

**FASB Emerging Issues Task Force**

**Issue No.** 10-E

**Title:** Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate

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**Background**

1. It is a common business practice for an investor to establish a single-purpose entity that is capitalized, in whole or in part, with nonrecourse debt, to purchase commercial real estate. The investor will frequently own all of the equity interests of the entity and will consolidate the entity because that investor has a controlling financial interest. The nonrecourse debt may provide the lender with certain protective rights (for example, approvals of significant leases) over the term of the loan and the lender may have additional rights upon an event of default. In the event that the entity defaults on the nonrecourse indebtedness, the lender may take possession of the real estate or a receiver may be appointed by the court to ensure that rents are collected for the lender's benefit. Granting the lender possession or appointing a receiver commonly occurs in foreclosure proceedings. In addition, the single-purpose entity may be placed or forced into bankruptcy pursuant to either Chapter 11—Reorganization, or Chapter 7—Liquidation, of Title 11—Bankruptcy, of the U.S. Code. In such instances, the bankruptcy court may appoint either the lender or a third-party to act as the trustee of the entity. Either event may limit the investor's ability to control the entity and therefore deconsolidation may be appropriate.

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**\* 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.**

2. When real property is financed with nonrecourse debt, in the event of deterioration of the property's cash flow or value, the investor may decide to allow the borrower to default on the borrowing and thereby transfer the property to the lender in full satisfaction of its obligation under the note. In that event, title to the property is conveyed to the lender, and the entity has no further obligation to the lender. For example, assume a single-purpose entity borrows \$1 million to purchase real property on a non-recourse basis. Several years later, the property has a fair value of \$600 thousand, while the balance due to the lender is \$800 thousand. The entity defaults on its debt obligation and transfers the property to the lender in full satisfaction of the loan. In current market conditions, it is increasingly common for real estate to have a current fair value that is less than the unpaid principal balance of the related nonrecourse debt. As a result, a growing number of owners and investors are voluntarily or involuntarily defaulting on their debt.

3. As discussed in paragraphs 970-323-40-1 and 976-10-15-4, sales of ownership interests in entities that are "in-substance real estate" should be evaluated under the provisions of Subtopic 360-20 as the sale of (the underlying) real estate. This Issue does not address whether an entity should be considered to be "in-substance real estate." Rather, this Issue assumes that the subsidiary (for example, a single-purpose entity that owns real estate) has been determined to be in-substance real estate.

4. This Issue seeks to resolve the differing views in practice about whether the guidance in Subtopic 360-20, Property, Plant, and Equipment—Real Estate Sales (formerly issued as FASB Statement No. 66, *Accounting for Sales of Real Estate*), applies to deconsolidation of in-substance real estate. Examples of events that result in deconsolidation of in-substance real estate entities include but are not limited to:

- a. The entity defaults on its debt obligations resulting in a change in the entity's primary beneficiary without a transfer of the entity's equity interests or its assets or the extinguishment of its debt. This may occur, for example, when the creditor has rights that are exercisable only in the event of default by the entity, but that once exercisable give the creditor the power to direct the activities that most significantly impact the entity's economic performance.

- b. The entity defaults on nonrecourse debt and the creditor becomes the primary beneficiary of the entity. The creditor subsequently loses control of the entity upon an extinguishment or modification of the debt with the entity.
  - c. The governance provisions of the entity are changed, triggering a change in control of the entity.
5. There is common agreement in practice that deconsolidation of a subsidiary is required whenever the parent no longer possesses a controlling financial interest. However, if a subsidiary being deconsolidated is in-substance real estate, there are differing views in practice about whether the parent must also satisfy the criteria in Subtopic 360-20 in order to derecognize the real estate in its statement of financial position.
6. If the investor is required to apply the guidance in Subtopic 360-20 when the entity is considered to be "in-substance real estate," generally the investor would not satisfy the requirements to derecognize the real estate prior to the legal transfer of the real estate (or the ownership of the entity) to the lender and the extinguishment of the related nonrecourse indebtedness. As a result, the investor would continue to include the real estate, debt, and the results of the entity's operations in its consolidated financial statements and would recognize the gain from the extinguishment of the debt only when the obligation has been legally satisfied. That is, even if the investor is required to deconsolidate the in-substance real estate subsidiary, the investor would be precluded from derecognizing the real estate asset and would continue to recognize a debt obligation on its balance sheet.
7. Recently the FASB issued Accounting Standards Update No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*, which addresses implementation issues related to the change in ownership provisions in Subtopic 810-10, Consolidation—Overall (formerly issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*). The Update amends the guidance in Subtopic 810-10 so that the decrease in ownership provisions of that Subtopic do not apply to sales of "in-substance real estate." In-substance real estate entities that are businesses

would be subject to the decrease in ownership provisions of Subtopic 810-10 absent that amendment.

8. Some believe that the transactions described in paragraph 4 are not *sales* of in-substance real estate and, accordingly, Subtopic 810-10 would apply. Under Subtopic 810-10, the investor would deconsolidate the investee entity and derecognize the real estate and debt in its consolidated statement of financial position and recognize a gain or loss for the difference between the carrying amounts of the real estate, related debt, and any remaining retained interest. The investor would report its interest in the single-purpose entity in accordance with either Topic 323, Investments—Equity Method and Joint Ventures, or Topic 325, Investments—Other, whichever is appropriate. The FASB decided to exclude sales of in substance real estate from the scope of the decrease in ownership provisions of Subtopic 810-10, because existing U.S. GAAP on accounting for sales of in substance real estate (Subtopics 360-20 and 976-605, Real Estate—Retail Land—Revenue Recognition) includes extensive guidance on how continuing involvement affects sale accounting and profit recognition. A substantial difference between the deconsolidation guidance in Subtopic 810-10 and the sale of real estate guidance in Subtopics 360-20 and 976-605 is that Subtopic 810-10 does not require an evaluation of continuing involvement.

