

# Statutory Issue Paper No. 40

## Real Estate Investments

### STATUS

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### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Current statutory accounting guidance for real estate investments is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. However, the Accounting Practices and Procedures Manuals contain no comprehensive guidance on accounting for sale of real estate or for real estate construction projects.
2. GAAP guidance for real estate is established in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FAS 67), *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and *AICPA Statement of Position 92-3, Accounting for Foreclosed Assets* (SOP 92-3). Current statutory guidance is similar to GAAP, except that GAAP requires recognition of impairment in the value of the investments through a writedown to the appropriate basis with a charge to realized gains and losses. Current statutory accounting guidance states that “Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost plus capitalized improvements, less normal depreciation.” The current statutory guidance gives reporting entities three options when an impairment is recognized: a) write down the investment real estate, b) nonadmit part of the value, or c) establish a reserve for specific properties as a liability.
3. The purpose of this issue paper is to establish statutory accounting principles for real estate investments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

4. Real estate investments shall be defined as direct-owned real estate properties acquired in exchange for consideration (including but not limited to cash, a contract for deed or mortgage, or other non-cash consideration), obtained through foreclosure or voluntary conveyance in satisfaction of a mortgage loan, or received as contributed surplus. Real estate investments meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.
5. Real estate investments include real estate occupied by the company, which is defined in *Issue Paper No. 23—Property Occupied by the Company*, and certain acquisition, development and construction arrangements (ADC) as defined in *Issue Paper No. 38—Acquisition, Development and Construction Arrangements* (Issue Paper No. 38).

6. Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances:

- Properties occupied by the company
- Properties held for the production of income
- Properties held for sale

7. Encumbrances represent outstanding mortgages or other debt related to the real estate investment and any unpaid accrued acquisition or construction costs. Interest expense shall be included in investment expenses.

8. The cost of real estate represents the fair market value of the consideration exchanged plus any costs incurred to place the real estate asset in usable condition, including but not limited to, brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, any additional expenditures made for equipment and fixtures that are made a permanent part of the structure and certain interest costs as provided for in *Issue Paper No. 44—Capitalization of Interest*. Where cost includes both land and building, the cost shall be allocated among the assets purchased based on the relative values determined using appraisals, as described in paragraph 12 below. The cost shall be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property. The cost of real estate which has been foreclosed upon shall be initially established in accordance with *Issue Paper No. 36—Troubled Debt Restructurings*. The cost of contributed real estate shall be initially established in accordance with *Issue Paper No. 73—Transactions as a nonreciprocal transfer*.

9. The cost of property included in real estate investments, other than land, shall be depreciated over the estimated useful life, not to exceed fifty years. Depreciation expense shall be included in investment expenses.

10. Properties occupied by the reporting entity and properties held for the production of income shall be carried at depreciated cost less encumbrances unless events or circumstances indicate the carrying amount of the asset (amount prior to reduction for encumbrances) may not be recoverable. Paragraph 5 of FAS 121 provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the reporting entity or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 5 of FAS 121 are present or if other events or changes in circumstances indicate that the carrying amount of properties occupied by the company or properties held for the production of income may not be recoverable, the reporting entity shall determine whether an impairment loss must be recognized in accordance with paragraph 6 of FAS 121. Property occupied by the reporting entity shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. FAS 121 is excerpted in paragraph 37 of this issue paper. An impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied by the company or properties held for the production of income. Fair value is determined in accordance with paragraph 12 of this issue paper. If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss.

11. Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property consistent with paragraph 16 of FAS 121. The intent to sell a property exists when management, having the authority to approve the action, has committed to a plan to dispose of the asset, either by sale or abandonment. Fair value of the asset shall be determined in accordance with

paragraph 12 of this issue paper. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 17 of FAS 121.

12. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another) and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale (i.e., the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus). If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:

- a. A physical inspection of the premises,
- b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization),
- c. current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach),
- d. costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment,
- e. replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

All appraisals obtained to determine fair market value of real estate investments shall be no more than five years old. However, if conditions indicate there has been a significant decrease in the fair market value of a property, then a current appraisal shall be obtained. Additionally, appraisals shall be obtained for real estate investments at the time of foreclosure or contribution. Contributed real estate shall be supported by an independent third party appraisal at the date of contribution. If either of the previous conditions exist but an appraisal has not been obtained, the related property shall be considered a nonadmitted asset until the required appraisals are obtained.

### **Income, Expenses, and Capital Improvements**

13. Rental income on real estate leased is addressed in *Issue Paper No. 22—Leases*, which requires that rental income be included in investment income. Expenses incurred in operating the real estate investment, including but not limited to, real estate taxes, utilities, and ordinary repair and maintenance, shall be charged to expense as incurred and included in investment expenses.

14. Expenditures that are necessary to put the asset back into good operating condition or to keep it in good operating condition, shall be charged to expense as incurred. Expenditures that add to or prolong the life of the property shall be added to the cost of the real estate (capitalized) and depreciated over the remaining estimated useful life of the property.

### **Sale of Real Estate**

15. Recognition of profit on sales of real estate investments shall be accounted for in accordance with paragraphs 29, 33 and 34 below. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

- a. A sale is consummated,
- b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property,
- c. The seller's receivable is not subject to future subordination, and
- 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 after the sale.

## DISCUSSION

The calculation of the buyer's initial investment specified in subparagraph 9 of paragraph 29 below shall be modified to reflect that buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

### Real Estate Projects Under Development

16. Costs and initial rental operations of real estate projects under development, which include ADC arrangements accounted for as real estate under the provisions of paragraph 3 of Issue Paper No. 38, shall be accounted for in accordance with paragraph 30 below. Costs incurred in connection with real estate projects shall be expensed as incurred unless the criteria established in paragraph 30 are met. The admitted value of a real estate project, or parts thereof, held for sale or development and sale shall not exceed the estimated selling price in the ordinary course of business less estimated costs of completion (to stage of completion assumed in determining the selling price), holding, and disposal (net realizable value). If costs exceed net realizable value, capitalization of eligible costs shall continue, however, an allowance shall be provided to reduce the admitted value to estimated net realizable value.

17. The statutory principles in this issue paper are consistent with the current statutory guidance except as follows:

- Paragraph 11 requires real estate held for sale to be carried at the lower of fair value less estimated costs to sell or depreciated cost. There are at least two states, Nevada and Arizona, which allow real property to be carried in excess of depreciated cost if supported by an appraisal.
- Paragraphs 10 and 11 distinguish between real estate held for sale and real estate not held for sale. Paragraph 11 requires the fair market value of real estate held for sale to be reduced by estimated selling costs in determining admitted value.
- Paragraph 10 provides that impairments for properties occupied by the company and properties held for the production of income shall be recorded as a realized loss. After an impairment is recognized, the carrying amount of the asset shall be accounted for as its new cost. Current statutory guidance provides three options for recording valuation adjustments: (a) direct write-down of asset, (b) nonadmit part of the asset, or (c) establish a reserve liability.
- Paragraph 12 provides for the utilization of appraisals in determining fair market value. The Accounting Practices and Procedures Manual for Life and Accident and Health and for Property and Casualty Insurance Companies define the term "appraised value" but do not require the use

- of an appraisal to support valuation allowances. At least two states, Minnesota and Missouri, have regulations that require the use of appraisals for certain real estate properties.
- Paragraph 6 conforms the balance sheet categories to be consistent with FAS 121. These differ from those required on the Property and Casualty Annual Statement and those required on the Life and Accident and Health Annual Statement. Real estate currently reported as “Other Properties” on the Property and Casualty Annual Statement shall be reported as “Properties held for the production of income” or “Properties held for sale.” Real estate currently reported as “Properties Acquired in the Satisfaction of Debt” on the Life and Accident and Health Annual Statement shall be reported as “Properties held for the production of income” or “Properties held for sale.”
  - Paragraph 15 adopts the GAAP guidance for sales of real estate, which augments and clarifies the current statutory guidance on sales of real estate.
  - Paragraph 16 adopts GAAP guidance for real estate construction projects; no current statutory guidance exists.
18. The statutory accounting principles established in this issue paper:
- Adopt *FASB Statement No. 66, Accounting for Sales of Real Estate*, with modification to paragraph 9 to indicate that only letters of credit from institutions listed by the Securities Valuation Office shall be included in determining the buyer's initial investment. Additionally, as they relate to FASB Statement 66, the following are adopted: *FASB Emerging Issues Task Force Issue No. 87-29, Exchange of Real Estate Involving Boot (EITF 87-29)*, *FASB Emerging Issues Task Force Issue No. 86-6, Antispeculation Clauses in Real Estate Sales Contracts*, *FASB Emerging Issues Task Force Issue No. 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66*, *FASB Emerging Issues Task Force Issue No. 88-24, Effect of Various Forms of Financing under FASB Statement No. 66* and *FASB Emerging Issues Task Force Issue No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds (EITF 87-9)*.
  - This issue paper adopts *FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*, *FASB Emerging Issues Task Force No 89-13, Accounting for the Cost of Asbestos Removal*, *FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate*, *FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination*, and *FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration /Environmental Exit Costs When Testing a Long-Lived Assets for Impairment*.
  - Adopt *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*. Foreclosed real estate held for sale should be valued as described within *SOP 92-3, Accounting for Foreclosed Assets*.
  - Adopt *SOP 92-1, Accounting for Real Estate Syndication Income* and *SOP 92-3, Accounting for Foreclosed Assets*.
  - Adopt *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, for real estate investments except for paragraphs 13, 14.c. and 14.d. which were rejected in *Issue Paper No. 68—Business Combinations and Goodwill*.

- Reject *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, "Chapter 10, Taxes, Section A-Real Estate and Personal Property Taxes"*

19. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

#### Conservatism

Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

#### Recognition

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

#### Drafting Notes/Comments

- Accounting for investments in real estate ventures are addressed in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*.
- Accounting for leases and sale-leaseback transactions involving real estate transactions are addressed in *Issue Paper No. 22—Leases*.
- *Issue Paper No. 36—Troubled Debt Restructurings* addresses accounting for the foreclosure of real estate; this paper addresses how to account for foreclosed real estate after foreclosure.
- *Issue Paper No. 34—Investment Income Due and Accrued* addresses requirements related to nonadmitted rental income due and accrued.
- Accounting for real estate occupied by the company is addressed in *Issue Paper No. 23—Property Occupied by the Company*.
- Accounting for leasehold improvements is addressed in *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee*.
- *Issue Paper No. 44—Capitalization of Interest* addresses capitalization of interest.
- Accounting for real estate property acquired by mortgage guaranty insurers in settlement of a claim is addressed in *Issue Paper No. 88—Mortgage Guaranty Insurance*.
- Depreciation of assets, including acceptable and unacceptable methods and maximum lives and disclosures, will be addressed in *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements*.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE****Statutory Accounting**

20. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies includes the following guidance in Chapter 4, Real Estate:

Directly-owned real estate is reported separately in the statutory financial statement. Holdings so reported are classified as properties (a) occupied by the company, (b) acquired in satisfaction of debt, and (c) investments in real estate. These classes may include real estate owned under contract of sale.

When real estate is owned indirectly through partnerships or joint ventures, it is reported as "Other Invested Assets" in the statutory financial statement.

Authorization and Limitations

Statutes and regulations promulgated by the states concerning limitations on investments in real property are widely divergent. Generally speaking, the thrust of these limitations is to provide an aggregate maximum investment value on holdings of real property. A typical example would be that real estate investments not exceed a stipulated percentage of total admitted assets or surplus. Also common among these limitations are provisions requiring the disposal of foreclosed properties within a certain period of time.

Cost

The cost of real estate acquired by purchase is the actual amount paid upon purchase, plus the costs incurred to place the real estate asset in usable condition. Elements of cost should also include brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, and any additional expenditures made for equipment and fixtures that are made a permanent part of the structure. Cost should be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property.

Where more than one property is acquired at a group price, or where the cost includes both land and building, the price paid must be allocated among the assets purchased. This normally is done on the basis of relative values, which may be determined by appraisals made for insurance purposes, by assessed valuations made for property tax purposes, by independent appraisal, or by some other reasonable method such as the previous owner's percentage allocation or underwriting estimates.

If property is acquired in a non-cash transaction, the acquired property should be recorded at the fair market value of the property or other asset given if the market value of the property acquired cannot reasonably be determined.

In determining the cost of investment real estate, an insurer should include the cost of personal property necessary to the income generating operations of the investment property. Furniture, fixtures, and equipment so capitalized should be depreciated over their useful lives.

Real estate acquired in satisfaction of debt includes property acquired through foreclosure and through voluntary conveyance.

The cost of real estate acquired through foreclosure or voluntary conveyance is recorded at the lower of fair market value at acquisition or cost. Cost includes the outstanding principal balance of the mortgage loan at the date of foreclosure or conveyance plus foreclosure costs, real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and to place the property in good repair. Uncollected interest or unrecovered advances made before foreclosure should also be included in cost.

### Book Value

For real estate that is occupied by the company and for investment real estate, book value would be the cost or other basic value, stated net of any encumbrance, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt and may also include accrued costs of acquisition or construction.

The book value of real estate sold under contract of sale is the balance resulting from the cost of the property, less reductions for cash received on account and for any purchase money mortgage that may have been accepted.

### Market Value

Market value is the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus.

### Appraised Value

An appraisal is an opinion of estimated market value for an adequately described property, as of a specified date, supported by the analysis of relevant data. To arrive at this value, three methods are used:

1. Market Data Approach - a comparative analysis of current sales prices of similar properties, after making necessary adjustments for any difference in the properties.
2. Cost Approach - an estimated value based on the cost of reproduction or replacement of the improvements, less depreciation, plus the value of the land. (Land value is usually determined by the market data approach.)
3. Income Approach - an estimated value based on the capitalization of income and productivity. It is concerned with the present value of future income.

In most appraisals, all three approaches ordinarily will have something to contribute. Each is used independently to reach an estimated value. Then, by applying to each separate value a weight proportionate to its merits in that particular instance, a conclusion is reached concerning one appropriate value. This procedure is known as correlation.

### Statement Value

The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual cost, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

### Income Derived from Real Estate

Income on real estate, or on space in buildings owned and occupied by the company, usually is received periodically and in advance and any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount



applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a period specified by statute or regulation, most jurisdictions require that the entire amount be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part should be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received should be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the rental income for the period.

In the statutory financial statement, a company must include in both its income and expenses an amount for rent relating to its occupancy of its own buildings.

This amount can be the estimated current market rental value of the space involved, or it can be the amount derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the company's investment in its home office building. The figure thus determined, being both charged to expenses and credited to income, has no effect either on the company's overall net income or surplus.

### Sale of Real Estate

A company can recognize the sale of any real estate that it owns as an immediate cash sale or as a contract of sale. In a sale for cash and/or mortgage, title transfers to the buyer when the sale is consummated. Any profit or loss on the sale is considered to be realized in the year of sale. In a sale involving an installment contract, often referred to as land contracts, title is retained by the seller and transferred to the buyer only when he has paid the entire sales price, or a substantial portion of it.

If the sale of real estate, including real estate occupied by the Company, includes a mortgage or other note from the Company, some states may require the transaction be reported as a financing transaction using the deposit method of accounting for sale-leaseback transaction.

An insurer does not take credit for any profit from the sale or exchange of its assets when the consideration received and otherwise properly reported as an admitted asset is in the form of an installment contract, unless such profit is fully reserved by a liability established which is equal to the portion of such profit which is unrealized. In computing the realized portion of the profit on installment contracts, payments are allocated at the rate the principal is reduced by said payments.

### Depreciation and Amortization

The cost of property, other than land, should be depreciated over its estimated useful life. Useful lives for buildings and improvements can best be obtained from contractors, appraisers, engineers, and manufacturers. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets. Depreciable life may at times be fixed by contract, such as in a leasehold investment.

A variety of depreciation methods is available and a company should select the method that is most appropriate provided, however, that the method is both systematic and rational. Depreciation methods in use include the straight-line method, and accelerated methods, such as sum-of-the-years digits and various declining balance methods.

Because real estate leasehold improvements revert to the lessor at the end of the lease and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

### Expenses and Capital Improvements

Repairs and maintenance expenditures may be classified as ordinary or extraordinary. As a general rule, expenditures for ordinary repairs that are necessary to put assets back into good operating condition, and for maintenance to keep them that way, are expensed as they are incurred.

Extraordinary expenditures which add to or prolong the life of the property should be capitalized. In practice, most organizations establish a minimum capitalization amount. Individual expenditures below this minimum are expensed rather than capitalized to avoid capitalization of immaterial amounts. Other expenses in operating real estate are expensed as incurred.

### Other Real Estate Taxes

Except for the development phase of a project, real and personal property taxes are charged against income. Real and personal property taxes are based upon the assessed valuation of property, as of a given date, as determined by the laws of a state or other taxing authority. The proper accounting treatment must determine when the liability for real and personal property taxes should be accrued. Consistency of application from year to year in establishing this liability is the most important consideration.

