Statutory Issue Paper No. 106

Real Estate Sales – An Amendment to SSAP No. 40—Real Estate Investments

STATUS
Finalized September 12, 2000

Current Authoritative Guidance for Real Estate Sales: SSAP No. 40R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 77

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for Real Estate is provided in *SSAP No. 40—Real Estate Investments* (SSAP No. 40). SSAP No. 40 adopted *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), 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. Although FAS 66 states that it is applicable to all sales of real estate, it does not explicitly define real estate or identify the real estate transactions to which it is specifically applicable.

2. Paragraph 1 of *FASB Statement No. 66, Accounting for Sales of Real Estate*, states, "This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business." *FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66* (FIN 43) clarifies that the phrase "all real estate sales" to include sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. *FASB Emerging Issues Task Force No. 00-13*, *Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98* (EITF 00-13) adds guidance relative to the definition of integral equipment.

3. The purpose of this issue paper is to adopt FIN 43 and EITF 00-13 which is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper supersedes paragraphs 16 and 17 of SSAP No. 40. The following guidance shall be followed when accounting for the sales of real estate.

5. Recognition of profit on sales of real estate investments shall be accounted for in accordance with *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), except as modified in paragraph 6 of this statement, *FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* (EITF 87-9), *FASB Emerging Issues Task Force No*. 87-29, *Exchange of Real Estate Involving Boot* (EITF 87-29), *FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66* (FIN 43) and *FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98*. This issue paper applies to all sales of real estate including real estate with property improvements or integral equipment. The terms "property improvements" and "integral equipment" refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building. 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.

6. The calculation of the buyer's initial investment specified in paragraph 9 of FAS 66 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.

DISCUSSION

7. This issue paper adopts FIN 43, which clarifies that the phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. This is consistent with SSAP No. 40 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also adopts EITF 00-13 which clarifies use of the term "integral equipment".

Drafting Notes/Comments

- Accounting for leases and sale-leaseback transactions involving real estate transactions are addressed in *SSAP No. 22—Leases*.
- Accounting for leasehold improvements is addressed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*.
- Accounting for transfers and servicing of financial assets and extinguishments of liabilities is addressed in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. SSAP No. 40, paragraphs 16 and 17 state:

> **Sale of Real Estate**
>
> 16. Recognition of profit on sales of real estate investments shall be accounted for in accordance with *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), except as modified in paragraph 17 of this statement*, FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* (EITF 87-9), and *FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot* (EITF 87-29). 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.

17. The calculation of the buyer's initial investment specified in paragraph 9 of FAS 66 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.

Generally Accepted Accounting Principles

9. FIN 43 provides the following guidance:

INTERPRETATION

2. Statement 66 applies to all sales of real estate, including real estate with property improvements or integral equipment. The terms property improvements and integral equipment as they are used in this Interpretation refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.

3. The provisions of Statement 66 do not apply to transactions that involve the following:

a. The sale of only property improvements or integral equipment without a concurrent (or contemplated) sale of the underlying land[1]

---

[1] Except for sales of property improvements or integral equipment with the concurrent lease (whether explicit or implicit in the transaction) of the underlying land to the buyer. Those transactions should be accounted for in accordance with paragraphs 38 and 39 of Statement 66. In addition, sales of property improvements or integral equipment subject to an existing lease of the underlying land are also subject to the provisions of Statement 66.

---

b. The sale of the stock or net assets of a subsidiary or a segment of a business if the assets of that subsidiary or that segment, as applicable, contain real estate, unless the transaction is, in substance, the sale of real estate

c. The sale of securities that are accounted for in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*.[2]

---

[2] Sales of those types of securities are addressed by *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

---

4. In the first sentence of paragraph 38 of Statement 66, the phrase property improvements is interpreted to include both property improvements and integral improvements (to conform that paragraph to the scope clarification provided by this Interpretation).

10. EITF 00-13 provides the following guidance:

1. With the issuance of Interpretation 43, which concludes that sales of integral equipment are within the scope of Statement 66, determining whether equipment constitutes "integral equipment" has taken on increased importance as that determination now affects whether the detailed guidance in Statement 66 should be applied to a transfer of equipment. Further, the appropriateness of sales-type lease classification by lessors for leases involving equipment is also impacted by the determination of whether the equipment to be leased is "integral equipment." In addition, that determination is important for reaching a conclusion as to whether Statement 98, with its more stringent provisions, applies to a sale-leaseback transaction.

2. Integral equipment is defined in Interpretation 43 as "any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost." The authoritative pronouncements governing the accounting for leasing transactions and sales of real estate do not provide any guidance for interpreting the phrase "cannot be removed and used separately without incurring significant cost," and, as a result, there may be diversity in practice with respect to determining what constitutes "integral equipment" for the purpose of applying Statements 13, 66, and 98.

3. This issue is how the determination of whether equipment is integral equipment should be made.

EITF 00-13 DISCUSSION

4. The Task Force agreed that the phrase "cannot be removed and used separately without incurring significant cost" contains two distinct concepts: (a) the ability to remove the equipment without incurring significant cost and (b) the ability of a different entity to use the equipment at another location without significant diminution in utility or value. The Task Force reached a consensus that the determination of whether equipment is integral equipment should be based on the significance of the cost to remove the equipment from its existing location (which would include the cost of repairing damage done to the existing location as a result of the removal), combined with the decrease in the value of the equipment as a result of that removal. The Task Force agreed that, at a minimum, the decrease in the value of the equipment as a result of its removal is the estimated cost to ship and reinstall the equipment at a new site. The nature of the equipment, and the likely use of the equipment by other potential users, should be considered in determining whether any additional diminution in fair value exists beyond that associated with costs to ship and install the equipment.

5. When the combined total of both the cost to remove plus the decrease in value (for leasing transactions, the information used to estimate those costs and the decrease in value should be as of lease inception) exceeds 10 percent of the fair value of the equipment (installed) (for leasing transactions, at lease inception), the equipment is integral equipment.

6. Refer to Exhibit 00-13A for an example that illustrates the application of this consensus.

Exhibit 00-13A

ILLUSTRATION OF THE APPLICATION OF THE EITF CONSENSUS
ON ISSUE 00-13

Company A leases equipment to Company B for use in a manufacturing facility. The fair value of the production equipment (installed) at lease inception is $1,075,000. The estimated cost to remove the equipment after installation (estimate is as of the beginning of the lease term) is $80,000, which includes $30,000 to repair damage to the existing location as a result of the removal. The estimated cost to ship and reinstall the equipment at a new site (estimated as of the beginning of the lease term) is $85,000. For this example, assume that the equipment would have the same fair value (installed) to the seller and a potential buyer. Therefore, there is no diminution in fair value of the equipment beyond the discount a purchaser would presumably require to cover the cost to ship and reinstall the equipment.

In accordance with this consensus, Company A would assess whether or not the production equipment is integral equipment as follows ($80,000 + $85,000) ÷ $1,075,000 = 15.3 percent. Because the cost of removal combined with the diminution in value exceeds 10 percent of the fair value (installed) of the production equipment, the cost to remove the equipment and use it separately is deemed to be significant. Therefore, the production equipment is integral equipment.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 40—Real Estate Investments*

Generally Accepted Accounting Principles

- *FASB Interpretation No. 43, Real Estate Sales, an interpretation of FASB Statement No. 66*
- *FASB Statement No. 66, Accounting for Sales of Real Estate*
- *FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98*

State Regulations

- No additional guidance obtained from state statutes or regulations.

