

FASB Emerging Issues Task Force

Issue No. 07-6

Title: Accounting for the Sale of Real Estate When the Agreement Includes a Buy-Sell Clause

Document: Issue Summary No. 1*

Date prepared: August 28, 2007

FASB Staff: Maples (ext. 462)/Wyatt (ext. 284)

EITF Liaison: Mitch Danaher

Date previously discussed: None

Previously distributed EITF materials: None

References:

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

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

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

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

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

*** The alternative views presented in this Issue Summary 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. When two investors enter into an arrangement to create a jointly-owned entity and one investor sells real estate to that entity, it is common to include a buy-sell clause in the agreement between the two investors. For example, two investors (Selling Investor and Other Investor) form a new entity. Selling Investor sells real estate to that newly formed entity. The agreement between the investors includes a buy-sell clause that provides that either investor may request a buy-out of the other investor's interest by providing notice (the Purchase Notice) to the other investor. The investor providing the Purchase Notice is referred to as the Offeror and the receiving investor is the Offeree. The Purchase Notice constitutes an irrevocable offer by the Offeror to buy the Offeree's entire interest in the entity. In the Purchase Notice, the Offeror names a price for the Offeree's equity at its discretion (the Named Price). However, upon receipt of the Purchase Notice, the Offeree can elect to either sell its interest in the entity to the Offeror or buy the Offeror's interest at the Named Price. Once the Purchase Notice is made and the buy-sell clause is invoked, the Offeror is contractually obligated to either purchase the Offeree's interest or sell its interest at the Named Price.

2. In these circumstances, the Offeror does not know whether it will ultimately be the buyer or seller as a result of invoking the clause. To the extent the Offeror names a price that is higher than fair value, it runs the risk that the Offeree will elect to sell and the Offeror will pay more than fair value for the Offeree's interest. Conversely, to the extent that the Offeror names a price for the Offeree's interest that is lower than fair value, it runs the risk that the Offeree will elect to purchase and the Offeror will have to sell its interest at less than fair value. This example is referred to as an "Unspecified Price" buy-sell clause. Other types of buy-sell clauses include:

- a. Fair Value Buy-Sell Clause—The fair value buy-sell clause requires that the Named Price be set at fair value at the time of any future offer.
- b. Specified Price Buy-Sell Clause—The specified price buy-sell clause requires that the Named Price be set at a specific amount or based on a specified formula.

3. The buy-sell clause is intended to provide the two investors with a means for dissolution of the arrangement without the need for appraisals (except in the fair value buy-sell clause

examples) of the entity's assets, which may be difficult to value. Buy-sell clauses are also intended to act as a means for dispute resolution in the event that one of the investors would like to exit an arrangement and a typical means of dissolution (for example, sale of the real estate to a third party) is not available for some reason (for example, market conditions are unfavorable). Unspecified Price buy-sell clauses (the type most frequently used) are designed to incorporate into the transaction price the natural tension between the interests of both investors in a buy-sell situation and thereby achieve an acceptable outcome for both investors without protracted negotiations over fair value and the need for binding arbitration to resolve disputes.

4. The sale of real estate by the Selling Investor is governed by FAS 66¹. Paragraph 5 of FAS 66 provides guidance that profit shall not be recognized by the full accrual method until all of the following criteria are met:

- a. A sale is consummated (paragraph 6).
- b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (paragraphs 8-16).
- c. The seller's receivable is not subject to future subordination (paragraph 17).
- d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property (paragraph 18).

5. Paragraphs 26-43 of FAS 66 describe some common forms of substantial continuing involvement with real estate and specify the appropriate accounting if those forms of involvement are present. Specifically, paragraphs 33 and 34 of FAS 66 require the seller to account for a sale as a partial sale if the seller retains an equity interest in the real estate or has an equity interest in the buyer. In a partial sale, profit (the difference between the proportionate sales value and the proportionate cost of the partial interest sold) shall be recognized at the date of sale if the criteria of paragraphs 33 and 34 are met.

6. Except for the potential impact of the buy-sell clause, the seller of the real estate (Selling Investor) as contemplated in this Issue has met the criteria in FAS 66 to recognize a partial sale.

¹ Throughout the Issue Summary, reference is made to reacquiring real estate previously sold. In the context of this Issue Summary, the possible reacquisition of the real estate would be accomplished through the acquisition of the Other Investor's equity interest in the jointly owned entity.

7. Paragraph 26 of FAS 66 addresses the retention of substantial risks or rewards of ownership associated with the real estate and provides guidance that if the seller (Selling Investor) has an obligation to repurchase the real estate (for example, a put option), or the terms of the transaction allow the buyer (Other Investor) to compel the seller or give an option to the seller to repurchase the real estate (for example, a call option), the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale. Some have questioned whether a buy-sell clause would be considered a prohibited form of continuing involvement under paragraph 26 of FAS 66 and therefore preclude partial sale and profit recognition.

8. The staff understands that arrangements with buy-sell clauses are generally evaluated based on the facts and circumstances of the arrangement and in most cases are currently accounted for as a partial sale. The staff also understands that the buy-sell clauses are commonly included in the agreements described in this Issue Summary as a potential means for dissolution of the arrangements but have rarely been executed.