The preferred basis for determining the liability and charges for real and personal property taxes should be established at the time of purchase. A practical aspect of the legal liability for these taxes must be considered when title to property is transferred during the taxable year, whereby the date of personal obligation generally controls. Adjustments for property taxes paid or accrued are frequently incorporated in agreements covering the sale of the real estate and determined between the buyer's and seller's obligations. Once established, this liability can be applied consistently throughout the ownership of the property.

21. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides similar guidance to the above paragraph.

22. The Accounting Practice and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22, *General Expenses and Taxes, Licenses and Fees*, includes the following guidance:

11. Real estate expenses include all costs except salaries and wages of company employees that relate to real estate, whether occupied by the company or not.

23. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19, *Expenses*, contains the following pertinent excerpts:

#### 3. Taxes, Licenses, and Fees

These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

24. Minnesota state regulations include the following specific guidelines related to valuation of real estate investments:

60A.122 Mortgage and real estate valuation

An insurer shall establish written procedures, approved by the company's board of directors, for the valuation of commercial mortgage loans and real estate owned. The procedures must be made available to the commissioner upon request. The commissioner shall review the insurer's compliance with the procedures in any examination of the insurer under section 60A.031.

60A.123 Valuation of foreclosures; reserves

Subdivision 1. Requirement. An insurer shall value its commercial mortgage loans and real estate acquired through foreclosure of commercial mortgage loans as provided in this section for the purpose of establishing reserves or carrying values of the investments and for statutory accounting purposes.

Subdivision 2. Performing mortgage loan. A performing mortgage loan must be carried at its amortized cost.

Subdivision 3. Distressed mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of its commercial mortgage loans which it classifies as distressed mortgage loans. The carrying value must be based upon one or more of the following procedures:

- (1) an internal appraisal;
- (2) an appraisal made by an independent appraiser;
- (3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer may determine the carrying value of its distressed mortgage loans through either an evaluation of each specific distressed mortgage loan or by a sampling methodology. Insurers using a sampling methodology shall identify a sampling of its distressed mortgage loans that represents a cross section of all of its distressed mortgage loans. The insurer shall make an evaluation of the appropriate carrying value for each sample loan. The carrying value of all of the insurer's distressed mortgage loans must be the same percentage of their amortized acquisition cost as the sample loans. The carrying value must be based upon an internal appraisal or an appraisal conducted by an independent appraiser.

(c) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its distressed mortgage loans.

Subdivision 4. Delinquent mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of each delinquent mortgage loan. The carrying value must be based upon one or more of the following procedures:

- (1) an internal appraisal;
- (2) an appraisal by an independent appraiser;
- (3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its delinquent mortgage loans.

Subdivision 5. Restructured mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of each restructured mortgage loan. The carrying value must be based upon one or more of the following procedures:

- (1) an internal appraisal;
- (2) an appraisal by an independent appraiser;
- (3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its restructured mortgage loans.

Subdivision 6. Mortgage loan in foreclosure.

(a) The insurer shall make an evaluation of the appropriate carrying value of each mortgage loan in foreclosure. The carrying value must be based upon an appraisal made by an independent appraiser.

(b) The insurer shall take a charge against its surplus for the difference between the carrying value and the amortized acquisition cost of its mortgage loans in the process of foreclosure.

Subdivision 7. Real estate owned.

(a) The insurer shall make an evaluation of the appropriate carrying value of real estate owned. The carrying value must be based upon an appraisal made by an independent appraiser.

(b) The insurer shall take a charge against its surplus for the difference between the carrying value and the amortized acquisition cost of real estate owned.

60A.125 Property and mortgage loan appraisal

Subdivision 1. Mortgage loans in the process of foreclosure. An insurer may rely upon an appraisal by an independent appraiser to determine the carrying value of mortgage loans in the process of foreclosure only if the date of the appraisal is within six months of the date the foreclosure procedure is begun. If no appraisal exists, the insurer shall acquire an appraisal within six months after the foreclosure proceeding has begun.

Subdivision 2. Real estate owned. An insurer may rely upon an appraisal by an independent appraiser to determine the carrying value of real estate owned only if the date of the appraisal is within six months of the date when title to the property was acquired. If no appraisal exists, the insurer shall acquire an appraisal within six months after title to the property is acquired.

Subdivision 3. Charge taken. An insurer shall take a charge against the surplus for mortgage loans in the process of foreclosure and real estate owned in the first calendar year in which it holds a current appraisal made by an independent appraiser as provided in this section.

25. Missouri state regulations also include specific guidelines related to valuation of real estate investments:

20 CSR 200-13.100 Appraisal requirements

Purpose: This rule upgrades the quality of real estate appraisals used by insurers by requiring appraisals meet the same standards as those applicable to federally-regulated financial institutions. This rule effectuates or aids in the interpretation of sections 375.330, 376.300 and 379.080, RSMo.

Editor's Note: The secretary of state has determined that the publication of this rule in its entirety would be unduly cumbersome or expensive. The entire text of the material referenced has been filed with the secretary of state. This material may be found at the Office of the Secretary of State or at the headquarters of the agency and is available to any interested person at a cost established by state law.

(1) Any real estate held as an investment for the production of income pursuant to section 375.330.1(7), RSMo, or any mortgage loan made pursuant to section 376.300.1(9) or 379.080.1(2)(f), RSMo, excluding purchase money mortgages as identified in section 376.300.1(9), RSMo, may be held as an admissible asset only if the appraisal --

(A) Is made of real estate no more than one hundred twenty (120) days before the date the deed or mortgage is recorded in the appropriate public records;

(B) Is a written statement that is independently and impartially prepared by a licensed or certified appraiser setting forth an opinion of defined value of an adequately described property as of a specific date, supported by presentation and analysis of relevant market information;

(C) Provides the current market value of the real estate, that is the value of the real estate in an arms-length sale as of the date of the appraisal; and

(D) Is made by an individual who is --

1. On the national registry of state-certified and licensed appraisers who are eligible to perform appraisals in federally related transactions, which national registry is maintained pursuant to United States P.L. 101-73, Title XI, Section 1103 (12 USC Section 3332); and

2. Certified or licensed to make the appraisal by the state in which the real estate is located.

(2) Notwithstanding any provision of section (1) of this rule to the contrary, no appraisal is necessary in order to admit as an asset the holding of any debt or security issued, assumed or guaranteed by the United States, any state, territory or possession of the United States, the District of Columbia or any administration, agency, authority or instrumentality of them, but only to the extent that the debt or security is issued, assumed insured or guaranteed by any such entity.

(3) Notwithstanding any provision of section (1) of this rule to the contrary, an insurer may establish written procedures, approved by the company's board of directors, for the valuation of its real estate and mortgage loans, which shall exempt the insurer from all of the provisions of section (1). The written procedures must be approved by the director. The director may review the insurer's compliance with these procedures. The director must be notified of any material changes to the written procedures. To be exempt under this section, an insurer's mortgage loan and real estate operations shall meet the following minimum standards:

(A) The insurer shall hold a combined mortgage loan and real estate portfolio valued at three hundred (300) million dollars or more;

(B) The insurer shall establish written procedures and obtain board approval and approval by the director within one hundred twenty (120) days (August 6, 1993) of the effective date of this rule (April 8, 1993);

(C) The insurer, as part of the written procedures, shall establish a reasonable system of valuation of its mortgage loans and real estate which includes the following elements:

1. A system to value its real estate acquired through foreclosure for the purpose of establishing reserves or carrying values of the investments and for statutory accounting purposes;

2. A program for the training, education and certification of employees, at least one (1) of whom must be certified as described in paragraph (1)(D)1. of this rule, who conducts internal appraisals of investments, or a system involving the use of independent certified appraisers as described in paragraph (1)(D)1. of this rule. Any internal appraiser shall not be compensated, directly or indirectly, on the basis of the outcome of appraisals performed and shall have direct reporting access to the chief investment officer of the insurer; and

3. Carrying values for the foreclosed real estate shall be based upon the internal appraisal or an independent appraisal and the value of the guarantees or other credit enhancements related to the investment; and

(D) The audit report of the independent certified public accountant which prepares the audit of the insurer's annual statement shall contain findings by the auditor that --

1. The insurer has adopted valuation procedures meeting the requirements of section (3) of this rule;

2. The procedures adopted by the board of directors have been uniformly applied by the insurer in conformance with section (3) of this rule; and

3. The management of the insurer has an adequate system of internal controls.

26. Nevada Statutes - Insurance Laws, TITLE 57 --- INSURANCE - Chapter 681B - ASSETS AND LIABILITIES provides the following guidance on real estate valuation:

#### 681B.180 Real property

1. Real property acquired pursuant to a mortgage loan or contract for sale, in the absence of a recent appraisal deemed by the commissioner to be reliable, shall not be valued at an amount greater than the unpaid principal of the defaulted loan or contract plus interest due and accrued at the date of such acquisition, together with any taxes and expenses paid or incurred in connection with such acquisition, and the cost of improvements thereafter made by the insurer and any amounts thereafter paid by the insurer on assessments levied for improvements in connection with the property.

2. Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than 3 years old, the commissioner may, at his discretion, call for and require a new appraisal in order to determine fair value.

27. Arizona Statutes - Insurance Laws, TITLE 20-- INSURANCE, Chapter 3 FINANCIAL PROVISIONS AND PROCEDURES, Article 1. Assets and Liabilities provides similar guidance:

20-513 Real and personal property valuation

A. Real property acquired pursuant to a mortgage loan or contract for sale, in the absence of a recent appraisal deemed by the director to be reliable, shall not be valued at an amount greater than the unpaid principal of the defaulted loan or contract at the date of such acquisition, together with any taxes and expenses paid or incurred in connection with such acquisition, and the cost of improvements thereafter made by the insurer and any amounts thereafter paid by the insurer on assessments levied for improvements in connection with the property.

B. Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than three years old, the director may at his discretion call for and require a new appraisal in order to determine fair value.

C. Personal property acquired pursuant to chattel mortgages made in accordance with section 20-555 shall not be valued at an amount greater than the unpaid balance of principal on the defaulted loan at the date of acquisition, together with taxes and expenses incurred in connection with the acquisition, or the fair value of the property, whichever amount is the lesser.

**Generally Accepted Accounting Principles**

28. *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, provides the following guidance:

48. Real estate investments shall be reported at cost less accumulated depreciation and an allowance for any impairment in value. Depreciation and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for any impairment in value relating to real estate investments shall be included in realized gains and losses.

29. *FASB Statement No. 66, Accounting for Sales of Real Estate*, provides the following guidance:

INTRODUCTION

1. This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business. The Statement distinguishes between retail land sales and other sales of real estate because differences in terms of sales and selling procedures lead to different profit recognition criteria and methods. Accounting for real estate sales transactions that are not retail land sales is specified in paragraphs 3-43. Accounting for retail land sales transactions is specified in paragraphs 44-50. This Statement 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*.

2. Although this Statement applies to all sales of real estate, many of the extensive provisions were developed over several years to deal with complex transactions that are frequently encountered in enterprises that specialize in real estate transactions. The decision trees on pages 75-79 highlight the major provisions of the Statement and will help a user of the Statement identify criteria that determine when and how profit is recognized. Those using this Statement to determine the accounting for relatively simple real estate sales transactions will need to apply only limited portions of the Statement. The general requirements for recognizing all of the profit on a nonretail land sale at the date of sale are set forth in paragraphs 3-5 and are highlighted on the decision tree on page 75. Paragraphs 6-18 elaborate on those general provisions. Paragraphs 19-43 provide more detailed guidance for a variety of more complex transactions.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

## Real Estate Sales Other Than Retail Land Sales

## Recognition of Profit by the Full Accrual Method

3. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Recognition of all of the profit at the time of sale or at some later date when both conditions exist is referred to as the full accrual method in this Statement.

4. 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.

5. Profit on real estate sales transactions<sup>1</sup> shall not be recognized by the full accrual method until all of the following criteria are met:

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<sup>1</sup> Profit on a sale of a partial interest in real estate shall be subject to the same criteria for profit recognition as a sale of a whole interest.

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- 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.

## Consummation of a Sale

6. 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 conditions<sup>2</sup> 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.

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

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## Buyer's Initial and Continuing Investment

7. "Sales value" shall be determined by:
- a. Adding to the stated sales price the proceeds from the issuance of a real estate option that is exercised and other payments that are in substance additional sales proceeds. These nominally may be management fees, points, or prepaid interest or fees that are required to be maintained in an advance status and applied against the amounts due to the seller at a later date.
  - b. Subtracting from the sale price a discount to reduce the receivable to its present value and by the net present value of services that the seller commits to perform without compensation or by the net present value of the services in excess of the compensation that will be received. Paragraph 31 specifies appropriate accounting if services are to be provided by the seller without compensation or at less than prevailing rates.
8. Adequacy of a buyer's initial investment shall be measured by (a) its composition (paragraphs 9-10) and (b) its size compared with the sales value of the property (paragraph 11).
9. The buyer's initial investment shall include only: (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from an independent established lending institution,<sup>3</sup> (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, shall be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.

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<sup>3</sup> An "independent established lending institution" is an unrelated institution such as a commercial bank unaffiliated with the seller.

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10. The initial investment shall not include:
- a. Payments by the buyer to third parties for improvements to the property
  - b. A permanent loan commitment by an independent third party to replace a loan made by the seller
  - c. Any funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer<sup>4</sup>

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<sup>4</sup> As an example, if unimproved land is sold for \$100,000, with a down payment of \$50,000 in cash, and the seller plans to loan the buyer \$35,000 at some future date, the initial investment is \$50,000 minus \$35,000, or \$15,000.

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11. The buyer's initial investment shall be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Lending practices of independent established lending institutions provide a reasonable basis for assessing the collectibility of receivables from buyers of real estate. Therefore, to qualify, the initial investment shall be equal to at least a major part of the difference between usual loan limits and the sales value of the property. Guidance on minimum initial investments in various types of real estate is provided in paragraphs 53 and 54.

12. The buyer's continuing investment in a real estate transaction shall not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that

debt and interest on the unpaid balance over no more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. For this purpose, contractually required payments by the buyer on its debt shall be in the forms specified in paragraph 9 as acceptable for an initial investment. Except as indicated in the following sentence, funds to be provided directly or indirectly by the seller (paragraph 10.c.) shall be subtracted from the buyer's contractually required payments in determining whether the initial and continuing investments are adequate. If a future loan on normal terms from an established lending institution bears a fair market interest rate and the proceeds of the loan are conditional on use for specified development of or construction on the property, the loan need not be subtracted in determining the buyer's investment.

#### Release Provisions

13. An agreement to sell property (usually land) may provide that part or all of the property may be released from liens securing related debt by payment of a release price or that payments by the buyer may be assigned first to released property. If either of those conditions is present, a buyer's initial investment shall be sufficient both to pay release prices on property released at the date of sale and to constitute an adequate initial investment on property not released or not subject to release at that time in order to meet the criterion of an adequate initial investment for the property as a whole.

14. If the release conditions described in paragraph 13 are present, the buyer's investment shall be sufficient, after the released property is paid for, to constitute an adequate continuing investment on property not released in order to meet the criterion of an adequate continuing investment for the property as a whole (paragraph 12).

15. If the amounts applied to unreleased portions do not meet the initial and continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in paragraph 5 as if each release were a separate sale.

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

#### Future Subordination

17. The seller's receivable shall not be subject to future subordination. This restriction shall not apply if (a) a receivable is subordinate to a first mortgage on the property existing at the time of sale or (b) a future loan, including an existing permanent loan commitment, is provided for by the terms of the sale and the proceeds of the loan will be applied first to the payment of the seller's receivable.

#### Continuing Involvement without Transfer of Risks and Rewards

18. If a seller is involved with a property after it is sold in any way that results in retention of substantial risks or rewards of ownership, except as indicated in paragraph 43, the absence-of-continuing-involvement criterion has not been met. Forms of involvement that result in retention of substantial risks or rewards by the seller, and accounting therefore, are described in paragraphs 25-42.

### Recognition of Profit When the Full Accrual Method Is Not Appropriate

19. If a real estate sales transaction does not satisfy the criteria in paragraphs 3-18 for recognition of profit by the full accrual method, the transaction shall be accounted for as specified in the following paragraphs.

#### Sale Not Consummated

20. 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.

21. If the net carrying amount of the property exceeds the sum of the deposit received, the fair value of the unrecorded note receivable, and the debt assumed by the buyer, the seller shall recognize the loss at the date the agreement to sell is signed.<sup>5</sup> If a buyer defaults, or if circumstances after the transaction indicate that it is probable the buyer will default and the property will revert to the seller, the seller shall evaluate whether the circumstances indicate a decline in the value of the property for which an allowance for loss should be provided.

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<sup>5</sup> Paragraph 24 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, specifies the accounting for an excess of costs over net realizable value for property that has not yet been sold.

