recognized under the full accrual method. As indicated above, obtaining a certificate of occupancy is a condition precedent that must usually be satisfied in order to meet the consummation of a sale criterion. However, proponents of View A note that paragraph 20 of FAS 66 allows profit recognition during the construction phase even though the certificate of occupancy has not been obtained because of the length of the construction period.

8. Proponents of View A believe that because the consummation criterion has not been met, the test for continuing investment does not need to be applied in order to recognize profit. Proponents of View A believe that paragraph 16 of FAS 66 supports this view and states, in part:

Tests of adequacy of a buyer's initial and continuing investments described in paragraphs 8-15 shall be applied cumulatively when the sale is consummated and annually afterward. [Emphasis added.]

9. Further, supporters of View A believe that the continuing investment test in paragraph 12 of FAS 66 is intended to address situations in which the seller provides financing to the buyer during the construction period. In condominium sales, proponents of this view believe that typically, the buyer obtains financing from a third party and such financing is not obtained until the individual unit has been completed. Therefore, the continuing investment test would not be applicable. Opponents of View A believe that the seller is effectively providing financing to the buyer since the seller is constructing the unit at the seller's own cost on behalf of the buyer. Therefore, opponents of View A believe that the continuing investment test would be applicable.

10. Paragraph 37 of FAS 66 also addresses the sale of individual units in condominium projects. Proponents of View A believe that entities should apply the requirements of paragraph 37 in determining whether the percentage of completion method is appropriate. Proponents of View A acknowledge that paragraph 37(d) requires an assessment of the collectibility of the sales price, which some believe requires an evaluation of the adequacy of the buyer's continuing investment. However, proponents of this view note that only paragraph 4 is parenthetically referenced in

paragraph 37(d) and that if an entity was required to evaluate the buyer's continuing investment, a parenthetical reference to paragraph 12 would have been included in paragraph 37(d) of FAS 66. Further, proponents of View A believe that since the continuing investment test was not required to be applied due to the sale not being consummated, this test would not need to be met in order to recognize profit under the percentage of completion method. Proponents of View A would apply the other collectibility criteria in paragraph 4 of FAS 66 (that is, initial investment, credit standing of the buyer, age, location, and adequacy of cash flow from the property).

11. Opponents of View A believe that the parenthetical reference in paragraph 37(d) of FAS 66 to paragraph 4 of FAS 66 explicitly requires the use of the continuing investment test as the continuing investment test is a component of the collectibility assessment. Paragraph 4 states,

In accounting for sales of real estate, collectibility of the sales price is demonstrated by the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

Further, opponents of View A believe that the reason paragraph 12 of FAS 66 is not referenced is because the continuing investment test would have already been satisfied prior to applying paragraph 37 of FAS 66.

12. Applying View A to the example above (paragraph 5), proponents of View A believe that if the seller meets all of the criteria in paragraph 37 of FAS 66 as of May 1, 2006, profits from the sale of the individual condominium unit should be recognized by the percentage of completion method.

View B: An entity should evaluate the adequacy of the buyer's continuing investment in determining whether to recognize profit under the percentage of completion method.

13. Proponents of View B acknowledge that FAS 66 provides certain exceptions to profit recognition under the percentage of completion method for condominium projects in the application of the consummation of a sale (paragraph 5(a) of FAS 66) and continuing involvement (paragraph 5(d) of FAS 66) criteria. However, as previously discussed, FAS 66 does not provide explicit exceptions for the continuing investment criterion (paragraph 5(b) of FAS 66). Therefore, proponents of View B believe that the continuing investment test in paragraph 12 of FAS 66 should be applied in determining whether to recognize profit under the percentage of completion method.

14. Proponents of View B believe that paragraphs 6 and 20 of FAS 66 waive the requirement of a certificate of occupancy as a condition precedent to closing for certain long term construction projects in evaluating whether the consummation of a sale has occurred pursuant to paragraph 5(a) of FAS 66. Paragraph 6 states:

A sale shall not be considered consummated until (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, and (d) all conditions² precedent to closing have been performed. Usually, those four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a preclosing.

² Paragraph 20 provides an exception to this requirement if the seller is constructing office buildings, condominiums, shopping centers, or similar structures.

15. Supporters of View B acknowledge that paragraph 20 allows for profit to be recognized during the process of construction, but it does not prescribe what method to recognize profit under. Proponents of View B point out that when an entity does not meet the requirement in paragraph 5(b) of FAS 66 for a continuing investment, the entity is required to follow the guidance in paragraph 23. Proponents of View B believe that paragraph 23 requires profit to be recognized under the reduced profit, installment, or cost recovery method (depending on certain conditions) if the continuing investment criterion has not been met. Paragraph 23 of FAS 66 states the following:

If the initial investment meets the criteria in paragraphs 8-11 but the continuing investment by the buyer does *not* meet the criteria in paragraphs 12 and 16, the seller shall recognize profit by the reduced profit method described in paragraphs 68 and 69 at the time of sale if payments by the buyer each year will at least cover both of the following:

- a. The interest and principal amortization on the maximum first mortgage loan that could be obtained on the property
- b. Interest, at an appropriate rate, on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan

If the criteria specified in this paragraph for use of the reduced profit method are not met, the seller may recognize profit by the installment method (paragraphs 56-61) or the cost recovery method (paragraphs 62-64). [Footnote reference omitted.]