Accounting Issue and Alternatives

Issue: Whether an irrevocable buy-sell clause represents a prohibited form of continuing involvement that would preclude partial sale and profit recognition pursuant to FAS 66.

View A: A buy-sell clause constitutes an option and precludes partial sale and profit recognition.

9. Proponents of View A believe that a buy-sell clause in an agreement between investors is an option that based upon the actions of the other investor, could result in the Selling Investor reacquiring the real estate it previously sold to the entity by obtaining all of the equity interests in the entity that holds the real estate. For example, the Selling Investor can acquire the Other Investor's interest in the entity if the Selling Investor makes an offer and the Other Investor decides not to purchase the Selling Investor's interest in the entity. Depending on the type of buy-sell clause, the Selling Investor would reacquire the Other Investor's interest in the entity in

accordance with the terms of the buy-sell clause (at the fair value, the Named Price, or the Specified Amount). In contrast, the Other Investor could activate the buy-sell clause and offer to purchase from the Selling Investor its interest in the entity. The Selling Investor would then have the option to sell its interest in the entity or buy the Other Investor's interest in accordance with the terms of the buy-sell clause. Proponents of View A refer to paragraph 26 of FAS 66, which states, in part, that when the terms of the transaction give an option to the seller to repurchase the real estate, the "transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale." Proponents observe that FAS 66 does not specifically address the probability that a seller would reacquire the sold real estate when assessing whether the seller has an option to reacquire the sold real estate. Further, proponents of View A believe that an analysis of the probability of whether an option would be exercised is not allowed based on the Task Force's discussion in Issue 86-6. Issue 86-6 states that "...a probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer."

10. Opponents of View A do not consider buy-sell clauses to be options because the buy-sell clause does not convey to the Selling Investor the unilateral right to purchase the real estate. As illustrated, the ability of one investor to purchase or sell the real estate pursuant to a buy-sell clause is contingent upon the decision of the Offeree. Opponents of View A also refer to Issue 86-6, which addresses land sale agreements that require a buyer to develop the land in a specific manner or within a specific time period (an antispeculation clause). Under the terms of those agreements, 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. The Task Force reached a consensus that the contingent option described in Issue 86-6 would not preclude recognition of a sale if the probability of the buyer not complying is remote. Opponents believe that this is similar to a buy-sell clause, in that the provisions serve as an option to repurchase the real estate contingent upon the Other Investor's action.

View B: The buy-sell clause should be evaluated based on facts and circumstances to determine whether the clause constitutes an option or other form of prohibited continuing involvement that precludes partial sale and profit recognition.

11. Proponents of View B disagree with proponents of View A and do not think a buy-sell clause always constitutes an option. Proponents of View B believe that when assessing whether a buy-sell clause constitutes an option or a prohibited form of continuing involvement, the totality of the arrangement needs to be analyzed to determine whether the facts and circumstances indicate that the buy-sell clause may function as an option.

12. Whether the Selling Investor would utilize the buy-sell clause as an option is a matter of judgment and requires an assessment of all relevant information at the time the arrangement is executed. The following (both individually and in the aggregate) are examples of indicators that may cause one to believe that the Selling Investor would utilize the buy-sell clause as an option (this list is not intended to be all inclusive):

- a. The Selling Investor may have a strategic necessity to retain ownership in the real estate in order to maintain the geographic presence associated with the real estate.
- b. The Selling Investor's investment strategies may indicate that the Selling Investor may have the desire or ability to acquire the Other Investor's interest in the entity.
- c. The entity's real estate may be adjacent to or near other real estate owned by the Selling Investor, which may create an economic compulsion for the Selling Investor to reacquire the real estate.
- d. The Selling Investor may have arrangements with the entity, such as management or third-party leasing arrangements, that may economically compel the Selling Investor to reacquire the real estate in order to retain the economic benefits (for example, leasing commissions from lessees) or escape the negative economic consequences (for example, below-market contract with the entity) of such arrangements.
- e. Tax implications may economically compel one investor to sell its interest in the entity to the other investor.

13. Some opponents of View B agree that fair value buy-sell clauses are not options and that the assessment of whether the Selling Investor would use the buy-sell clause as an option to repurchase the real estate is based on facts and circumstances but believe that a buy-sell with a

Named Price at anything other than fair value would indicate that the Selling Investor effectively has a option.

View C: A fair value buy-sell clause should be evaluated based on facts and circumstances to determine whether the clause constitutes an option or other form of prohibited continuing involvement that precludes partial sale and profit recognition.. If the Named Price in a buy-sell clause can be other than fair value, the clause constitutes an option and precludes partial sale and profit recognition.