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#### Initial or Continuing Investments Do Not Qualify

22. If the buyer's initial investment does not meet the criteria specified in paragraphs 8-11 for recognition of profit by the full accrual method and if recovery of the cost of the property is reasonably assured if the buyer defaults, the installment method described in paragraphs 56-61 shall be used. If recovery of the cost of the property is not reasonably assured if the buyer defaults or if cost has already been recovered and collection of additional amounts is uncertain, the cost recovery method (described in paragraphs 62-64) or the deposit method (described in paragraphs 65-67) shall be used. The cost recovery method may be used to account for sales of real estate for which the installment method would be appropriate.

23. 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,<sup>6</sup> on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan

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<sup>6</sup> Paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*, provide criteria for selecting an appropriate rate for present-value calculations.

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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).

### Receivable Subject to Future Subordination

24. If the seller's receivable is subject to future subordination as described in paragraph 17, profit shall be recognized by the cost recovery method (paragraphs 62-64).

### Continuing Involvement without Transfer of Risks and Rewards

25. If the seller has some continuing involvement with the property and does not transfer substantially all of the risks and rewards of ownership, profit shall be recognized by a method determined by the nature and extent of the seller's continuing involvement. Generally, profit shall be recognized at the time of sale if the amount of the seller's loss of profit because of continued involvement with the property is limited by the terms of the sales contract. The profit recognized shall be reduced by the maximum exposure to loss. Paragraphs 26-43 describe some common forms of continuing involvement and specify appropriate accounting if those forms of involvement are present. If the seller has some other form of continuing involvement with the property, the transaction shall be accounted for according to the nature of the involvement.

26. The seller has an obligation to repurchase the property, or the terms of the transaction allow the buyer to compel the seller or give an option<sup>7</sup> to the seller to repurchase the property. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

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<sup>7</sup> A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase.

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27. The seller is a general partner in a limited partnership that acquires an interest in the property sold (or has an extended, noncancelable management contract requiring similar obligations) and holds a receivable from the buyer for a significant<sup>8</sup> part of the sales price. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement.

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<sup>8</sup> For this purpose, a significant receivable is a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property. It would include:

- a. 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 that the seller will not be liable for
  - b. An all-inclusive or wraparound receivable held by the seller to the extent that it exceeds prior-lien financing for which the seller has no personal liability
  - c. Other funds provided or to be provided directly or indirectly by the seller to the buyer
  - d. The present value of a land lease when the seller is the lessor (footnote 15)
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28. The seller guarantees<sup>9</sup> the return of the buyer's investment or a return on that investment for a limited or extended period. For example, the seller guarantees cash flows, subsidies, or net tax benefits. If the seller guarantees return of the buyer's investment or if the seller guarantees a return on the investment for an extended period, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the deposit method shall be used until operations of the property cover all operating expenses, debt service, and contractual payments. At that time, profit shall be recognized on the basis of performance of the services required, as illustrated in paragraphs 84-88.

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<sup>9</sup> Guarantees by the seller may be limited to a specified period of time.

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29. The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained, for example, until rentals of a property are sufficient to cover operating expenses and debt service. If support is required or presumed to be required<sup>10</sup> for an extended period of time, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If support is required or presumed to be required for a limited time, profit on the sale shall be recognized on the basis of performance of the services required. Performance of those services shall be measured by the costs incurred and to be incurred over the period during which the services are performed. Profit shall begin to be recognized when there is reasonable assurance that future rent receipts will cover operating expenses and debt service including payments due the seller under the terms of the transaction. Reasonable assurance that rentals will be adequate would be indicated by objective information regarding occupancy levels and rental rates in the immediate area. In assessing whether rentals will be adequate to justify recognition of profit, total estimated future rent receipts of the property shall be reduced by one-third as a reasonable safety factor unless the amount so computed is less than the rents to be received from signed leases. In this event, the rents from signed leases shall be substituted for the computed amount. Application of this method is illustrated in paragraphs 84-89.

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<sup>10</sup> Support shall be presumed to be required if: (a) a seller obtains an interest as a general partner in a limited partnership that acquires an interest in the property sold; (b) 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; (c) a seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property; or (d) a seller agrees to manage the property for the buyer on terms not usual for the services to be rendered, and the agreement is not terminable by either the seller or the buyer.

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30. If the sales contract does not stipulate the period during which the seller is obligated to support operations of the property, support shall be presumed for at least two years from the time of initial rental unless actual rental operations cover operating expenses, debt service, and other contractual commitments before that time. If the seller is contractually obligated for a longer time, profit recognition shall continue on the basis of performance until the obligation expires. Calculation of profits on the basis of performance of services is illustrated in paragraphs 84-89.

31. If the sales contract requires the seller to provide management services relating to the property after the sale without compensation or at compensation less than prevailing rates for the service required (paragraph 7) or on terms not usual for the services to be rendered (footnote 10(d)), compensation shall be imputed when the sale is recognized and shall be recognized in income as the services are performed over the term of the management contract.

32. The transaction is merely an option to purchase the property. For example, undeveloped land may be "sold" under terms that call for a very small initial investment by the buyer (substantially less than the percentages specified in paragraph 54) and postponement of additional payments until the buyer obtains zoning changes or building permits or other contingencies specified in the sales agreement are satisfactorily resolved. Proceeds from the issuance of the option by a property owner shall be accounted for as a deposit (paragraphs 65-67). Profit shall not be recognized until the option either expires or is exercised. When an option to purchase real estate is sold by an option holder,<sup>11</sup> the seller of the option shall recognize income by the cost recovery method (paragraphs 62-64) to the extent nonrefundable cash proceeds exceed the seller's cost of the option if the buyer's initial and continuing investments are not adequate for profit recognition by the full accrual method (paragraphs 7-16).

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<sup>11</sup> When an option to purchase real estate is sold by an option holder, the sales value includes 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 is \$650,000.

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33. The seller has made a partial sale. A sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. Profit (the difference between the sales value and the proportionate cost of the partial interest sold) shall be recognized at the date of sale if:

- a. The buyer is independent of the seller.
- b. Collection of the sales price is reasonably assured (paragraph 4).
- c. The seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

34. If the buyer is not independent of the seller, for example, if the seller holds or acquires an equity interest in the buyer, the seller shall recognize the part of the profit proportionate to the outside interests in the buyer at the date of sale. If the seller controls the buyer, no profit on the sale shall be recognized until it is realized from transactions with outside parties through sale or operations of the property.

35. If collection of the sales price is not reasonably assured, the cost recovery or installment method of recognizing profit shall be used.

36. If the seller is required to support the operations of the property after the sale, the accounting shall be based on the nature of the support obligation. For example, the seller may retain an interest in the property sold and the buyer may receive preferences as to profits, cash flows, return on investment, and so forth. If the transaction is in substance a sale, the seller shall recognize profit to the extent that proceeds from the sale, including receivables from the buyer, exceed all of the seller's costs related to the entire property. Other examples of support obligations are described in paragraphs 29-31.

37. If individual units in condominium projects<sup>12</sup> 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:

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<sup>12</sup> A condominium project may be a building, a group of buildings, or a complete project.

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- a. Construction is beyond a preliminary stage.<sup>13</sup>

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<sup>13</sup> Construction is not beyond a preliminary stage if engineering and design work, execution of construction contracts, site clearance and preparation, excavation, and completion of the building foundation are incomplete.

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- b. The buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest.<sup>14</sup>

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<sup>14</sup> The buyer may be able to require a refund, for example, if a minimum status of completion of the project is required by state law and that status has not been attained; if state law requires that a "Declaration of Condominium" be filed and it has not been filed, except that in some states the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable; if the sales contract provides that permanent financing at an acceptable cost must be available to the buyer at the time of closing and it is not available; or if the 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, and they are not so registered.

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- 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.

38. The seller sells property improvements and leases the underlying land to the buyer of the improvements. In these circumstances, the transactions are interdependent and it is impracticable to distinguish between profits on the sale of the improvements and profits under the related lease. The transaction shall be accounted for as a lease of both the land and improvements if the term of the land lease to the buyer from the seller of the improvements 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 for a substantial period, for example, 20 years.

39. If the land lease described in paragraph 38 covers substantially all of the economic life of the improvements and extends for at least 20 years, the profit to be recognized on the sale of the improvements at the time of sale shall be (a) the present value of the rental payments<sup>15</sup> not in excess of the seller's cost of the land plus (b) the sales value of the improvements minus (c) the carrying value of the improvements and the land. Profit on (1) the buyer's rental payments on the land in excess of the seller's cost of the land and (2) the rent to be received on the land after the maturity of the primary indebtedness on the improvements or other customary amortization term shall be recognized when the land is sold or the rents in excess of the seller's cost of the land are accrued under the lease. Calculations of profit in those circumstances are illustrated in paragraphs 82 and 83.

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<sup>15</sup> The present value of the specified rental payments is the present value of the lease payments specified in the lease over the term of the primary indebtedness, if any, on the improvements, or over the customary amortization term of primary debt instruments on the type of improvements involved. The present value is computed at an interest rate appropriate for (a) primary debt if the lease is not subordinated or (b) secondary debt if the lease is subordinated to loans with prior liens.

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40. The sale of the property is accompanied by a leaseback to the seller of all or any part of the property for all or part of its remaining economic life. Real estate sale and leaseback transactions shall be accounted for in accordance with the provisions of this Statement and *FASB Statement No. 13, Accounting for Leases*, and *FASB Statement No. 28, Accounting for Sales with Leasebacks*. Statement 13 as amended by Statement 28 provides criteria for determining if a leaseback is a capital lease or an operating lease. If the leaseback is a capital lease, the seller-lessee shall record an asset and an obligation as prescribed by Statement 13. Regardless of whether the leaseback is a capital lease or an operating lease, a sale shall be recorded, and the property sold and any related debt assumed by the buyer shall be removed from the seller-lessee's balance sheet. The criteria in this Statement then shall be used to determine the amount of profit that would be recognized at the date of sale, absent the leaseback provisions. The profit so determined shall be accounted for in accordance with the provisions of Statements 13 and 28 (usually deferred and amortized over the term of the lease) unless other provisions of this Statement require postponement of profit recognition until a later event.

41. The sales contract or an accompanying agreement requires the seller to develop the property in the future, to construct facilities on the land, or to provide off-site improvements or amenities. The seller is involved with future development or construction work if the buyer is unable to pay amounts due for that work or has the right under the terms of the arrangement to defer payment until the work is done. If future costs of development can be reasonably estimated at the time of sale, profit allocable to (a) performance before the sale of the land and (b) the sale of the land shall be recognized when the sale of the land meets the criteria in paragraph 5. Profit allocable to

performance after the sale shall be recognized by the percentage-of-completion method as development and construction proceed, provided that cost and profit can be reasonably estimated from the seller's previous experience.

42. The profit shall be allocated to the sale of the land and the later development or construction work on the basis of estimated costs of each activity; the same rate of profit shall be attributed to each activity. No profit shall be recognized at the time of sale if future costs of development cannot be reasonably estimated at that time.

43. The seller will participate in future profit from the property without risk of loss (such as participation in operating profits or residual values without further obligation). If the transaction otherwise qualifies for recognition of profit by the full accrual method, the transfer of risks and rewards of ownership and absence of continuing involvement criterion shall be considered met. The contingent future profits shall be recognized when they are realized.<sup>16</sup> All the costs of the sale shall be recognized at the time of sale; none shall be deferred to periods when the contingent profits are recognized.

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<sup>16</sup> Paragraph 17 of *FASB Statement No. 5, Accounting for Contingencies*, addresses accounting for gain contingencies.

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#### Retail Land Sales

44. A single method of recognizing profit shall be applied to all sales transactions within a project<sup>17</sup> that have been consummated.<sup>18</sup> That method of recognizing profit shall be changed when certain conditions are met for the entire project (paragraph 49).

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<sup>17</sup> A retail land sales "project" is a homogeneous, reasonably contiguous area of land that may, for development and marketing, be subdivided in accordance with a master plan.

<sup>18</sup> Retail land sales shall be considered consummated when all of the criteria in paragraph 47 are met.

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#### Recognition of Profit

45. The full accrual method of accounting described in paragraphs 70-72 shall be applied to a sale if all of the following conditions are met:

- a. Expiration of refund period. The buyer has made the down payment and each required subsequent payment until the period of cancellation with refund has expired. That period shall be the longest period of those required by local law, established by the seller's policy, or specified in the contract.
- b. Sufficient cumulative payments. The cumulative payments of principal and interest equal or exceed 10 percent of the contract sales price.
- c. Collectibility of receivables. Collection experience for the project in which the sale is made or for the seller's prior projects indicates that at least 90 percent of the contracts in the project in which the sale is made that are in force 6 months after the criteria in paragraph 46 are met will be collected in full.<sup>19</sup> The collection experience with the seller's prior projects may be applied to a new project if the prior projects:

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<sup>19</sup> The six-month period is solely a test of eligibility for the accrual method and is not intended to restrict the recognition of profit before the six-month period expires.

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- (1) Had predominantly the same characteristics (type of land, environment, clientele, contract terms, sales methods)<sup>20</sup> as the new project.

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<sup>20</sup> Examples of sales methods include telephone sales, broker sales, and site-visitation sales.

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- (2) Had a sufficiently long collection period to indicate the percentage of current sales of the new project that will be collected to maturity. A down payment of at least 20 percent shall be an acceptable indication of collectibility.

- d. Nonsubordination of receivables. The receivable from the sale is not subject to subordination to new loans on the property except that subordination by an individual lot buyer for home construction purposes is permissible if the collection experience on those contracts is the same as on contracts not subordinated.
- e. Completion of development. The seller is not obligated to complete improvements of lots sold or to construct amenities or other facilities applicable to lots sold. Paragraphs 6-49 specify accounting methods that shall be used if the above criteria are not met.

46. The percentage-of-completion method of accounting <sup>21</sup> described in paragraphs 73-75 shall be applied to a sale that meets all of the following criteria:

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<sup>21</sup> In the AICPA Guide, Accounting for Retail Land Sales, this was called the "accrual method."

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- a. The period of cancellation with refund has expired (paragraph 45.a.).
- b. Cumulative payments equal or exceed 10 percent (paragraph 45.b.).
- c. Receivables are collectible (paragraph 45.c.).
- d. Receivables are not subject to subordination (paragraph 45.d.).
- e. There has been progress on improvements. The project's improvements have progressed beyond preliminary stages, and there are indications that the work will be completed according to plan. Some indications of progress are:
- (1) The expenditure of funds on the proposed improvements.
  - (2) Initiation of work on the improvements.
  - (3) Existence of engineering plans and work commitments relating to lots sold.
  - (4) Completion of access roads and amenities such as golf courses, clubs, and swimming pools.

In addition, there shall be no indication of significant delaying factors, such as the inability to obtain permits, contractors, personnel, or equipment, and estimates of costs to complete and extent of progress toward completion shall be reasonably dependable.

- f. Development is practical. There is a reasonable expectation that the land can be developed for the purposes represented and the properties will be useful for those purposes at the end of the normal payment period. For example, it should be expected that legal restrictions, including environmental restrictions, will not seriously hamper development and that improvements such as access roads, water supply, and sewage treatment or removal are feasible within a reasonable time. Paragraphs 47 and 48 specify accounting methods that shall be used if the above criteria are not met.

47. The installment method of accounting described in paragraphs 56-61 shall be applied to a sale that meets all of the following criteria:

- a. The period of cancellation with refund has expired (paragraph 45.a.).
- b. Cumulative payments equal or exceed 10 percent (paragraph 45.b.).
- c. The seller is financially capable. The seller is clearly capable of providing both land improvements and off-site facilities promised in the contract and of meeting all other representations it has made. It is financially capable of funding or bonding the planned improvements in the project when required. That capability may be indicated by the seller's equity capitalization, its borrowing capacity, or its positive cash flow from operations.

48. If a retail land sale transaction does not meet the criteria for accounting by the methods described in paragraphs 45-47, that transaction shall be accounted for as a deposit as described in paragraphs 65-67.

#### Change from Installment to Percentage-of-Completion Method

49. When all of the conditions in paragraph 46 are satisfied on a retail land sales project originally reported by the installment method, the percentage-of-completion method of accounting may be adopted for the entire project (current and prior sales) and the effect accounted for as a change in accounting estimate.<sup>22</sup>

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<sup>22</sup> The credit to income resulting from the change is the profit not yet recognized less (a) a discount, if required, to reduce the receivable balances to their present values at the date of change to the percentage-of-completion method (using the appropriate interest rates, as specified in paragraphs 13 and 14 of Opinion 21, in effect at the time of the original sales) and (b) the liability (also discounted) for remaining future performance. The computation is illustrated in paragraph 97.

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#### Financial Statement Presentation and Disclosures

50. In addition to disclosures otherwise required by generally accepted accounting principles, the financial statements of enterprises with retail land sales operations shall disclose:

- a. Maturities of accounts receivable for each of the five years following the date of the financial statements
- b. Delinquent accounts receivable and the method(s) for determining delinquency
- c. The weighted average and range of stated interest rates of receivables
- d. Estimated total costs and estimated dates of expenditures for improvements for major areas from which sales are being made over each of the five years following the date of the financial statements
- e. Recorded obligations for improvements

Financial statement presentations of retail land sales transactions are illustrated in paragraphs 95-97.

