

FASB Emerging Issues Task Force

Issue No. 06-8

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

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Previously distributed EITF materials: Issue Summary No. 1, dated August 15, 2006

References:

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

AICPA Statement of Position 75-6, "Questions Concerning Profit Recognition on Sales of Real Estate" (SOP 75-6)

AICPA Industry Accounting Guide, "Accounting for Profit Recognition on Sales of Real Estate" (the Real Estate Guide)

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

Background

1. At the September 7, 2006 EITF meeting, the Task Force reached a tentative conclusion on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. The draft abstract was posted to the website on September 26, 2006, for a comment period that ended on October 13, 2006.

2. Comment letters received on the draft abstract have been distributed to Task Force members and have been analyzed by the FASB staff. At the November 16, 2006 EITF meeting, the Task Force will have the opportunity to consider those comment letters as it redeliberates the tentative conclusion in the draft abstract and addresses issues raised in this Issue Summary Supplement. The Task Force will then be asked to affirm the tentative conclusion as a consensus.

Formal Comments Received on the Draft Abstract

3. Two comment letters were received on the draft abstract from preparers of financial statements. The respondents generally did not agree with the Task Force's tentative conclusions.

4. The respondents both disagreed with the tentative conclusion reached by the Task Force as it pertains to the continuing investment test in paragraph 12 of Statement 66 because they believe that paragraph 12 was intended to apply only to situations in which the seller is providing financing to the buyer. One of the respondents also indicated that they believe that the continuing investment test in paragraph 12 of Statement 66 is not applicable because a sale has not been consummated since the conditions in paragraph 6 of Statement 66 will not be met until the condominium project is completed. That same respondent references paragraph 16 of Statement 66, which states, in part:

Tests of adequacy of a buyer's initial and continuing investments...shall be applied cumulatively when the sale is consummated and annually afterward.

Therefore, the respondent believes that since a sale has not been consummated, the continuing investment test should not be applied. The staff believes that the Task Force has previously considered these views and the staff does not believe the issue needs to be readdressed by the Task Force.

5. One of the respondents requested that the Task Force clarify whether only non-refundable payments should be considered for purposes of applying the initial and continuing investment criteria in Statement 66. The respondent indicated that under the Interstate Land Sales Full Disclosure Act, administered by the U.S. Department of Housing and Urban Development, there is a limitation on the amount of money a developer may retain as liquidated damages, which is set at 15 percent of the principal paid by the buyer generally for projects with over 100 units or an expected construction term in excess of 2 years. As a result, only 15 percent of the principal paid by the buyer would be a non-refundable payment. The staff believes, consistent with paragraph 4 of Statement 66, that the initial and continuing investment tests are intended to give the buyer a stake in the property sufficient enough so that the risk of loss through default motivates the buyer to honor its obligation to the seller. The staff believes that this can only be accomplished through non-refundable payments. The staff does not believe that this requirement is different from any other sale of real estate. Therefore, the staff recommends that the draft abstract be modified to clarify that the buyer's initial and continuing investments should be in any of the forms specified in paragraph 9 of Statement 66 and should consider only the non-refundable portion of the investments. Suggested changes to the wording in the draft abstract are indicated in the marked draft abstract included as Exhibit 06-8A.

6. The recommendations to the Task Force are based on the staff's analysis of the information received, the staff's subsequent discussions with comment letter respondents and auditors, and whether any of the new information was previously considered in the Task Force's initial deliberation on this Issue. In addition, there is one issue that the staff believes the Task Force should consider addressing as a result of the comment letters and subsequent discussions concerning how the tests should be applied on a reassessment date.

7. The respondents requested clarity regarding how the initial and continuing investment tests should be applied on a reassessment date. The staff believes that paragraph 37 of Statement 66 allows for a reassessment of whether the criteria in paragraph 37 have been met. The reassessment can be triggered by changes in the circumstances described in paragraph 37 of Statement 66, including the ability to satisfy the continuing investment test. However, there was

disagreement amongst respondents and other constituents regarding whether the reassessment of the initial and continuing investment tests should be on a cumulative basis from the Contract Date (the date the individual unit is effectively sold through receipt of a down-payment and execution of the agreement to purchase) or prospectively from the reassessment date.