14. Proponents of View C believe that in addition to the indicators listed under View B, if the buy-sell clause can be priced at a value other than fair value, then the Selling Investor could compel the Other Investor to sell the real estate (the interest in the entity) back to the Selling Investor by offering a Named Price in excess of fair value of the property. By offering a Named Price in excess of fair value, proponents of View C assert that the buy-sell clause could function in a manner similar to the purchase option described in the consensus on Question 2 in Issue 97-1, which states, in part:

An option on the part of the buyer-lessor to put the leased property to the seller-lessee in the event of a default by the seller-lessee is **tantamount to a purchase option by the seller-lessee because it would be within the control of the seller-lessee to economically compel the buyer-lessor to put the leased property to the seller-lessee** (for example, if the seller-lessee ceased making its scheduled lease payments). [Emphasis added in bold.]

15. Proponents of View C acknowledge that Issue 97-1 is written in the context of sale-leaseback transactions. However, proponents of View C believe that the concept expressed in Issue 97-1 provides guidance by analogy since the assessment is based on what the seller-lessee could do in the future to compel the other party. Proponents of View C believe that with the ability to set the exercise price at an amount other than fair value, the Offeror can influence the outcome of the buy-sell clause.

16. Proponents of View C also believe that a Named Price at fair value does not eliminate the possibility that based on the facts and circumstances of the arrangement, the Selling Investor

could use the buy-sell clause as an option to reacquire the real estate. Proponents of View C believe that when the buy-sell clause is stipulated to be at fair value, the facts and circumstances of the arrangement should be assessed to determine whether the Selling Investor will use the clause as an option. Proponents of View C utilize the same indicators as the proponents of View B in determining whether a buy-sell clause could represent an option or other form of prohibited continuing involvement.

17. Opponents of View C argue that many buy-sell clauses used in practice today do not specify fair value for the Named Price and, as indicated in the background to this Issue, to include a fair value requirement would render the main business purpose of the buy-sell clause ineffective.

International Convergence

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

In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

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

Effective Date and Transition

20. The staff recommends that the consensus on this Issue be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. The staff has identified the following transition alternatives for Task Force consideration:

Alternative A: Entities should recognize the effect of the change as a change in accounting principle through retrospective application to all prior periods for all arrangements that existed during the period of the financial statements presented. Entities should disclose the cumulative-effect of the change on retained earnings in the statement of financial position for the first period presented.

Alternative B: Entities should recognize the effect of the change as a change in accounting principle through retrospective application to all prior periods based on the terms as they exist for all arrangements at the effective date. Entities should disclose the cumulative-effect of the change on retained earnings in the statement of financial position for the first period presented.

Alternative C: Entities should recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately.

21. The staff considers Alternative A to be consistent with paragraph 7 of FAS 154, which requires retrospective application to changes in accounting principles. In addition, retrospective application is the transition method that best achieves consistency of financial information between periods and facilitates comparability of accounting data. If it is impracticable to apply retrospective application, paragraph 9 of FAS 154 allows for the new accounting principle to be applied on a prospective basis.

22. Alternative B is very similar in application to Alternative A since it requires retrospective application. However, Alternative B requires entities to evaluate only the arrangements with buy-sell clauses that are in effect at the effective date of this Issue.

23. Alternative C carries the benefit of consistency and comparability for the current year and future years without the burden of recasting prior years' amounts. Similar to Alternative B,

Alternative C also requires entities to evaluate only the arrangements with buy-sell clauses in effect at the effective date of this Issue. The staff acknowledges that with the reduced costs and burdens of Alternative C comes less consistency and comparability for years prior to the year of adoption.

24. Opponents to all of these Alternatives observe that in addition to the significant volume of transactions expected to be within the scope of this Issue, Alternatives A, B, and C could require entities to reassess arrangements that were consummated many years ago. Opponents observe that many of the transactions within the scope of this Issue are dated (date back 20 to 30 years) and will not provide information that enhances the user's ability to assess the performance of the arrangements. In addition, opponents also believe that the cost of the effort to apply these transition alternatives is greater than the resulting benefits to users of the financial information.

25. In addition, opponents of these alternatives believe that the election of View B or View C of this Issue by the Task Force would require the use of hindsight, which could result in the substance of the transaction being viewed differently from the substance at the time the transaction was initially consummated. For example, for a transaction entered into in 1985, it may prove difficult, if not impossible, to obtain a proper understanding of the context under which the transaction was consummated to enable the issuer to properly evaluate the facts and circumstances of that transaction. Because of the assumptions required in assessing the transaction, an issuer may draw a different conclusion from the one drawn had the transaction been assessed at the consummation date.

Alternative D: Entities should recognize the effect of the change on a prospective basis to transactions entered into after the effective date.

26. Alternative D would eliminate the need to reassess significantly-aged transactions, which may not be considered relevant in today's market, and eliminate the need to perform activities that may not be considered cost beneficial. As discussed in the Opponents view to Alternatives A, B, and C many of the arrangements within the Scope of this Issue may have been consummated as long as 25 or 30 years ago.

27. Opponents of Alternative D are concerned with the inconsistency of allowing buy-sell clauses initiated prior to the effective date of this Issue to be accounted for in a manner inconsistent with the consensus reached.

Disclosure

28. The staff also considered requiring disclosures and concluded not to recommend any incremental disclosure requirements beyond those already required by FAS 66.