#### Amendments to Other Pronouncements

51. The references to the AICPA Industry Accounting Guides, Accounting for Profit Recognition on Sales of Real Estate and Accounting for Retail Land Sales, and the AICPA Statements of Position (SOPs) 75-6, Questions Concerning Profit Recognition on Sales of Real Estate and 78-4, Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate, are deleted from Appendix A of *FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*. The references to the profit recognition Guide in paragraph 7 of

FASB Statement No. 26, *Profit Recognition on Sales-Type Leases of Real Estate*, and in footnote “\*” and paragraphs 23-25 of Statement 28 are amended to refer to *Statement No. 66, Accounting for Sales of Real Estate*.

Effective Date and Transition

52. This Statement shall be applied to real estate sales transactions entered into after December 31, 1982 and to changes in methods of accounting for real estate sales transactions made after that date. Earlier application is encouraged but not required. The disclosures required by paragraph 50 shall be provided in financial statements for periods ending after December 15, 1982.

Appendix A:

MINIMUM INITIAL INVESTMENTS

53. Minimum initial investment requirements for sales, other than retail land sales, that are to be accounted for by the full accrual method are specified in paragraph 11. The table of minimum initial investments in paragraph 54 is based on usual loan limits for various types of properties. However, lenders' appraisals of specific properties may differ. Therefore, if a recently placed permanent loan or firm permanent loan commitment for maximum financing of the property exists with an independent established lending institution, the minimum initial investment should be whichever of the following is greater:

- a. The minimum percentage of the sales value (paragraph 7) of the property specified in paragraph 54
- b. The lesser of:
  - (1) The amount of the sales value of the property in excess of 115 percent of the amount of a newly placed permanent loan or firm permanent loan commitment from a primary lender that is an independent established lending institution
  - (2) Twenty-five percent of the sales value

54. This table does not cover every type of real estate property. To evaluate initial investments on other types of property, enterprises may make analogies to the types of properties specified, or the risks of a particular property can be related to the risks of the properties specified. Use of this table is illustrated in paragraphs 77-83.

	Minimum Initial Investment Expressed as a Percentage of Sales Value
Land	
Held for commercial, industrial, or residential development to commence within two years after sale	20
Held for commercial, industrial, or residential development to commence after two years	25
Commercial and Industrial Property	
Office and industrial buildings, shopping centers, and so forth:	
Properties subject to lease on a long-term lease basis to parties with satisfactory credit rating; cash flow currently sufficient to service all indebtedness	10
Single-tenancy properties sold to a buyer with a satisfactory credit rating	15
All other	20
Other income-producing properties (hotels, motels, marinas, mobile home parks, and so forth):	

Cash flow currently sufficient to service all indebtedness	15
Start-up situations or current deficiencies in cash flow	25
Multifamily Residential Property	
Primary residence:	
Cash flow currently sufficient to service all indebtedness	10
Start-up situations or current deficiencies in cash flow	15
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 <sup>a</sup>
Secondary or recreational residence	10 <sup>a</sup>

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<sup>a</sup> If collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience, the minimum initial investment shall be at least 60 percent of the difference between the sales value and the financing available from loans guaranteed by regulatory bodies such as the Federal Housing Authority (FHA) or the Veterans Administration (VA), or from independent, established lending institutions. This 60-percent test applies when the 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 initial investment. If independent first mortgage financing is utilized, the adequacy of the initial investment on sales of single-family residential property should be determined in accordance with paragraph 53.

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#### Appendix B:

#### DESCRIPTION OF CERTAIN METHODS OF ACCOUNTING FOR REAL ESTATE SALES TRANSACTIONS

55. This appendix describes several of the methods of profit recognition that are provided for by this Statement.

##### Installment Method

56. The installment method apportions each cash receipt and principal payment by the buyer on debt assumed between cost recovered and profit. The apportionment is in the same ratio as total cost and total profit bear to the sales value. The calculation is illustrated in paragraph 90.

57. If the stated interest rate is equal to or less than an appropriate interest rate, it is acceptable not to reduce the receivable to its present value. This ordinarily results in reducing profit recognized in the earlier years.

58. Under the installment method, the receivable less profits not recognized does not exceed what the property value would have been if the property had not been sold.

59. The income statement, or related footnotes, for the period including the date of sale presents the sales value, the gross profit that has not yet been recognized, and the total cost of the sale. Revenue and cost of sales (or gross profit) are presented as separate items on the income statement or are disclosed in the footnotes when profit is recognized as earned. This presentation is illustrated in paragraph 96.

60. Paragraph 75 describes accounting for obligations for future improvement costs under the percentage-of-completion method. That description applies as well to accounting for those obligations under the installment method.

61. If after adoption of the installment method the transaction meets the requirements for the full accrual method (specified in paragraphs 3-18) of recognizing profit for real estate sales other than retail land sales, the seller may then change to the full accrual method. The remaining profit that was not recognized is recognized in income at that time.

#### Cost Recovery Method

62. Under the cost recovery method, no profit is recognized until cash payments by the buyer, including principal and interest on debt due to the seller and on existing debt assumed by the buyer, exceed the seller's cost of the property sold.<sup>23</sup> The receivable less profits not recognized, if any, does not exceed what the depreciated property value would have been if the property had not been sold.

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<sup>23</sup> For an all-inclusive or "wrap-around" receivable held by the seller, interest collected is 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.

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63. The income statement for the period including the date of sale presents the sales value, the gross profit that has not yet been recognized, and the total cost of the sale. Gross profit not yet recognized is offset against the related receivable on the balance sheet. Principal collections reduce the related receivable, and interest collections on such receivables increase the unrecognized gross profit on the balance sheet. Gross profit is presented as a separate item of revenue on the income statement when it is recognized as earned.

64. If, after the adoption of the cost recovery method, the transaction meets the requirements for the full accrual method (specified in paragraphs 3-18), the seller may then change to the full accrual method. The remaining profit that was not recognized is recognized in income at that time.

#### Deposit Method

65. Under the deposit method, the seller does not recognize any profit, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and discloses that those items are subject to a sales contract. The seller continues to charge depreciation to expense as a period cost for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, is reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund offset carrying charges (property taxes and interest on existing debt) on the property. Interest collected that is subject to refund and is included in the deposit account before a sale is consummated is accounted for as part of the buyer's initial investment (paragraph 7) at the time the sale is consummated.

66. When a contract is canceled without a refund, deposits forfeited are recognized as income. When deposits on retail land sales are ultimately recognized as sales, the interest portion is recognized as interest income.

67. The seller's balance sheet presents nonrecourse debt assumed by the buyer among the liabilities; the debt assumed is not offset against the related property. The seller reports the buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

Reduced-Profit Method

68. A reduced profit is determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales contract over the maximum period specified in paragraph 12 and excluding requirements to pay lump sums. The present value is calculated using an appropriate interest rate,<sup>24</sup> but not less than the rate stated in the sales contract. This method permits profit to be recognized from level payments on the buyer's debt over the maximum term established in paragraph 12 and postpones recognition of other profits until lump sum or other payments are made.

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<sup>24</sup> Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.

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69. To illustrate, assume a sale of land that cost the seller \$800,000 and is being sold for \$1,000,000 with the following financing:

Buyer's initial investment	\$ 250,000
First mortgage note payable to an independent lending institution (Terms--15 percent interest payable annually over 20 years: \$79,881 per year including principal and interest)	500,000
Second mortgage note payable to seller (Terms--12 percent interest payable annually over 25 years: \$31,875 per year including principal and interest)	<u>250,000</u>
Total selling price	\$1,000,000 =====

The amortization term of the second mortgage (25 years) exceeds the term permitted by paragraph 12 (20 years for sales of land). It is assumed that the payments by the buyer each year will meet the requirement in paragraph 23, that the reduced-profit method is to be applied, and that the market interest rate is 16 percent.

The present value of \$31,875 per year for 20 years at a market rate of 16 percent is \$31,875 x 5.92884 = \$188,982.

The profit to be recognized at the time of sale is reduced by the difference between the face amount of the seller's receivable (\$250,000) and the reduced amount (\$188,982), or \$61,018. The profit recognized at the time of sale is \$1,000,000 (sales price) minus \$800,000 (cost) minus \$61,018, or \$138,982. Additional profit of \$61,018 is recognized as the second mortgage payments are received in years 21 through 25.

Full Accrual Method--Retail Land Sales

70. Revenues and costs are accounted for under the accrual method as follows:

- a. The net receivable is discounted to the present value of the payments required. The present value is determined using an appropriate interest rate,<sup>25</sup> not less than the rate stated in the sales contract. The objective is to value the net receivable at the amount at which it could be sold without recourse to the seller at the date of the sales contract.

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<sup>25</sup> Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.

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- b. An allowance is provided for receivables that are not expected to be collected because of cancellation in subsequent periods. Receivable balances applicable to canceled

contracts are charged in their entirety to the allowance for contract cancellations when those contracts are canceled.

- c. Costs of sales (land and improvement costs incurred, carrying costs, and so forth) are based on sales net of those sales expected to be canceled in future periods.

71. Historical data is evaluated to predict the collection of receivables from current sales. The historical data is selected from a representative sample of receivables that reflect the latest available collection data and cover an adequate period of time. The receivables in the sample are considered uncollectible and the allowance for contract cancellations provided for previously recognized sales (paragraph 70.b.) is appropriately adjusted if payments due are unpaid at the end of the sample period selected for the following delinquency periods:

<u>Percent of Contract Price Paid</u>	<u>Delinquency Period</u>
Less than 25 percent	90 days
25 percent but less than 50 percent	120 days
50 percent and over	150 days

The specified delinquency periods may be extended if the seller's recent experience has been better or if the buyer has accepted, or is willing to accept, personal liability on its debt, provided that the buyer's ability to complete payment on the contract can be determined.

72. Many sellers have programs to accelerate collections of receivables or contract provisions that encourage prepayment with a reduction of the principal as the major incentive for prepayment. If a seller expects to institute those or similar programs in the future, the amount of profit recognized at the date of sale is reduced through charges to income for anticipated discounts not otherwise recognized. Reductions that are given sporadically are charged to income in the period they occur.

#### Percentage-of-Completion Method--Retail Land Sales

73. The earnings process is not complete if a seller is obliged to complete improvements of lots sold or to construct amenities and other facilities applicable to lots sold, if those obligations are significant in relation to total costs, and if they remain unperformed at the time the sale is recognized. Therefore, the amount of revenue recognized (the discounted contract price) at the time a sale is recognized is measured by the relationship of costs already incurred to total estimated costs to be incurred, including costs of the marketing effort. If performance<sup>26</sup> is incomplete, the portion of revenue related to costs not yet incurred is recognized as the costs are incurred.

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<sup>26</sup> *Performance* means completion of the improvements required under the sales contract by either the seller or contractors retained by the seller. However, payments made to municipalities or other governmental organizations not under the direct or joint control of the seller constitute performance by the seller if those organizations are not financed solely by liens on property in the project and they undertake to complete the improvements without further risk or obligation of the seller.

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74. The costs already incurred and total costs to be incurred include land cost, costs previously charged to expense, such as interest and project carrying costs incurred prior to sale, and selling costs<sup>27</sup> directly associated with a project. The accounting described in this paragraph and paragraph 73 is illustrated in paragraphs 91-95.

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<sup>27</sup> Accounting for selling costs is addressed in *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*.

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75. If there is an obligation for future improvement costs that is recognized under the percentage-of-completion method:

- a. Estimates are based on costs generally expected in the construction industry locally.

- b. Unrecoverable costs of off-site improvements, utilities, and amenities are provided for. In determining the amount of unrecoverable costs, estimates of amounts to be recovered from future sale of the improvements, utilities, and amenities are discounted to present value as of the date the net unrecoverable costs are recognized.

76. Estimates of future improvement costs are reviewed at least annually. Changes in those estimates do not lead to adjustment of revenue applicable to future improvements that has been previously recorded unless the adjusted total estimated cost exceeds the applicable revenue. When cost estimates are revised, the relationship of the two elements included in the revenue not yet recognized--costs and profit--is recalculated on a cumulative basis to determine future income recognition as performance takes place. If the adjusted total estimated cost exceeds the applicable revenue previously recognized, the total anticipated loss is charged to income when it meets the criteria in paragraph 8 of Statement 5. When anticipated losses on lots sold are recognized, the enterprise also considers recognizing a loss on land and improvements not yet sold.

Appendix C:

ILLUSTRATIONS OF CALCULATIONS FOR RECOGNITION OF PROFIT ON SALES OF REAL ESTATE OTHER THAN RETAIL LAND SALES <sup>28</sup>

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<sup>28</sup> The financing and interest rate assumptions in this appendix are based on conditions at the time the profit recognition Guide was issued. They should not be considered as indicative of financing and interest rate assumptions that would be appropriate under different circumstances and at different times.

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Exhibits

	Paragraph Numbers
I. Illustration of Effect of Land Lease--New Multifamily Residential Property	77-83
II. Illustration of Profit Recognition--Sale of Property with Construction and Support Obligations by Seller	84-89
Schedule A: Example of Profit Calculation (assuming actual rental revenue equals adjusted projection)	87
Schedule B: Example of Profit Calculation (assuming actual rental revenue equals unadjusted projection)	88
Schedule C: Calculation of Adjusted Projected Rental Revenue	89
III. Illustration of Profit Recognition--Installment Method, with Debt Assumed by Buyer	90

Exhibit I--Illustration of Effect of Land Lease--New Multifamily Residential Property

77. Land improvements may be sold and concurrently the land under the improvements may be leased to the buyer of the improvements.

78. This exhibit illustrates the effect of loans issued in connection with long-term land leases on evaluations of the adequacy of a buyer's initial investment if improvements on the 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.

79. The calculations are illustrated for four different circumstances: two examples with a primary land lease and two with a subordinated land lease.



80. Primary Land Lease: 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, 8 1/2%, payable in equal monthly installments of principal and interest	657,000
Note received by seller from buyer: 12-year term, 9 1/2%, payable in equal monthly installments of principal and interest	<u>93,000</u>
	<u>\$ 875,000</u>
	=====

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 on land lease of \$1,583.33 discounted at 8 1/2% (interest rate on loan from insurance company): $\$1,583.33 + (\$1,583.33 \times 127.9071)$	\$ 204,000
Loan from insurance company	657,000
Equivalent primary debt	861,000
Note receivable from buyer	<u>93,000</u>
Total debt or equivalent	954,000
Down payment	<u>125,000</u>
Sales value	<u>\$1,079,000</u>
	=====

Because 15% of the sales value of the improvements is \$161,850, the initial investment 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.

## 81. Primary Land Lease: Land Owned by Third Party Lessor--Qualifying

## Assumptions:

Sales price of improvements	\$ 875,000
	=====

## Represented by proceeds of:

Cash down payment	\$ 165,000
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Loan by insurance company: lien on leasehold improvements, 28-year term, 8 1/2%, payable in equal monthly installments of principal and interest	657,000
--	---------

Note received by seller from buyer: 12-year term, 9 1/2%, payable in equal monthly installments of principal and interest	<u>53,000</u>
	<u>\$ 875,000</u>
	=====

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 on land lease of \$1,490 discounted at 8 1/2% (interest rate on loan from insurance company): $\$1,490 + (\$1,490 \times 127.9071)$	\$ 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	<u>165,000</u>
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Sales value	<u>\$1,067,000</u>
	=====

Because 15% of the sales value of the improvements is \$160,050, the initial investment 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 initial investment required by the second test is:

Sales value	\$1,067,000
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115% of \$849,000 (loan from primary lender)	<u>976,350</u>
--	----------------

	<u>\$ 90,650</u>
	=====

The initial investment 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:  $\$902,000/\$849,000 = 106\%$ . Because 106% is less than 115%, the initial investment exceeds the difference between the sales value of the property and 115% of the equivalent primary debt.

## Profit recognition:

Sales price of improvements	\$ 875,000
-----------------------------	------------

Less: Cost of improvements	<u>750,000</u>
----------------------------	----------------

Profit recognized at time of sale	<u>\$ 125,000</u>
	=====

## 82. Subordinated Land Lease: Land Owned by Seller--Qualifying

## Assumptions:

Sales price of improvements	\$ 914,000
	=====

## Represented by proceeds of:

Cash down payment	\$ 154,000
Loan by insurance company: first lien on the fee or on subordinated leasehold, 28-year term, 8 1/4%, payable in equal monthly installments of principal and interest	<u>760,000</u>
	<u>\$ 914,000</u>
	=====

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 on land lease at \$965 discounted at 12% (imputed interest for a second lien receivable): $\$965 + (\$965 \times 96.432696)$	\$ 94,000
Loan from insurance company (primary debt)	<u>760,000</u>
Total debt or equivalent	854,000
Down payment	<u>154,000</u>
Sales value	<u>\$1,008,000</u>
	=====

The initial investment (\$154,000) is more than 15% of the sales value. ( $15\% \times \$1,008,000 = \$151,200$ ).