Accounting Issues and Alternatives

Issue: When an entity reassesses the criteria in paragraph 37 of Statement 66, whether the entity should apply the initial and continuing investment tests on a cumulative basis from the Contract Date or prospectively from the reassessment date.

View A: The initial and continuing investment tests should be applied on a cumulative basis from the Contract Date.

8. Proponents of View A believe that Statement 66 explicitly requires the application of the initial and continuing investment tests on a cumulative basis from the date that an individual unit is sold. Paragraph 16 of Statement 66 states, in part:

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

Further, proponents of View A believe that if the tests are not applied on a cumulative basis from the Contract Date, a seller would be permitted to recognize profit solely due to the passage of time (described further in View B). Proponents of View A believe that the initial and continuing investment tests are intended to demonstrate the buyer's commitment to pay the remaining sales price through a sufficient stake in the property. Proponents of View A do not believe that the passage of time without any increases to the buyer's investments gives the buyer a sufficient stake in the property to motivate the buyer to honor its obligation to the seller.

View B: The initial and continuing investment tests should be applied prospectively from the reassessment date.

9. Proponents of View B believe that the initial and continuing investment tests should be applied prospectively on a reassessment date. That is, proponents of View B would perform the tests as if the down-payment was received on the reassessment date. Proponents of View B believe that a reassessment event is essentially a new transaction for which profit recognition should be assessed. Proponents of View B also believe that View B can be supported by referring to SOP 75-6 (portions of which were extracted and included in FAS 66¹). Specifically, proponents of View B refer to the following question and answer in SOP 75-6:

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

Answer: The Guide indicates that under certain conditions the effective date of the sale for accounting purposes is required to be deferred....² When a transaction is recorded under the deposit method, the date from which the cumulative test would begin to apply would be delayed until the sale is recorded for accounting purposes. [Footnote added.]

Therefore, proponents of View B believe that the cumulative initial and continuing investment tests would begin to apply on the date that the deposit method is no longer required. While proponents of View B acknowledge that the answer to this question was not extracted and included in Statement 66, proponents of View B believe that the intent of the Board during the extraction process was not to reconsider the existing specialized literature related to sales of real estate. Specifically, paragraph 99 of Statement 66 states, in part:

Board members have assented to the issuance of this Statement on the basis that it is an appropriate extraction of existing specialized principles and practices and that a comprehensive reconsideration of those principles and practices was not contemplated in undertaking this FASB project.

¹ SOP 75-6 was issued to clarify and elaborate on the recommendations of the Real Estate Guide. Both the Guide and SOP 75-6 were superseded upon issuance of Statement 66.

² SOP 75-6 references paragraphs in the Real Estate Guide requiring deferral of a sale, including deferral of a sale due to inadequate buyer investment.

10. Opponents of View B note that both the Real Estate Guide and SOP 75-6 were superseded upon the issuance of Statement 66. Therefore, any guidance provided in the specialized literature that was not extracted and included in Statement 66 is not relevant in determining how the initial and continuing investment tests are performed. Opponents of View B believe that the Board considered which aspects of the AICPA Guides and Statements of Positions would be extracted and included in Statement 66 and that the omission of concepts implies that such concepts were no longer relevant or acceptable. Specifically, paragraph 104 of Statement 66 states:

A draft of this Statement was reviewed by the FASB Task Force on Specialized Principles for the Real Estate Industry to ensure that the specialized principles in the Guides and SOPs had been extracted correctly. Based on the task force's comments, the Board believes that the specialized profit recognition principles in the Guides and SOPs have been correctly identified and included in this Statement.

Opponents of View B also believe that the guidance in SOP 75-6 is circular when applied to sales of individual condominium units because, generally, the sole reason for applying the deposit method is due to the buyer's initial and continuing investments being inadequate.