16. Proponents of View B acknowledge that paragraph 37 of FAS 66, which addresses a form of continuing involvement (that is, a partial sale), permits the application of the percentage of completion method if certain criteria are met. However, proponents of View B believe that before assessing whether any forms of continuing involvement exist (paragraph 5(d) of FAS 66), the initial and continuing investment tests in paragraph 5(b) of FAS 66 would need to be satisfied. Therefore, supporters of View B believe that an entity would not be able to recognize profit under the percentage of completion method unless the buyer had adequate initial and continuing investments and met all of the criteria in paragraph 37.

17. Proponents of View B point out that View A is predicated upon the absence of a certificate of occupancy, which prevents the consummation of a sale and results in the inapplicability of the continuing investment test. Under View A, the consummation criterion is a condition precedent to both the initial and continuing investment tests, which would also result in the initial investment test not being required before profit is recognized under the percentage of completion method. This would allow for the percentage of completion method of profit recognition to be applied even when no initial payment is received from the buyer.

18. Proponents of View B believe that sellers can meet the continuing investment criterion by requiring the buyer to either (a) make additional annual payments totaling an amount equal to the level annual payment to fund principal and interest for the purchase price of the property or (b)

increase the minimum initial investment by an equivalent aggregate amount. Proponents of View B believe that this is supported through paragraph 16 of FAS 66, which states, in part:

If the initial investment exceeds the minimum prescribed, the excess shall be applied toward the required annual increases in the buyer's investment.

Supporters of View B believe that developers may obtain a down payment in excess of the amount required under paragraph 54 of FAS 66; therefore, meeting the continuing investment requirement may not be burdensome.

19. Applying this view to the example in paragraph 5, proponents of View B believe that if the buyer meets the continuing investment test by making an additional payment in an amount equal to the level annual payment to fund principal and interest for the purchase price of the property either (a) on or before May 1 in each of the subsequent years as required by paragraph 12 of FAS 66 or (b) by increasing the minimum initial investment by an equivalent aggregate amount and assuming that all of the requirements of paragraph 37 of FAS 66 are met, then profit for the sale of the individual condominium unit would be recognized under the percentage of completion method (assuming that no other forms of continuing involvement exist). If the buyer does not make an additional payment in order to meet the continuing investment test, then profit for the sale of the individual condominium unit may be recognized under the reduced profit, installment or cost recovery method as prescribed by paragraph 23 of FAS 66.

International Convergence

20. IAS 18 provides guidance on the sale of real estate, and states in paragraph 9 in the Appendix of IAS 18:

When the aggregate of the payments received, including the buyer's initial down payment, or continuing payments by the buyer, provide insufficient evidence of the buyer's commitment to complete payment, revenue is recognised only to the extent cash is received.

21. While IAS 18 would appear to be consistent with the requirements in FAS 66, there is currently no guidance specific to the issue raised in this Issue Summary under IFRS. However,

the IFRIC has decided to add to its agenda a project to clarify the circumstances in which IAS 18 is applicable, and to develop factors in determining whether real estate sales (before construction is complete) should be accounted for as a construction contract in accordance with IAS 11 or as a sale of goods in accordance with IAS 18.

Effective Date, Transition, and Disclosure

22. The consensus on this Issue shall be effective for the first annual reporting period beginning after March 15, 2007. Early adoption is permitted as of the beginning of an entity's fiscal year. Entities that have not accounted for sales of condominiums in a manner that is consistent with the consensus on this Issue should recognize the consensus on this Issue as a change in accounting principle through a cumulative effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position at the beginning of the year of adoption. Further, entities should disclose the cumulative-effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position.

23. The FASB staff believes that the application of this consensus may result in a significant change in accounting and financial reporting for certain entities that have not accounted for sales of condominiums in a manner that is consistent with the consensus on this Issue. Accordingly, the FASB staff believes that recognizing the change in accounting principle through a cumulative-effect adjustment with the recommended effective date would allow entities ample time to prepare for the implementation of this consensus.

24. Condominium development arrangements are generally long term in nature and can potentially span across multiple reporting periods. It may be difficult for certain entities to apply the consensus on this Issue retrospectively as it would require entities to obtain historical information that could go back several years. Further, applying the consensus on a prospective basis will result in condominium unit sales that were not accounted for in a manner consistent with the consensus; continuing to be accounted for in such a manner after the effective date of the consensus on this Issue and thereby creating an inconsistency. In addition, prospective

application will result in units in the same building being accounted for differently. Therefore, the FASB staff does not believe that either retrospective or prospective application of the consensus on this Issue would provide users with useful financial information.