The initial investment is also larger than the excess of the sales value over 115% of the primary debt.

Sales value	\$1,008,000
115% of \$760,000	<u>874,000</u>
Excess of sales value over 115% of debt	<u>\$ 134,000</u>
	=====

Therefore, the initial investment of \$154,000 is adequate, and recognizing profit on the sale of the improvements is appropriate.

## Profit recognition:

Sales value	\$1,008,000
Less: Cost of improvements	\$750,000
Cost of land	<u>200,000</u>
Profit recognized at time of sale	<u>\$ 58,000</u>
	=====

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

83. Subordinated Land Lease: Land Owned by Seller--Nonqualifying

Assumptions:

Sales price of improvements	\$ 875,000
	=====

Represented by proceeds of:

Cash down payment	\$ 132,000
Loan by insurance company: first lien on the fee or on subordinated leasehold, 28-year term, 8 1/4%, payable in equal monthly installments of principal and interest	<u>743,000</u> \$ 875,000 =====

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

Computations:

Present value of 336 monthly payments on land lease of \$1,611 discounted at 12% (imputed interest for a second lien receivable): \$1,611 + (\$1,611 x 96.432696)	\$ 157,000
Loan from insurance company (primary debt)	<u>743,000</u>

Total debt or equivalent	900,000
Down payment	<u>132,000</u>
Sales value	\$1,032,000 =====

The initial investment (\$132,000) is less than 15% of the sales value (15% x \$1,032,000 = \$154,800), and therefore 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:

Sales value		\$1,032,000
Less: Cost of improvements	\$750,000	
Cost of land	<u>200,000</u>	<u>950,000</u>
Anticipated profit on sale of improvements		\$ 82,000 =====

Cash received or to be received by the seller, other than the proceeds of the primary loan, is:

Down payment	\$ 132,000
Present value of land lease payments	<u>157,000</u>
	\$ 289,000 =====

The percentage 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 (present value of the land lease) - \$200,000 (cost of the land).

Exhibit II--Illustration of Profit Recognition--Sale of Property with Construction and Support Obligations by Seller

84. This exhibit illustrates the method of accounting required for a sale of property in which the seller is obligated to construct multifamily units and in which cash flow deficits are anticipated. The example applies to obligations of the seller specified in paragraphs 28-30. FAS 66, Par. 85

85. Assumptions:

- a. Company X develops and sells multifamily residential projects. The Company performs directly all developmental activities, including initial planning, site acquisition, obtaining of financing, and physical construction of the project.
- b. During the year ended December 31, 19X1 the Company began a project of 100 units. The project was planned and substantial activity had been performed in 19X1 but physical construction had not started as of December 31, 19X1. However, all contracts had been let, and the Company had obtained construction financing.
- c. On December 31, 19X1, the Company sold the project to a limited partnership syndication (fully formed) in which it is the sole general partner:

Sales value	\$1,100,000 =====
Represented by proceeds of:	
Cash down payment	\$ 165,000
Permanent financing assumed by the buyer, consisting of a 28-year 8 1/2% 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 9 1/2% over 12 years	<u>110,000</u> \$1,100,000 =====

- d. The closing occurred on December 31, 19X1 and included delivery or performance of the following:
  - (1) The Company delivered to the buyer a legal title to the land and all existing improvements.
  - (2) 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.
  - (3) The Company received from the buyer \$165,000 cash and a second mortgage note for \$110,000.
  - (4) The Company signed a contract to deliver the completed project for a single price of \$1,100,000.

- e. Costs incurred by the Company and total costs estimated to complete the project, as of December 31, 19X1, were:

	<u>Costs to Date</u>	<u>Estimated Costs to Complete</u>	<u>Total Estimated Costs</u>
Land	\$117,000		\$117,000
Feasibility, zoning, architectural	35,000		35,000
Finance and other	85,000	\$ 10,000	95,000
Site improvements		20,000	20,000
Building construction		<u>571,000</u>	<u>571,000</u>
Total	<u>\$237,000</u> =====	<u>\$601,000</u> =====	<u>\$838,000</u> =====

- f. 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 will commence in 19X2. Accordingly, a support period of two years is presumed for 19X3 and 19X4.
- g. Based on its market analysis, the projected results are as follows:

	<u>19X2</u>	<u>19X3</u>	<u>19X4</u>
Rental expense	\$ 37,000	\$ 58,000	\$ 58,000
Debt service	<u>93,000</u>	<u>93,000</u>	<u>93,000</u>
Total	130,000	151,000	151,000
Rental revenue	<u>(75,000)</u>	<u>(150,000)</u>	<u>(180,000)*</u>
Anticipated net deficit (surplus)in cash flow	55,000	1,000	(29,000)
Safety factor of 1/3 of rental revenue	<u>25,000</u>	<u>50,000</u>	<u>60,000</u>
Adjusted anticipated net deficit in cash flow	<u>\$ 80,000</u> =====	<u>\$ 51,000</u> =====	<u>\$ 31,000</u> =====

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

86. Calculations of Profit to Be Recognized:

Schedules A and B (paragraphs 87 and 88) 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 will support operations (19X2 - 19X4). The following features should be noted:

- a. The percentage 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 percentage in (a) is applied) is determined by adding the sales value and two-thirds of the projected revenue during the period of support of operations and deducting the estimated total costs of the project, including costs of operating the property and debt service.
  - (1) 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.

- (2) 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.
- (3) One-third of projected revenue should be excluded from the estimate of profit to provide a margin of safety (refer to paragraph 85.g.). Actual results incorporated in the calculation need not be reduced by a safety factor.
- (4) 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. This will 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 A shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in paragraph 85.g. adjusted for the safety margin of one-third of revenue.
- d. Schedule B shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in paragraph 85.g. before adjustment for safety margin.
- e. Schedule C illustrates the calculation of estimated future rent receipts by adjustment for a safety margin.

87. Schedule A

Example of Profit Calculation  
(assuming actual rental revenue equals adjusted projection)

REVENUES

Sales value	\$1,100,000
Adjusted--projected rental revenue <sup>29</sup>	
19X2	50,000
19X3	100,000
19X4	<u>120,000</u>
	<u>1,370,000</u>

---

<sup>29</sup> Two-thirds of projected revenue during periods of support of operations; this can also be calculated as projected rental expenses plus projected service less projected deficit cash flow.

---

COSTS

Total estimated costs of project (paragraph 85.e.)	838,000
Estimated rental expenses and debt service	
19X2	130,000
19X3	151,000
19X4	<u>151,000</u>
	<u>1,270,000</u>

TOTAL PROJECTED PROFIT	\$ 100,000 =====
------------------------	---------------------

Profit to be recognized:  
Cost to date  
 Total costs x projected profit

Profit recognized in period of sale:	
<u>\$ 237,000</u>	
1,270,000 x \$100,000 = \$18,661	
Total profit to date	\$ 18,661
Less profit previously reported	<u>0</u>
Current profit recognition	\$ 18,661 =====
Profit recognized in period of construction:	
<u>\$ 838,000</u>	
1,270,000 x \$100,000 = \$65,984	
Total profit to date	\$ 65,984
Less profit previously recognized	<u>18,661</u>
Current profit recognition	\$ 47,323 =====
Profit recognized during support period (19X2):	
<u>\$ 968,000</u>	
1,270,000 x \$100,000 = \$76,221	
Total profit to date	\$ 76,221
Less profit previously recognized	<u>65,984</u>
Current profit recognition	\$ 10,237 =====
Profit recognized during support period (19X3):	
<u>\$1,119,000</u>	
1,270,000 x \$100,000 = \$88,110	
Total profit to date	\$ 88,110
Less profit previously recognized	<u>76,221</u>
Current profit recognition	\$ 11,889 =====
Profit recognized during support period (19X4):	
<u>\$1,270,000</u>	
1,270,000 x \$100,000 = \$100,000	
Total profit to date	\$ 100,000
Less profit previously recognized	<u>88,110</u>
Current profit recognition	\$ 11,890 =====

88. Schedule B

Example of Profit Calculation  
(assuming actual rental revenue equals unadjusted projection)  
(in thousands)

Profit Recognized in Period of Sale	Profit Recognized in Period of Construction	Profit Recognized during Support Period		
		19X2	19X3	19X4



REVENUES					
Sales value	\$1,100	\$1,100	\$1,100	\$1,100	\$1,100
Adjusted--projected rental revenue)*					
19X2	50	50	75†	75†	75†
19X3	100	100	100	150†	150†
19X4	120	120	120	150\$	151‡
	<u>1,370</u>	<u>1,370</u>	<u>1,395</u>	<u>1,475</u>	<u>1,476</u>
COSTS					
Same as Schedule A	<u>1,270</u>	<u>1,270</u>	<u>1,270</u>	<u>1,270</u>	<u>1,270</u>
TOTAL PROJECTED PROFIT	\$ 100	\$ 100	\$ 125	\$ 205	\$ 206
	=====	=====	=====	=====	=====

Profit to be recognized:

Cost to date  
Total costs x projected profit

Profit recognized in period of sale:

\$ 237,000  
1,270,000 x \$100,000 = \$18,661

Total profit to date	\$ 18,661
Less profit previously reported	<u>0</u>
Current profit recognition	<u>\$ 18,661</u>
	=====

Profit recognized in period of construction:

\$ 838,000  
1,270,000 x \$100,000 = \$65,984

Total profit to date	\$ 65,984
Less profit previously reported	<u>18,661</u>
Current profit recognition	<u>\$ 47,323</u>
	=====

Profit recognized during support period (19X2):

\$ 968,000  
1,270,000 x \$125,000 = \$95,276

Total profit to date	\$ 95,276
Less profit previously reported	<u>65,984</u>
Current profit recognition	<u>\$ 29,292</u>
	=====

Profit recognized during support period (19X3):

\$1,119,000  
1,270,000 x \$205,000 = \$180,626

Total profit to date	\$180,626
Less profit previously reported	<u>95,276</u>
Current profit recognition	<u>\$ 85,350</u>
	=====

Profit recognized during support period (19X4):

\$1,270,000  
 1,270,000 x \$206,000 = \$206,000

Total profit to date	\$206,000
Less profit previously reported	<u>180,626</u>
Current profit recognition	\$ 25,374
	=====

\*Two-thirds of projected revenue during periods of support of operation; this can also be calculated as projected rental expenses plus projected debt service less projected deficit cash flow.

†Actual rental revenue.

‡Because 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 19X4 rental revenue should be adjusted to 19X3 actual rental revenue.

§Actual rental revenue excluding amounts not needed to meet cash flow requirements of the property.

89. Schedule C

Calculation of Adjusted Projected Rental Revenue

Assume an office building under development is sold together with an agreement to support operations of the property for three years. The projected annual rent roll is \$1,000,000 of which \$350,000 is supported by signed lease agreements. The projected rental revenue for the first year of operation is \$600,000; the second year \$750,000; and the third year \$1,000,000. At the time of sale, the amounts to be included in the calculation would be as follows:

<u>Year</u>	<u>Projected Rental Revenue</u>	<u>Safety Factor (33-1/3%)</u>	<u>Adjusted Projected Rental Revenue</u>
1	\$ 600,000	\$200,000	\$400,000
2	750,000	250,000	500,000
3	1,000,000	333,333	666,667

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

Exhibit III: Illustration of Profit Recognition--Installment Method, with Debt Assumed by Buyer

90. Assumptions:

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

The initial investment 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, after 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: Under the installment method, profit recognition attributable to the down payment is \$60,000, representing 40% (\$400,000/\$1,000,000) of \$150,000.

Profit recognition attributable to the principal payments by the buyer on the first and second mortgages is \$24,000, representing 40% of \$60,000 (\$25,000 + \$35,000).

Appendix D: Illustrations of Calculations for Recognition of Profit on Retail Land Sales <sup>30</sup>

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<sup>30</sup> The financing and interest rate assumptions in this appendix are based on conditions at the time the profit recognition Guide was issued. They should not be considered as indicative of financing and interest rate assumptions that would be appropriate under different circumstances and at different times.

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Exhibits	Paragraph Numbers
I. Initial Measure of Consideration	
(Percentage-of-Completion Method).....	91-95
Schedule A: Present Value of Sales Contracts Receivable.....	92
Schedule B: Computation of Interest Income for Financial Reporting Purposes.....	93
Schedule C: Determination of Income Tax Payable.....	94
Schedule D: Percentage-of-Completion Method-- Illustration of Financial Statement Presentation of Transactions Assumed in Paragraph 91.....	95
II. Installment Method.....	96-97
Schedule A: Illustration of Financial Statement Presentation Based on Assumptions in Paragraph 91.....	96
Schedule B: Installment Method Changed to Percentage-of-Completion Method at Beginning of Year 4.....	97

Exhibit I--Initial Measure of Consideration  
(Percentage-of-Completion Method)  
(amounts in thousands)

91. Assumptions:

Gross sales contracts recorded in year 1 (stated interest of 6%)	\$1,000
Estimated uncollectible principal amount (sales contracts of \$200* less estimated down payments to be forfeited of \$20)	<u>(180)</u>
Net sales contracts receivable	820
Down payments and collections in year 1 relative to above sales contracts (\$80 + \$20)	<u>100</u>
Collections projected (principal amounts) for years 2 through 10	\$ 720 =====
Land cost (applicable to sales contracts of \$800)	\$ 60
Selling expenses in year 1	300

Future improvement costs (applicable to sales contracts of \$800)	120
Minimum annual yield required on contracts receivable	12%

Discount Required:	
Sales contracts receivable in year 1 (see above)	\$ 720
Present value of 108 level monthly payments of \$8.65 on sales contracts receivable (discounted at 12%) (Schedule A)	<u>570</u>
Discount required	\$ 150
	=====

Computation of Revenue Applicable to Future Improvements:

$$\frac{\$120}{\$60 + \$300 + \$120} = 25\%$$

$$25\% \times \$650(\$1,000 - \$200 - \$150) = \$163$$

Profit Recognition in Year 1:

Revenue recognized:	
Cash received in year 1	\$ 100
Present value of balance of sales contracts receivable (Net sales \$820, less discount \$150)	<u>570</u>
	670
Less: revenue applicable to future improvements	<u>163</u>
Net revenue	507
Less: Costs and expenses (\$60 + \$300)	<u>360</u>
Pretax income	\$ 147
	=====

\*It is assumed that 90% of contracts in force 6 months after sales are recognized will ultimately be collected in full (paragraph 45).

92. Schedule A

Year	Present Value of Sales Contracts Receivable (amounts in thousands)			Present Value @ 12%
	Receivable Collections		Annual Collections	
	Principal	Interest*		
2	\$ 62	\$ 42	\$104	\$ 97
3	66	38	104	87
4	70	34	104	77
5	75	29	104	68
6	79	25	104	60
7	84	20	104	53
8	89	15	104	47
9	95	9	104	43
10	<u>100</u>	<u>4</u>	<u>104</u>	<u>38</u>
	\$720	\$216	\$936	\$570
	=====	=====	=====	=====

\*Assumes no interest for year 1.

93. Schedule B

Computation of Interest Income for Financial Reporting Purposes  
(amounts in thousands)

Year	Debit:	Debit:	Credit:	Credit:
	Cash	Unamortized Valuation Discount	Contracts Receivable	Interest Income*
2	\$104	\$ 24	\$ (62)	\$ (66)
3	104	24	(66)	(62)
4	104	22	(70)	(56)
5	104	21	(75)	(50)
6	104	19	(79)	(44)
7	104	16	(84)	(36)
8	104	12	(89)	(27)
9	104	8	(95)	(17)
10	104	4	(100)	( 8)
	<u>\$936</u>	<u>\$150</u>	<u>\$(720)</u>	<u>\$(366)</u>
	=====	=====	=====	=====

\*Total interest income equals \$216 stated interest plus \$150 discount, or \$366.

94. Schedule C

Determination of Income Tax Payable  
(amounts in thousands)

Year	Principal Receipts	Profit from Installment Sale	Interest Income from Receivable	Selling Expense	Taxable Income (Loss)	Tax Effect of Loss Carry- forward		Net Tax
						Tax	from Year 1	
1	\$100	\$ 82*		\$(300)	\$(218)			
2	62	48	\$ 42		90	\$(43)	\$ 43	
3	66	51	38		89	(43)	43	
4	70	54	34		88	(42)	19	(\$ 23)
5	75	58	29		87	(42)		(42)
6	79	61	25		86	(41)		(41)
7	84	65	20		85	(41)		(41)
8	89	69	15		84	(40)		(40)
9	95	74	9		83	(40)		(40)
10	100	78	4		82	(40)		(40)
	<u>\$820</u>	<u>\$640</u>	<u>\$216</u>	<u>\$(300)</u>	<u>\$556</u>	<u>\$(372)</u>	<u>\$105†</u>	<u>(\$ 267)</u>
	=====	=====	=====	=====	=====	=====	=====	=====

Assumption: The installment method is used for income tax purposes.