11. Proponents of View B believe that if the initial and continuing investment tests were applied on a cumulative basis from the date the tests were initially applied (as described in View A), all things being equal (that is, down-payment, creditworthiness, and so forth), similar units would be accounted for differently depending on when the unit was sold. For example, Unit #1, which is sold early in the construction process of a five year project, would likely be accounted for under the deposit method through the life of the project, whereas Unit #2, which is sold a year before completion of the project, would be accounted for under the percentage of completion method (assuming the initial investment is adequate). This would result in the seller accounting for sales of similar units to equivalent buyers differently at the same point in time (that is, one year from completion).

12. Proponents of View B believe that the point at which a unit is sold should not determine how profit is recognized for the sale of the individual unit. In this example, proponents of View

B believe that upon reassessment one year from completion of the project, the seller should apply the initial and continuing investment tests from the reassessment date for Unit #1 and recognize profit under the percentage of completion method for both Unit #1 and Unit #2 on a consistent basis.

13. Opponents of View B note that if the tests were applied prospectively from the reassessment date, then sellers would be guaranteed to recognize profit under the percentage of completion method without the buyer making continuing investments. The question opponents of View B pose is if profit recognition under the percentage of completion method is guaranteed prior to completion of the condominium project without any additional investments from the buyer, then why not permit sellers to recognize profit under the percentage of completion method on the Contract Date? Opponents of View B believe that this would be inconsistent with the Task Force's tentative conclusion that a seller should apply the initial and continuing investment tests to conclude that sales prices are collectible.

Other Comments Received on the Draft Abstract

14. The staff noted that the other comments raised by the respondents were previously considered by the Task Force during its initial deliberations. Therefore, the staff believes that there are no additional issues or comments that warrant consideration by the Task Force at the November 16, 2006 EITF meeting.

EITF ABSTRACTS (DRAFT[†])

Issue No. 06-8

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

Dates Discussed: September 7, 2006; [November 15–16, 2006]

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

ISSUE

1. Paragraph 37 of Statement 66 provides guidance on what criteria must be met to recognize profit under the percentage-of-completion method for individual units in a condominium project that are being sold separately. One criterion is that the sales price is collectible (paragraph 37(d) of Statement 66). To provide guidance on how entities should assess the collectibility of the sales price, paragraph 37(d) of Statement 66 parenthetically references paragraph 4 of Statement 66.
2. Under paragraph 4 of Statement 66, "...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." Questions have been raised about whether the continuing investment test in paragraph 12 of Statement 66 should be applied in order to conclude that the sales price is collectible and to recognize profit under the percentage-of-completion method.
3. The issue is whether an entity needs to evaluate the adequacy of the buyer's continuing investment pursuant to paragraph 12 of Statement 66 to recognize profit under the percentage-of-completion method.

Scope

4. The scope of this Issue is limited to the sale of individual units in a condominium project.

EITF DISCUSSION

5. The Task Force reached a [consensus] that in assessing the collectibility of the sales price pursuant to paragraph 37(d) of Statement 66, an entity should evaluate the adequacy of the buyer's initial and continuing investment to conclude that the sales price is collectible. The buyer's initial and continuing investments should be in any of the forms specified in paragraph 9 of Statement 66 and should only consider the non-refundable portion of the investments.

[†]~~This draft abstract is being exposed for a public comment period that will end on October 13, 2006.~~

6. An entity can meet the continuing investment criterion in paragraph 12 of Statement 66 by requiring the buyer to either (a) make additional payments during the construction term at least equal to the level annual payments that would be required to fund principal and interest on a customary mortgage for the remaining purchase price of the property or (b) increase the minimum initial investment by an equivalent aggregate amount. The remaining purchase price should be determined based on the sales price of the property. The Task Force believes that the test should be performed using a hypothetical loan between the seller and the buyer. The Task Force ultimately concluded that because paragraph 12 of Statement 66 refers to the buyer's "debt for the purchase price of the property," using the remaining purchase price would be consistent with Statement 66.

7. If an entity is unable to meet the criteria in paragraph 37, including an assessment of collectibility using the initial and continuing investment tests described in paragraphs 8–12 of Statement 66, then the entity should apply the deposit method as described in paragraphs 65–67 of Statement 66.

Transition

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

Board Ratification

9. At its [November 29, 2006] meeting, the Board ratified the [consensus] reached by the Task Force in this Issue.

STATUS

10. No further EITF discussion is planned.