\* Profit on land sale computed on installment method as follows:

Gross profit = \$800 - \$180 = \$620

Principal payment X profit margin:  $\$80 \times \frac{\$620}{\$800} = \$62$

Forfeited down payments 20  
\$82  
===

†Carryforward amount is 48% of \$218 = \$105.

95. Schedule D

Percentage-of-Completion Method-Illustration of Financial Statement  
 Presentation of Transactions Assumed in Paragraph 91  
 (amounts in thousands)

Balance Sheets	Beginning of Year 1	End of Year									
		1	2	3	4	5	6	7	8	9	10
<b>Assets:</b>											
Cash	\$300	\$100	\$204	\$308	\$389	\$451	\$514	\$547	\$581	\$615	\$649
Contracts receivable		720	658	592	522	447	368	284	195	100	
Less: Allowance for contract cancellations*		--									
Unamortized valuation discount		(150)	(126)	(102)	(80)	(59)	(40)	(24)	(12)	(4)	
		<u>570</u>	<u>532</u>	<u>490</u>	<u>442</u>	<u>388</u>	<u>328</u>	<u>260</u>	<u>183</u>	<u>96</u>	
Land	<u>75</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>
	<u>\$375</u>	<u>\$685</u>	<u>\$751</u>	<u>\$813</u>	<u>\$846</u>	<u>\$854</u>	<u>\$857</u>	<u>\$822</u>	<u>\$779</u>	<u>\$726</u>	<u>\$664</u>
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====
<b>Liabilities and equity:</b>											
Deferred income taxes		\$ 71	\$103	\$133	\$137	\$119	\$100	\$ 81	\$ 59	\$ 32	
Revenue applicable to future improvements†		163	163	163	163	163	163	122	81	40	
Capital stock	\$375	375	375	375	375	375	375	375	375	375	\$375
Retained earnings		<u>76</u>	<u>110</u>	<u>142</u>	<u>171</u>	<u>197</u>	<u>219</u>	<u>244</u>	<u>264</u>	<u>279</u>	<u>289</u>
	<u>\$375</u>	<u>\$685</u>	<u>\$751</u>	<u>\$813</u>	<u>\$846</u>	<u>\$854</u>	<u>\$857</u>	<u>\$822</u>	<u>\$779</u>	<u>\$726</u>	<u>\$664</u>
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====

Income Statements	Year										Total	
	1	2	3	4	5	6	7	8	9	10		
<b>Revenues:</b>												
Gross Sales	\$1,000											\$1,000
Less:												
Estimated uncollectible sales	(180)											(180)
Revenue applicable to future improvements	(163)											(163)
Valuation discount	(150)											(150)
Net sales	507											507
Improvement revenue-- prior sales							\$ 41	\$ 41	\$ 41	\$ 40		163
Interest income (Schedule B)		\$ 66	\$ 62	\$ 56	\$ 50	\$ 44	36	27	17	8	366	
	507	66	62	56	50	44	77	68	58	48	1,036	
<b>Costs and expenses:</b>												
Cost of sales	60											60
Improvement costs-- prior sales							30	30	30	30	120	
Selling expenses	<u>300</u>						<u>30</u>	<u>30</u>	<u>30</u>	<u>30</u>	<u>300</u>	
	<u>360</u>						<u>30</u>	<u>30</u>	<u>30</u>	<u>30</u>	<u>480</u>	
Income before provision for												

income taxes	147	66	62	56	50	44	47	38	28	18	556
Provision for income taxes:											
Current				23	42	41	41	40	40	40	267
Deferred	<u>71</u>	<u>32</u>	<u>30</u>	<u>4</u>	<u>(18)</u>	<u>(19)</u>	<u>(19)</u>	<u>(22)</u>	<u>(27)</u>	<u>(32)</u>	<u>267</u>
Net Income	\$ 76	\$ 34	\$ 32	\$ 29	\$ 26	\$ 22	\$ 25	\$ 20	\$ 15	\$ 10	\$ 289
	====	====	====	====	====	====	====	====	====	====	=====

\* Assumes that all cancellations occurred in year 1 without refunds of down payments.

† Assumes that future performance occurred equally in years 7, 8, 9, and 10.

Note: The illustrative statements are not intended to represent retail land sales company financial statements because they include only items necessary to illustrate timing of revenue and income recognition.

## EXHIBIT II--INSTALLMENT METHOD

### 96. Schedule A

#### Illustration of Financial Statement Presentation Based on Assumptions in Paragraph 91 (amounts in thousands)

Balance Sheets	Beginning	End of Year										
	Of Year 1	1	2	3	4	5	6	7	8	9	10	
<b>Assets:</b>												
Cash	\$300	\$100	\$204	\$308	\$389	\$451	\$514	\$547	\$581	\$615	\$649	
Contracts receivable		720	658	592	522	447	368	284	195	100		
Less: Profit applicable future improvements		(342)	(313)	(282)	(249)	(213)	(175)	(135)	(93)	(48)		
		378	345	310	273	234	193	149	102	52		
Land	<u>75</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	
	\$375	\$493	\$564	\$633	\$677	\$700	\$722	\$711	\$698	\$682	\$664	
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	
<b>Liabilities and equity:</b>												
Deferred income taxes			\$ 33	\$ 66	\$ 75	\$ 64	\$ 54	\$ 42	\$ 29	\$ 15		
Liability for future improvements		<u>120</u>	<u>120</u>	<u>120</u>	<u>120</u>	<u>120</u>	<u>120</u>	<u>90</u>	<u>60</u>	<u>30</u>		
Capital stock	\$375	375	375	375	375	375	375	375	375	375	\$375	
Retained earnings (deficit)	<u>375</u>	<u>(2)</u>	<u>36</u>	<u>72</u>	<u>107</u>	<u>141</u>	<u>173</u>	<u>204</u>	<u>234</u>	<u>262</u>	<u>289</u>	
	\$375	\$493	\$564	\$633	\$677	\$700	\$722	\$711	\$698	\$682	\$664	
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	
<b>Income Statements</b>												
	Point of Sale in Year 1	Year										
		1	2	3	4	5	6	7	8	9	10	Total
<b>Revenues:</b>												
Sales	\$1,000	\$1,000										\$1,000
Interest income			\$42	\$38	\$34	\$29	\$25	\$20	\$15	\$9	\$4	216
Profit deferred*	(427)	(427)										(427)
Profit recognized†			29	31	33	36	38	40	42	45	48	342
	573	573	71	69	67	65	63	60	57	54	52	1,131
<b>Costs and expenses:</b>												
Cost of Sales‡	225	225										225
Selling expenses	300	300										300

Loss on cancellations§		50										50
	<u>525</u>	<u>575</u>										<u>575</u>
Income (loss) before provision for income taxes	48	(2)	71	69	67	65	63	60	57	54	52	556
Provision for income taxes:												
Current					23	42	41	41	40	40	40	267
Deferred	<u>23</u>		<u>33</u>	<u>33</u>	<u>9</u>	<u>(11)</u>	<u>(10)</u>	<u>(12)</u>	<u>(13)</u>	<u>(14)</u>	<u>(15)</u>	
	23		33	33	32	31	31	29	27	26	25	267
Net income (loss)	\$ 25	\$ (2)	\$38	\$36	\$35	\$34	\$32	\$31	\$ 30	\$28	\$27	\$289
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====

Notes to Exhibit II, Schedule A

(amounts in thousands)

*Computation of profit deferred:	
Sales	\$1,000
Cost of sales (see Note‡)	(225)
Selling expense	(300)
Profit	\$ 475
	=====
Percentage	47.5%
	=====
Uncollected receivables	\$ 900
Profit percentage	47.5%
Profit deferred	\$ 427
	=====
†Profit recognized is 47.5% of principal collections.	
‡Costs applicable to gross sales contracts:	
Land	\$ 75
Future development	150
	\$ 225
	=====
§Loss on cancellations:	
Contracts cancelled in Year 1	\$ 200
	=====
Unpaid balance	\$ 180
Costs recovered (credited to cost of sales):	
Land at cost	\$15
Future development	30 (45)
Profit at 47.5% of \$180	(85)
Unrecovered selling cost	\$ 50
	=====

97. Schedule B

Installment Method Changed to Percentage-of-Completion Method at Beginning of Year 4  
(amounts in thousands)

		<u>End of Year</u>									
Balance Sheets		1	2	3	4	5	6	7	8	9	10
Assets:											
Cash	\$100	\$204	\$308	\$389	\$451	\$514	\$547	\$581	\$615	\$649	
Contracts receivable	720	658	592	522	447	368	284	195	100		
Less:											
Profit applicable to											



future improvements	(342)	(313)	(282)								
Unamortized valuation discount				(80)	(59)	(40)	(24)	(12)	(4)	—	
Land	378	345	310	442	388	328	260	183	96	—	
	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>
	\$493	\$564	\$633	\$846	\$854	\$857	\$822	\$779	726	\$664	
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====
Liabilities and equity:											
Deferred income taxes		\$ 33	\$ 66	\$137	\$119	\$100	\$ 81	\$ 59	\$ 32		
Liability for future improvements (revenue applicable to future improvements after Year 3)	\$120	120	120	163	163	163	122	81	40		
Capital stock	375	375	375	375	375	375	375	375	375	\$375	
Retained earnings (deficit)	(2)	36	72	171	197	219	244	264	279	289	
	\$493	\$564	\$633	\$846	\$854	\$857	\$ 822	\$779	\$726	\$664	
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====

	Year										Total
Income Statements	1	2	3	4	5	6	7	8	9	10	
Revenues:											
Gross sales											
contracts recorded	\$1,000										\$1,000
Improvement revenue--prior sales							\$41	\$41	\$41	\$40	163
Profit deferred	(427)										(427)
Profit recognized		\$29	\$31								60
Interest income*		42	38	\$56	\$50	\$44	36	27	17	8	318
Income resulting from change from installment to percentage-of-completion method† (described fully in notes to financial statements)				137							137
	573	71	69	193	50	44	77	68	58	48	1,251
Costs and expenses:											
Cost of sales	225										225
Improvement costs--prior sales							30	30	30	30	120
Selling expenses	300										300
Loss on cancellations	50										50
	575	—	—	—	—	—	30	30	30	30	695
Income (loss) before provision for income taxes	(2)	71	69	193	50	44	47	38	28	18	556
Provision for income taxes:											
Current				23	42	41	41	40	40	40	267
Deferred		33	33	71	(18)	(19)	(19)	(22)	(27)	(32)	—
		33	33	94	24	22	22	18	13	8	267
Net income (loss)	\$ (2)	\$38	\$36	\$ 99	\$26	\$22	\$25	\$20	\$15	\$10	\$ 289
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====

Notes to Exhibit II, Schedule B:

\* Interest at stated rate for Years 2 and 3; 12% after change from installment to percentage-of-completion method.

† Computation of effect of change from installment to percentage-of-completion method:

	(Amounts in thousands)	
Profit not yet recognized under installment method:		
Original	\$427	
Recognized in prior years	(60)	
Applicable to canceled contracts	<u>(85)</u>	<u>\$282</u>
Less, valuation discount required:		
Receivables at beginning of year 4	592	
Present value of payments due (principal and interest) at 12%	<u>(490)</u>	<u>102</u> 180
Less:		
Revenue to be recognized in future as performance takes place	163	
Costs to be recognized in future	<u>(120)</u>	<u>43</u>
Net amount credited to income (before taxes)		\$137 =====

30. *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*, provides the following guidance:

1. This Statement establishes accounting and reporting standards for acquisition, development, construction, selling, and rental costs associated with real estate projects. It also provides guidance for the accounting for initial rental operations and criteria for determining when the status of a rental project changes from nonoperating to operating.

SCOPE AND APPLICABILITY

2. This Statement does not apply to:

- a. Real estate developed by an enterprise for use in its own operations,<sup>1</sup> other than for sale or rental.

<sup>1</sup> In this context, "real estate developed by an enterprise for use in its own operations" includes real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent's operations) when the property is reported in the group's consolidated financial statements. However, such property is not "real estate developed for use in the enterprise's operations" when reported in the separate financial statements of the entity that developed it.

- b. "Initial direct costs" of sales-type, operating, and other types of leases, which are defined in *FASB Statement No. 17, Accounting for Leases--Initial Direct Costs*. The accounting for initial direct costs is prescribed in *FASB Statement No. 13, Accounting for Leases*.

- c. Costs directly related to manufacturing, merchandising, or service activities as distinguished from real estate activities.

Paragraphs 20-23 of this Statement do not apply to real estate rental activity in which the predominant rental period is less than one month.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

## General

3. Paragraphs 4-25 specify the accounting for the following as they relate to real estate projects: (a) preacquisition costs<sup>2</sup> (b) taxes and insurance, (c) project costs, (d) amenities, (e) incidental operations, (f) allocation of capitalized costs to components of a real estate project, (g) revisions of estimates, (h) abandonments and changes in use, (i) selling costs, (j) rental costs, and (k) costs in excess of estimated net realizable value.

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<sup>2</sup> Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

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## Acquisition, Development, and Construction Costs

## Preacquisition Costs

4. Payments to obtain an option to acquire real property shall be capitalized as incurred. All other costs related to a property that are incurred before the enterprise acquires the property, or before the enterprise obtains an option to acquire it, shall be capitalized if all of the following conditions are met and otherwise shall be charged to expense as incurred:

- a. The costs are directly identifiable with the specific property.
- b. The costs would be capitalized if the property were already acquired.
- c. Acquisition of the property or of an option to acquire the property is probable.<sup>3</sup> This condition requires that the prospective purchaser is actively seeking to acquire the property and has the ability to finance or obtain financing for the acquisition and that there is no indication that the property is not available for sale.

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<sup>3</sup> Probable is defined in *FASB Statement No. 5, Accounting for Contingencies*, as "likely to occur" and is used in the same sense in this Statement.

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5. Capitalized Preacquisition costs (a) shall be included as project costs upon the acquisition of the property or (b) to the extent not recoverable by the sale of the options, plans, etc., shall be charged to expense when it is probable that the property will not be acquired.

## Taxes and Insurance

6. Costs incurred on real estate for property taxes and insurance shall be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress.<sup>4</sup> Costs incurred for such items after the property is substantially complete and ready for its intended use<sup>5</sup> shall be charged to expense as incurred.

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<sup>4</sup> The phrase activities necessary to get the property ready for its intended use are in progress is used here with the same meaning as it has for interest capitalization in paragraph 17 of *FASB Statement No. 34, Capitalization of Interest Cost*.

<sup>5</sup> The phrase substantially complete and ready for its intended use is used here with the same meaning as it has for interest capitalization in paragraph 18 of Statement 34.

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### Project Costs

7. Project costs clearly associated with the acquisition, development, and construction of a real estate project shall be capitalized as a cost of that project. Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate. Indirect costs that do not clearly relate to projects under development or construction, including general and administrative expenses, shall be charged to expense as incurred.

### Amenities

8. Accounting for costs of amenities shall be based on management's plans for the amenities in accordance with the following:

- a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs in excess of anticipated proceeds shall be allocated as common costs because the amenity is clearly associated with the development and sale of the project. The common costs include expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project.
- b. If an amenity is to be sold separately or retained by the developer, capitalizable costs of the amenity in excess of its estimated fair value as of the expected date of its substantial physical completion shall be allocated as common costs. For the purpose of determining the amount to be capitalized as common costs, the amount of cost previously allocated to the amenity shall not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, results in a gain or loss that shall be included in net income in the period in which the sale occurs.

Costs of amenities shall be allocated among land parcels<sup>6</sup> benefited and for which development is probable.

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<sup>6</sup> A land parcel may be considered to be an individual lot or unit, an amenity, or a phase.

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9. Before an amenity is substantially completed and available for use, operating income (or loss) of the amenity shall be included as a reduction of (or an addition to) common costs. When an amenity to be sold separately or retained by the developer is substantially completed and available for use, current operating income and expenses of the amenity shall be included in current operating results.

### Incidental Operations

10. Incremental revenue from incidental operations in excess of incremental costs of incidental operations shall be accounted for as a reduction of capitalized project costs. Incremental costs in excess of incremental revenue shall be charged to expense as incurred, because the incidental operations did not achieve the objective of reducing the costs of developing the property for its intended use.

### Allocation of Capitalized Costs to the Components of a Real Estate Project

11. The capitalized costs of real estate projects shall be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs shall be allocated as follows:

- a. Land cost and all other common costs<sup>7</sup> (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.

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<sup>7</sup> Including the costs of amenities to be allocated as common costs (paragraphs 8 and 9).

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- b. Construction costs shall be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs shall be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances.

#### Revisions of Estimates

12. Estimates and cost allocations shall be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs shall be revised and reallocated as necessary for material changes on the basis of current estimates.<sup>8</sup> Changes in estimates shall be reported in accordance with paragraph 31 of *APB Opinion No. 20, Accounting Changes*.

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<sup>8</sup> Paragraph 76 of *Statement No. 66, Accounting for Sales of Real Estate*, discusses revisions of estimates relating to retail land sales accounted for by the percentage-of-completion method.

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#### Abandonments and Changes in Use

13. If real estate, including rights to real estate, is abandoned (for example, by allowing a mortgage to be foreclosed or a purchase option to lapse), capitalized costs of that real estate shall be expensed. Such costs shall not be allocated to other components of the project or to other projects even if other components or other projects are capable of absorbing the losses.

14. Real estate donated to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the real estate donated shall be allocated as a common cost of the project.

15. Changes in the use of real estate comprising a project or a portion of a project may arise after significant development and construction costs have been incurred. If the change in use is made pursuant to a formal plan for a project that is expected to produce a higher economic yield (as compared to its yield based on use before change), the development and construction costs to be charged to expense shall be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project when it is substantially complete and ready for its intended use.

16. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the project costs to be charged to expense shall be limited to the amount by which total project costs exceed the estimated net realizable value of the property determined on the assumption it will be sold in its present state.

#### Costs Incurred to Sell and Rent Real Estate Projects, Including Initial Rental Operations

##### Costs Incurred to Sell Real Estate Projects

17. Costs incurred to sell real estate projects shall be capitalized if they (a) are reasonably expected to be recovered from the sale of the project or from incidental operations and (b) are incurred for (1) tangible assets that are used directly throughout the selling period to aid in the sale of the project or (2) services that have been performed to obtain regulatory approval of sales. Examples of costs incurred to sell real estate projects that ordinarily meet the criteria for capitalization are costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

18. Other costs incurred to sell real estate projects shall be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method of accounting other than full accrual.<sup>9</sup> Costs that do not meet the criteria for capitalization shall be expensed as incurred.

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<sup>9</sup> FASB Statement 66 discusses the circumstances under which the appropriate accounting methods are to be applied, including the full accrual method.

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19. Capitalized selling costs shall be charged to expense in the period in which the related revenue is recognized as earned. When a sales contract is canceled (with or without refund) or the related receivable is written off as uncollectible, the related unrecoverable capitalized selling costs shall be charged to expense or an allowance previously established for that purpose.

#### Costs Incurred to Rent Real Estate Projects

20. If costs incurred to rent real estate projects, other than initial direct costs,<sup>10</sup> under operating leases are related to and their recovery is reasonably expected from future rental operations, they shall be capitalized. Examples of such costs are costs of model units and their furnishings, rental facilities, semipermanent signs, “grand openings,” and unused rental brochures. Costs that do not meet the criteria for capitalization shall be expensed as incurred, for example, rental overhead.

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<sup>10</sup> Initial direct costs are defined in Statement 17. The accounting for initial direct costs is prescribed in Statement 13.

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21. Capitalized rental costs directly related to revenue from a specific operating lease shall be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease shall be amortized over the period of expected benefit. The amortization period shall begin when the project is substantially completed and held available for occupancy.<sup>11</sup> Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases shall be charged to expense when it becomes probable that the lease(s) will be terminated.

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<sup>11</sup> Refer to paragraph 22 for the definition of substantially completed and held available for occupancy.

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#### Initial Rental Operations

22. When a real estate project is substantially completed and held available for occupancy, rental revenues and operating costs shall be recognized in income and expense as they accrue, all carrying costs (such as real estate taxes) shall be charged to expense when incurred, depreciation on the cost of the project shall be provided, and costs to rent the project shall be amortized in accordance with paragraph 21 of this Statement. A real estate project shall be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer but no later than one year from cessation of major construction activity (as distinguished from activities such as routine maintenance and cleanup).

23. If portions of a rental project are substantially completed and occupied by tenants or held available for occupancy and other portions have not yet reached that stage, the substantially completed portions shall be accounted for as a separate project. Costs incurred shall be allocated between the portions under construction and the portions substantially completed and held available for occupancy.

## Recoverability

24. The carrying amount of a real estate project, or parts thereof, held for sale or development and sale shall not exceed net realizable value. If costs exceed net realizable value, capitalization of costs associated with development and construction of a property shall not cease, but rather an allowance shall be provided to reduce the carrying amount to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a subdivision and amenities). Therefore, a multi phase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

25. Evidence of insufficient rental demand for a rental project currently under construction may indicate an impairment of the carrying value. If it is probable that the insufficient rental demand is other than temporary, an allowance for losses shall be provided, whether or not construction is actually suspended.

## Amendments to Other Pronouncement

26. The references to AICPA Statements of Position 78-3, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects, and 80-3, Accounting for Real Estate Acquisition, Development, and Construction Costs, are deleted from Appendixes A and B of *FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, respectively.

## Effective Date and Transition

27. This Statement shall be applied to costs of real estate projects incurred in fiscal years beginning after December 31, 1982. Earlier application is encouraged but not required.

31. *AICPA Statement of Position 92-3, Accounting for Foreclosed Assets*, provides the following guidance:

### Scope

.01 This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets<sup>1</sup> after foreclosure. (Paragraphs A-6 and A-7 of the Appendix [paragraph .18] discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for (a) inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins; (b) marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, Accounting for Certain Marketable Securities; and (c) foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects. Except for the requirements in paragraphs .12 and .17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix [paragraph .18]).

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<sup>1</sup>As used in this SOP, the term foreclosed assets includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*. It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

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## Background

.02 Paragraph 29 of *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued in 1977, requires the following: “After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.” That requirement has been interpreted in diverse ways.

.03 The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide Audits of Stock Life Insurance Companies requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, Accounting Practices of Real Estate Investment Trusts [section 10,060.17 and .21] (as amended by SOP 78-2 [section 10,170]), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide Audits of Savings Institutions and in the Industry Audit Guide Audits of Finance Companies are consistent with SOPs 75-2 [section 10,060] and 78-2 [section 10,170]. The AICPA Industry Audit Guide Audits of Banks states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide Audits of Property and Liability Insurance Companies does not address accounting for foreclosed assets. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.04 In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

.08 AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

.09 This SOP affects the following AICPA statements of position and industry audit and accounting guides:

- a. SOP 75-2, Accounting Practices of Real Estate Investment Trusts, paragraphs 15-23, 25, 27, 28, 29a, 29b , and 29c [section 10,060]
- b. SOP 78-2, Accounting Practices of Real Estate Investment Trusts, paragraph 6 [section 10,170.06]
- c. Audits of Banks
- d. Audits of Savings Institutions
- e. Audits of Finance Companies
- f. Audits of Property and Liability Insurance Companies
- g. Audits of Stock Life Insurance Companies
- h. Guide for the Use of Real Estate Appraisal Information

## Conclusions

### Held-for-Sale Presumption

.10 Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require



the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

.11 The presumption of sale can be rebutted if (a) management intends to hold a foreclosed asset for the production of income, (b) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (c) that intent is supported by a preponderance of the evidence.

#### Foreclosed Assets Held for Sale

.12 After foreclosure, foreclosed assets held for sale should be carried at the lower of (a) fair value<sup>2</sup> minus estimated costs to sell or (b) cost<sup>3</sup>. Such determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.<sup>4</sup>

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<sup>2</sup> Fair value, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

The fair value of the assets transferred is the amount that the [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.<sup>6</sup>

<sup>6</sup> Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB [Accounting Principles Board] Opinion No. 16 ["Business Combinations"], paragraphs 12-14 of APB Opinion No. 21, "Interest on Receivables and Payables," and paragraph 25 of APB Opinion No. 29, "Accounting for Nonmonetary Transactions."

<sup>3</sup> The cost of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix [paragraph .18]).

<sup>4</sup> Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

.13 The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

.14 *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*, was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects*; SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs*, and the AICPA Industry Audit Guide *Accounting for Retail Land Sales*. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

### Foreclosed Assets Held for the Production of Income

.15 After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

### Change in Classification

.16 If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

### Effective Date and Transition

.17 This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of (a) the fair value of the asset minus the estimated costs to sell the asset or (b) the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative effect adjustments as of the beginning of the year this SOP is first applied is permitted.

32. *FASB Emerging Issues Task Force Issue No. 86-6, Antispeculation Clauses in Real Estate Sales Contracts* provides the following guidance relating to the use of “antispeculation” clauses:

#### ISSUE

Land sale agreements sometimes contain “antispeculation” clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Antispeculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of the sales contract, the seller has the right, but not the obligation, to reacquire the property. Paragraph 26 of Statement 66 states that, if the terms of a transaction give the seller an option to repurchase the property, then the transaction is accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

The issue is whether Statement 66 precludes the seller from accounting for the transaction as a sale when an antispeculation clause exists.

#### EITF DISCUSSION

The Task Force reached a consensus that the contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. Task Force members described a number of factors that would lead them to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. Task Force members also indicated that a probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

33. *FASB Emerging Issues Task Force Issue No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*, allows the modification of the down payment criteria established in FAS 66. For a seller of owner-occupied single-family residential homes that are financed under a FHA or VA government-insured program, the down payment criteria set forth in paragraphs 53 and 54 of FAS 66 is modified to the normal down payment requirements or loan limits established under those programs and profit may be recorded under the full accrual method provided that the mortgage receivable is insured from loss under the FHA or VA program. EITF 87-9 provides the following guidance:

#### ISSUE

Financial institutions and other sellers of real estate may require mortgage insurance on a portion of the financing provided to the buyer by the seller, particularly in transactions involving residential property. In addition, surety bonds may be accepted by sellers of real estate to support the buyer's notes in lieu of an irrevocable letter of credit.

Paragraph 9 of Statement 66 provides that "the buyer's notes supported by irrevocable letters of credit from an independent established lending institution" may be included as part of the buyer's initial and continuing investment in determining whether it is appropriate for a seller of real estate to recognize profit on a transaction under the full accrual method.

The issues are:

1. Whether a financial instrument (such as a surety bond) may be considered equivalent to an irrevocable letter of credit in determining whether it is appropriate to recognize income under the full accrual method if (a) the seller's rights of collection, (b) the surety's obligation for payment, and (c) the surety's recourse to the buyer under the instrument in the event of default are the same as for an irrevocable letter of credit.
2. Whether government or private mortgage insurance covering a part of the mortgage balance should be considered equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method.

A related subissue is whether the minimum down payment percentages set forth in Statement 66 apply or whether the loan limits in the government programs may be used if a buyer of single-family residential property qualifies for a Federal Housing Administration (FHA) or Veterans Administration (VA) loan that requires little (less than 5 percent) or no down payment and the principal amount of the mortgage is insured or guaranteed either in full or in part by the FHA or VA. Paragraph 11 of Statement 66 requires an initial investment that is adequate to demonstrate the buyer's commitment to pay for the property and is "equal to at least a major part of the difference between usual loan limits and the sales value of the property." Paragraphs 53 and 54 of Statement 66 provide guidance on the minimum initial investment in the property required by the buyer to demonstrate a commitment to pay for the property that is necessary for the seller to recognize profit under the full accrual method.

#### EITF DISCUSSION

On the first issue, the Task Force reached a consensus that an irrevocable financial instrument, such as a surety bond, from an established independent insuring institution that includes the preceding characteristics (such that the instrument has all the rights and obligations of an irrevocable letter of credit) may be considered by the seller to be equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method. The Task Force noted that the requirement in Statement 66 to demonstrate the buyer's commitment to pay is an important criterion that must be met before profit is recognized by the full accrual method.

On the second issue, the Task Force reached a consensus that mortgage insurance should not be considered the equivalent of an irrevocable letter of credit in the determination of whether it is

appropriate to recognize profit under the full accrual method because the purchase of mortgage insurance is not deemed to demonstrate a commitment by the buyer to honor its obligation to pay for the property.

With respect to the subissue, the Task Force reached a consensus that a seller of owner-occupied single-family residential homes that finances a sale under an FHA or VA government-insured program may use the normal down payment requirements or loan limits established under those programs as a surrogate for the down payment criteria set forth in paragraphs 53 and 54 of Statement 66 and may record profit under the full accrual method provided that the mortgage receivable is fully insured from loss under the FHA or VA program. In that specific circumstance, the Task Force believes that departure from the minimum initial investment criteria of Statement 66 is justified because all of the credit risk associated with the receivable from the sale is transferred to the governmental agency. However, the Task Force emphasized that in all other circumstances (for example, FHA or VA programs that provide for less than full insurance or seller financing using private mortgage insurance) the minimum initial investment criteria set forth in Statement 66 should be followed.

Subsequently, several Task Force members indicated that they did not recall the consensus being limited to transactions that are fully insured under the FHA and VA programs. Some Task Force members indicated their belief that the consensus should be applied to all sales of residential property for which the seller provides financing under the FHA or VA program and the buyer has complied with the normal lending terms for those programs in the specific location of the property, irrespective of whether the mortgage is fully insured. Others suggested that they are uncomfortable addressing transactions that are not fully insured under those programs without a better understanding of how the programs insure the seller in the event of a default by the buyer.

At a subsequent meeting, the Task Force discussed the FHA mortgage insurance program and the VA loan guarantee program with representatives from the FHA and the VA. An FHA representative confirmed that the FHA program normally insures 100 percent of the outstanding mortgage principal, and a VA representative stated that the VA program generally provides first-dollar loss coverage of either 40 or 50 percent of the qualified loan amount, but coverage of not more than \$36,000. Coverage under the VA program is reduced on a pro rata basis as the principal of the loan is paid off. Neither program provides for split coverage with private insurers. Also, in the event of a default by the borrower, both the FHA and the VA programs provide for recourse against the borrower.

The Task Force reached a consensus that the term fully should be deleted from the consensus reached above, thus permitting profit recognition under the full accrual method for all loans insured under the current FHA or VA programs. Task Force members noted that the consensus applies only to FHA and VA coverage and not to private mortgage insurance.

34. *FASB Emerging Issues Task Force Issue No. 87-29, Exchange of Real Estate Involving Boot (EITF 87-29)*, suggests that a seller should follow FAS 66 for the monetary portion of a transaction involving an exchange of real estate involving boot. EITF 87-29 provides the following guidance:

#### ISSUE

Statement 66 indicates that the accounting for exchanges of real estate is covered by Opinion 29, which addresses nonmonetary transactions, and not by Statement 66. However, in Issue No. 86-29, "Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value," the Task Force reached a consensus that an exchange of nonmonetary assets that would otherwise be based on recorded amounts under paragraph 21 of Opinion 29 but that involves boot should be considered a monetary (rather than nonmonetary) transaction if the boot is at least 25 percent of the fair value of the exchange. As a result of that consensus, an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate would be recorded by both parties based on fair value when the boot is at least 25 percent of the fair value of the exchange. (Those types of exchanges will be referred to in this

Issue as exchanges of similar real estate.) The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite for the use of fair value. If the boot in an exchange of similar real estate is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 would be applied by the receiver of boot, and the payer of boot would not recognize a gain.

The issues are:

1. Whether Statement 66 applies to an exchange of similar real estate that is not subject to Opinion 29 because the transaction involves enough boot for the exchange to be considered monetary under the consensus for Issue 86-29
2. If applicable, how Statement 66 should be applied.

#### EITF DISCUSSION

The Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of this consensus.

35. *FASB Emerging Issues Task Force Issue No. 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66* provides the following guidance on accounting for sales of real estate:

#### ISSUE

Party A has a 75 percent interest in real estate and Party B has the other 25 percent interest. Party A sells its interest to Party B and receives a 10 percent cash down payment and a note for the balance of the sales price. For this transaction, paragraph 54 of Statement 66 specifies a minimum required initial investment of 15 percent of the sales value. Party B pledges the 100 percent interest in the property as security for the note to Party A; no debt is outstanding on the property.

Under paragraph 9 of Statement 66, only the 10 percent cash down payment of Party B would be included as part of the buyer's initial investment. Paragraph 11 of Statement 66 states that the initial investment should "be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable."

The issues are:

1. Whether the buyer's ownership interest in a purchased property that is pledged as security for a note should be included as part of the buyer's initial investment in determining whether profit may be recognized under the full accrual method
2. If so, in other situations in which a note is collateralized by assets other than the purchased property (for example, other real estate properties or marketable securities), whether those assets should be included as part of the buyer's initial investment in determining whether profit may be recognized under the full accrual method.

The Task Force reached a consensus that Statement 66 precludes profit recognition under the full accrual method for this transaction because purchased property or other assets pledged as security for a note should not be included as part of the buyer's initial investment.

36. *FASB Emerging Issues Task Force Issue No. 88-24, Effects of Various Forms of Financing under FASB Statement No. 66* provides the following guidance on how profit should be recognized under FASB Statement No. 66:

#### ISSUE

The sale of real estate often involves significant financing relative to the sales price. That financing may be provided by independent third parties, the seller, or both. The financing may involve a nonrecourse mortgage (that is, the lender's only recourse upon default of the buyer is to repossess the underlying real estate) and it may involve the buyer's assumption of preexisting recourse or nonrecourse mortgage obligations of the seller.

Paragraph 3 of Statement 66 provides that profit shall be recognized in full when real estate is sold, provided (1) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (2) the earnings process is virtually complete, that is, the seller is not obligated to perform significant activities after the sale to earn the profit. Paragraph 4 of Statement 66 states that 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. If the full profit is not recognized, Statement 66 requires use of the installment, cost recovery, or reduced-profit recognition methods in certain circumstances.

The issue is how profit should be recognized under Statement 66 when a real estate sales transaction involves various forms of financing.

#### EITF DISCUSSION

Modifying a previous consensus on this issue, the Task Force reached a consensus that the following guidelines should be applied by the seller to real estate sales transactions. (The requirements for the consummation of a real estate sales transaction and the appropriate accounting when some common forms of continuing involvement exist appear in paragraphs 6 and 25-43, respectively, of Statement 66 and are not affected by this consensus.)

1. The initial and continuing investment requirements for the full accrual method of profit recognition of Statement 66 are applicable unless the seller receives as the full sales value of the property (a) cash, without any seller contingent liability on any debt on the property incurred or assumed by the buyer, (b) the buyer's assumption of the seller's existing nonrecourse debt on the property, (c) the buyer's assumption of all recourse debt on the property with the complete release of the seller from those obligations, or (d) any combination of such cash and debt assumption. When the seller has unconditionally received all amounts it is entitled to from the sale and is not at risk related to the financing, the buyer's commitment to pay for the property is not a factor in the seller's recognition of profit.
2. To recognize profit by the full accrual method, debt incurred by the buyer that is secured by the property, whether incurred directly from the seller or other parties or indirectly through assumption, and payments to the seller from the proceeds of such indebtedness shall not be included as part of the buyer's initial investment. A sufficient amount of the buyer's own cash or other qualifying forms of investment demonstrates the buyer's commitment to pay for the property; however, the buyer's borrowing secured by the property does not demonstrate such a commitment. Paragraphs 9 and 10 of Statement 66 provide additional guidance on what are included in and excluded from initial investment.

3. Under the installment, cost recovery, and reduced-profit recognition methods, debt incurred by the buyer that is secured by the property, whether incurred directly from the seller or other parties or indirectly through assumption, and payments to the seller from the proceeds of such indebtedness are not considered buyer's cash payments. However, if the profit deferred under the applicable method exceeds the outstanding amount of seller financing and the outstanding amount of buyer's debt secured by the property for which the seller is contingently liable, the seller shall recognize the excess in income.

Exhibit 88-24A presents examples of the application of this consensus.

#### STATUS

No further EITF Discussion is planned

37. *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides the following guidance:

#### INTRODUCTION

1. This Statement establishes accounting standard for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of.
2. Long-lived assets such as plant and equipment generally are recorded at cost, which is usually fair value at the date of acquisition. The original cost usually is reduced over time by depreciation (amortization) so that the cost to the asset is allocated to the periods in which the asset is used. That practice has been modified in some circumstances when an assets has been determined to be impaired, in which case the asset has been written down to a new carrying amount that is less than the remaining cost and a loss has been recognized. Accounting standards generally have not addressed when impairment losses should be recognized or how impairment losses should be measured. As a result, practice has been diverse.

#### SCOPE

3. This Statement applies to long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and to long-lived assets and certain identifiable intangibles to be disposed of. The Statement applies to all entities. This Statement does not apply to financial instruments, long-term customer relationships of financial institution (for example, core deposit intangibles and credit cardholder intangibles), mortgage and other servicing rights, deferred policy acquisition costs, or deferred tax assets.

#### Assets to Be Held and Used

#### Recognition and Measurement of Impairment

4. An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.
5. The following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:
  - a. A significant decrease in the market value of an asset
  - b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset
  - c. A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator
  - d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset

- e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

6. If the examples of events or changes in circumstances set forth in paragraph 5 are present or if other events or changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, the entity shall estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Future cash flows are the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the entity shall recognize an impairment loss in accordance with this Statement. Otherwise, an impairment loss shall not be recognized; however, a review of depreciation policies may be appropriate.<sup>1</sup>

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<sup>1</sup> Paragraph 10 of *APB Opinion No. 20, Accounting Changes*, addresses the accounting for changes in depreciation estimates, and paragraph 32 addresses the accounting for changes in the method of depreciation. Whenever there is reason to assess the recoverability of the carrying amount of an asset under paragraphs 4 and 5 of this Statement, there may be reason to review the depreciation estimates and method under paragraphs 10 and 32 of Opinion 20. However, an impairment loss that results from applying this Statement should be recognized prior to performing that review. The provisions of Opinion 20 apply to the reporting of changes in the depreciation estimates and method regardless of whether an impairment loss is recognized under paragraph 6 of this Statement.

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7. An impairment loss recognized in accordance with paragraph 6 shall be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

8. In estimating expected future cash flows for determining whether an asset is impaired (paragraph 6), and if expected future cash flows are used in measuring assets that are impaired (paragraph 7), assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

9. Estimates of expected future cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.



10. In limited circumstances, the test specified in paragraph 6 will be applicable at only the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings. In those instances, if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of this Statement. If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement.

11. After an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. For a depreciable asset, the new cost shall be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

#### Goodwill

12. If an asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping (paragraph 8) in determining recoverability. If some but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date unless there is evidence to suggest that some other method of associating the goodwill with those assets is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles.

#### Reporting and Disclosure

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although there is no requirement to report a subtotal such as "income from operations," entities that present such a subtotal must include the impairment loss in that subtotal.

14. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

- a. A description of the impaired assets and the facts and circumstances leading to the impairment
- b. The amount of the impairment loss and how fair value was determined
- c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement
- d. If applicable, the business segment(s) affected.

#### Recognition and Measurement

15. *APB Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, requires that certain assets to be disposed of be measured at the lower of carrying amount or net realizable value.<sup>2</sup> All long-lived assets and certain identifiable intangibles to be disposed of that are not covered by that Opinion and for which management, having the authority to approve the action, has committed to a plan to dispose of the assets, whether by sale or abandonment, shall be reported at the lower of carrying amount or fair value less cost to sell. The fair value of the assets to be disposed of shall be measured in accordance with paragraph 7 of this Statement.

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<sup>2</sup>Paragraphs 13-16 of Opinion 30 prescribe the accounting for the disposal of a segment of a business. Paragraph 13 defines a segment of a business as “a component of an entity whose activities represent a separate major line of business or class of customer.” Paragraph 15 of that Opinion prescribes the determination of a gain or loss on the disposal of a segment of a business and states:

In the unusual circumstance, it would be expected that the plan of disposal would be carried out within a period of one year from the measurement date and that such projections of operating income or loss would not cover a period exceeding approximately one year.

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16. Cost to sell an asset to be disposed of generally includes the incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Costs generally excluded from cost to sell an asset to be disposed of include insurance, security services, utility expenses, and other costs of protecting or maintaining an asset. However, if a contractual agreement for the sale of an asset obligates an entity to incur costs in the future to effect the ultimate sale, those costs shall be included as adjustments to the cost to sell an asset to be disposed of. If the fair value of an asset is measured by the current market value or by using the current selling price for a similar asset, that fair value shall be considered to be a current amount and that fair value and cost to sell shall not be discounted. If the fair value of an asset is measured by discounting expected future cash flows and if the sale is expected to occur beyond one year, the cost to sell also shall be discounted. Assets to be disposed of covered by this Statement shall not be depreciated (amortized) while they are held for disposal.

17. Subsequent revisions in estimates of fair value less cost to sell shall be reported as adjustments to the carrying amount of an asset to be disposed of, provided that the carrying amount of the asset does not exceed the carrying amount (acquisition cost or other basis less accumulated depreciation or amortization) of the asset before an adjustment was made to reflect the decision to dispose of the asset.

#### Reporting and Disclosure

18. An entity that holds assets to be disposed of that are accounted for in accordance with paragraphs 15-17 of this Statement shall report gains or losses resulting from the application of those paragraphs as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although entities are not required to report a subtotal such as “income from operations,” entities that present such a subtotal must include the gains or losses resulting from the application of paragraphs 15-17 in that subtotal.

19. An entity that accounts for assets to be disposed of in accordance with paragraphs 15-17 shall disclose all of the following in financial statements that include a period during which those assets are held:

- a. A description of assets to be disposed of, the facts and circumstances leading to the expected disposal, the expected disposal date, and the carrying amount of those assets
- b. If applicable, the business segment(s) in which assets to be disposed of are held
- c. The loss, if any, resulting from the application of paragraph 15 of this Statement
- d. The gain or loss, if any, resulting from changes in the carrying amounts of assets to be disposed of that arises from application of paragraph 17 of this Statement
- e. The caption in the income statement or statement of activities in which the gains or losses in (c) and (d) are aggregated if those gains or losses have not been presented as a separate caption or reported parenthetically on the face of the statement
- f. The results of operations for assets to be disposed of to the extent that those results are included in the entity's results of operations for the period and can be identified.

**OTHER RELEVANT INFORMATION:**

38. The NAIC Technical Resource Group Proposed Draft Life Codification contains proposed revisions to Chapter 4, *Real Estate*, primarily related to statement value and requiring recognition of permanent impairments on real estate investments and adoption of the provisions of FAS 66 for accounting for sales of real estate. Certain other insignificant changes were also made in the text. Sections which contain proposed changes are as follows:

**Authorization and Limitations**

Often, statutes and regulations promulgated by the states include limitations on holding investments in real property. These limitations may include provisions requiring the disposal of foreclosed properties within a certain period of time.

**Market Value**

Market value is the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale--the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus. Estimates of market value are determined by a qualified real estate appraiser.

**Appraised Value**

An appraisal is an opinion of estimated market value for an adequately described property, as of a specified date, supported by the analysis of relevant data. To arrive at this value, three methods are typically used:

1. Market Data Approach - a comparative analysis of current sales prices of similar properties, after making necessary and reasonable adjustments for any difference in the properties.
2. Cost Approach - an estimated value based on the cost of reproduction or replacement of the improvements, less depreciation, plus the value of the land. (Land value is usually determined by the market data approach.)
3. Income Approach - an estimated value based on the capitalization of income and productivity. It is concerned with the present value of future income future cash flows.

**Statement Value**

The statement value of all real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual cost, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company. If home office or investment real estate has been permanently impaired, the asset value must be reduced and a realized loss recorded. If the impairment on the properties is other than permanent, the property is valued at depreciated cost and no loss needs to be recognized. Real estate is considered permanently impaired when caused by obsolescence or condemnation as opposed to temporarily impaired which is caused by temporary market conditions which are expected to reverse themselves. Implicit within the designation "temporarily impaired" is the ability and intent to hold the real estate until such conditions are rectified.

Properties acquired in satisfaction of debt which are held for investment, should be transferred at the lower of cost or current market value, as determined by a qualified appraiser, to the investment real estate category.

The value of the investment real estate and property classified as property acquired in satisfaction of debt may not exceed the lower of current market value as determined by a

qualified appraiser or cost balance transferred from mortgage loan plus capitalized improvements, less normal depreciation. A realized loss is recognized if there is a permanent decrease in the market value of the property subsequent to the date of acquisition. If the decline in value is considered temporary an unrealized loss is recognized. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a contra-asset. This contra-asset is a specific reserve in addition to the general reserve established under the Asset Valuation Reserve.

#### Income Derived from Real Estate

Income on real estate usually is received periodically and in advance. Any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a three month period, the entire amount must be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part must be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received must be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the investment income for the period.

#### Sale of Real Estate

Life insurance companies must follow Statement of Financial Accounting Standards (FASB) No. 66 in determining whether a sale has taken place, whether all requirements have been met to recognize profit under the full accrual method, and, if not appropriate, which method of profit recognition should be followed: the deposit, installment or cost recovery method.

Sale of retail land must be accounted for under provisions of FASB #66: (1) by the full accrual method, (2) by the percentage-of-completion method, (3) by the installment sales method, or (4) by the deposit method.

Sale-leaseback transactions involving real estate must be accounted for under the provisions of FASB #98. A sale-leaseback transaction is one in which an owner sells the property and leases back the same property from the purchaser.

A company can recognize the sale of any real estate that it owns as an immediate cash sale or as a contract of sale. In a sale for cash and/or mortgage, title transfers to the buyer when the sale is consummated. Any profit or loss on the sale is considered to be realized in the year of sale. In a sale involving an installment contract, often referred to as land contracts, title is retained by the seller and transferred to the buyer only when he has paid the entire sales price, or a substantial portion of it.

If the sale of real estate, including real estate occupied by the Company, includes a mortgage or other note from the Company, some states may require the transaction be reported as a financing transaction using the deposit method of accounting for sale-leaseback transaction.

An insurer does not take credit for any profit from the sale or exchange of its assets when the consideration received and otherwise properly reported as an admitted asset is in the form of an installment contract, unless such profit is fully reserved by a liability established which is equal to the portion of such profit which is unrealized. In computing the realized portion of the profit on installment contracts, payments are allocated at the rate the principal is reduced by said payments.

39. The draft discussion material from previous Property/Casualty codification projects proposed changes to Chapter 4, *Real Estate*, primarily removing the option to establish a reserve for specific properties in lieu of writing down or nonadmitting part of the investment real estate balance when market

value is less than book value. In addition, it provides guidance on how to determine whether a decrease in market value has occurred and how a writedown would be recorded. Sections which contain proposed revisions are provided below:

#### Statement Value

The statement value of all real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

The value of all other real estate (investment real estate and property acquired in satisfaction of debt) may not exceed the lower of (a) current market value, or (b) cost plus capitalized improvements less normal depreciation. When market value is less than book value, insurers shall either: (a) write down book value to market value, or (b) nonadmit the excess of book value over market value.

(In determining whether a decrease in the market value of investment real estate has occurred, the net income derived from each investment should be divided by an appropriate capitalization rate, and compared to the book value. If the result of this calculation is less than book value for two consecutive years, there would be a presumption that a decrease in value had occurred, which would indicate that a new appraisal of the real estate is appropriate.)

If the book value is to be written down, it would be recorded as a Decrease by Adjustment in Book Value on Schedule A, carried forward to Part 1A as a Decrease by Adjustment in Book Value, and recorded as an unrealized capital loss on the Underwriting and Investment Exhibit. If the excess value is to be nonadmitted, the aggregate nonadmitted amount for all real estate would be recorded on Exhibit 1, and recorded as a change in nonadmitted assets on the Underwriting and Investment Exhibit.

#### Sale of Real Estate

A company may sell real estate for cash (and/or a mortgage), or as an installment sale. In a sale for cash (and/or mortgage), where title transfers to the buyer as part of the consummated transaction, any profit or loss on the sale shall be reported in the year of sale. Under installment contracts, the seller retains title until all or a substantial portion of payments have been made. The Seller shall recognize a profit on the sale (under a pro rata method) only to the extent that payments have been received. If the seller records the entire profit at the commencement of the contract, it shall establish a reserve to offset the portion of profits which are unrealized (i.e., not yet paid by the buyer). Losses on installment sales shall be recognized immediately. An insurer may elect to use an accounting method that is more conservative in its recognition of gains, such as the cost-recovery method or the deposit method if the facts of the situation so indicate.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate, and Chapter 22, General Expenses and Taxes, Licenses and Fees
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 4, Real Estate, Chapter 19, *Expenses*, and Appendix A, Mortgage Guaranty Insurance Accounting Principles
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

- *Issue Paper No. 22—Leases*
- *Issue Paper No. 23—Property Occupied by the Company*
- *Issue Paper No. 36—Troubled Debt Restructurings*
- *Issue Paper No. 38—Acquisition, Development and Construction Arrangements*
- *Issue Paper No. 44—Capitalization of Interest*
- *Issue Paper No. 68—Business Combinations and Goodwill*

### **Generally Accepted Accounting Principles**

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 66, Accounting for Sales of Real Estate*
- *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*
- *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*
- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, “Chapter 10, Taxes, Section A-Real Estate and Personal Property Taxes*
- *AICPA Statement of Position 92-1, Accounting for Real Estate Syndication Income*
- *AICPA Statement of Position 92-3, Accounting for Foreclosed Assets*
- *FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*
- *FASB Emerging Issues Task Force Issue No. 86-6, Antispeculation Clauses in Real Estate Sales Contracts*
- *FASB Emerging Issues Task Force Issue No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*
- *FASB Emerging Issues Task Force Issue No. 87-29, Exchange of Real Estate Involving Boot*
- *FASB Emerging Issues Task Force Issue No. 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66*
- *FASB Emerging Issues Task Force Issue No. 88-24, Effects of Various Forms of Financing under FASB Statement No. 66*
- *FASB Emerging Issues Task Force No 89-13, Accounting for the Cost of Asbestos Removal*
- *FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate*
- *FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination*
- *FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration /Environmental Exit Costs When Testing a Long-Lived Assets for Impairment.*

### **State Regulations**

- Minnesota regulations - 60A.122 and 60A.123
- Missouri regulations 20 CSR 200-13.100
- Arizona Statutes - Insurance Laws, TITLE 20
- Nevada Statutes - Insurance Laws, TITLE 57

### **Other Sources of Information**

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 4, Real Estate
- Draft discussion material from previous Property/Casualty codification projects, Chapter 4, Real Estate