9. This Issue is also relevant to lending institutions because of the issuance of Accounting Standards Update No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (formerly issued as FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*). That guidance eliminated the exclusion of troubled-debt restructurings from the events that require reconsideration of whether an entity is a variable interest entity, and now reconsideration of which party is the primary beneficiary of a variable interest entity. Further, it changed the primary beneficiary analysis from one primarily based on quantitative exposure to the majority of expected losses/residual returns to one based on (a) control of most significant decisions and (b) participation in benefits/losses. In today's economic environment, the consolidation analysis may more frequently result in the lender being the primary beneficiary—especially for troubled special purpose entities—requiring the lender to consolidate the special purpose entity.

## Scope

10. This Issue applies to all reporting entities that are required to deconsolidate a subsidiary that is in-substance real estate.

## Accounting Issue and Alternatives

**Issue 1: Whether Subtopic 360-20 applies to the derecognition of real estate in the consolidated financial statements of a reporting entity that is required to deconsolidate a subsidiary that is in substance real estate other than as a result of a sale or transfer of an ownership interest in the subsidiary.**

*View A: A reporting entity is required to apply the guidance in Subtopic 360-20 to determine whether to derecognize real estate owned by a former in-substance real estate subsidiary that the reporting entity is required to deconsolidate.*

11. Proponents of View A observe that Topic 810, Consolidation, was recently amended by Update 2010-02 to clarify that sales of in-substance real estate are not within the scope of the guidance in Subtopic 810-10 applicable to the accounting for decreases in a parent's ownership interest in a subsidiary.

12. Proponents of View A believe that the scope of Subtopic 360-20 extends beyond legal form "sales" and is applicable to all arrangements involving the potential derecognition of real estate including, for example, deconsolidation of subsidiaries that are in substance real estate and "the sale or transfer of an investment in the form of a financial asset that is in substance real estate." Accordingly, proponents of View A believe that if a subsidiary that is in substance real estate is to be conveyed by a reporting entity to the lender to satisfy nonrecourse indebtedness, the guidance in Subtopic 360-20 should be applied by the reporting entity to determine whether to derecognize real estate. Similarly, if the conveyance of other rights, such as the right to collect rents and the right to operate the real estate until, for example, a court legally transfers the real estate and extinguishes the debt, results in a requirement for a reporting entity to deconsolidate a

subsidiary that is in-substance real estate, the reporting entity should apply the requirements of Subtopic 360-20 to determine whether to derecognize the real estate.

13. Proponents of View A also note that applying Subtopic 360-20 in this manner is consistent with other circumstances in which "derecognition" or "sales recognition" guidance has a higher (or different) threshold than the relevant deconsolidation guidance. For example, practice has generally accepted that "contribution-leasebacks" and "spin-off-leasebacks" of real estate are accounted for pursuant to the guidance in Subtopic 840-40, Leases—Sale-Leaseback Transactions, and, as a result, the derecognition of the real estate is not subject only to the deconsolidation guidance in Subtopic 810. Additionally, as clarified by Update 2010-02, a reporting entity should apply Topic 860, Transfers and Servicing, to the potential derecognition of subsidiaries that are in substance financial assets and not limit its evaluation to Subtopic 810-10. The staff notes that the SEC staff at the 2009 AICPA SEC Conference also expressed that view.

14. The deconsolidation requirements of Subtopic 810-10 are independent of the derecognition requirements of Subtopic 360-20. That is, Subtopic 810-10 deconsolidation requirements apply to "entities," whereas the derecognition requirements of Subtopic 360-20 apply to "assets." Proponents of View A believe that it is important to emphasize that separation because the accounting for real estate assets in Subtopic 360-20 is not symmetrical—that is, the same real estate property may be recognized as an asset of more than one entity (for example, buyer and seller) if the derecognition requirements of Subtopic 360-20 are not met. However, the consolidation requirements of Subtopic 810-10 are symmetrical. Accordingly, one party must deconsolidate an entity in order for another party to consolidate the entity and, in some cases, neither may control or consolidate. The creditor (that is, the party that has the power to direct the activities that most significantly impact the economic performance of the in-substance real estate entity) would not be permitted to consolidate the entity if the borrower is required to consolidate it. Accordingly, to achieve the same non-symmetrical accounting result for real estate assets regardless of whether they represent an in-substance real estate entity, proponents of View A believe that both the requirements of Subtopic 360-20 and the requirements of Subtopic 810-10 must be applied. Additionally, they note that this is consistent with situations in which an entity

represents in-substance financial assets, in which case the transaction or asset-based requirements of Topic 860, Transfers and Servicing, may produce a different outcome than the requirements of Subtopic 810-10, which is applicable to entities. However, the different aspects of the literature do not conflict; they may merely produce different outcomes for the accounting for the entity than for the assets.

15. Proponents of View A also believe that it is counterintuitive for the reporting entity to be required to apply Subtopic 360-20 to the derecognition of real estate it owns directly (regardless of whether the derecognition event involves a "sale" or "transfer"), but not to the derecognition of real estate owned through a single-purpose in-substance real estate subsidiary (particularly when the subsidiary is frequently wholly-owned by the reporting entity).

16. Finally, proponents of View A believe that requiring different accounting for real estate that is held in a subsidiary from real estate that is not would increase opportunities for accounting arbitrage and result in greater complexity of an entity's financial statements making it more difficult to evaluate that entity's performance.

17. Opponents of View A believe that the guidance in Subtopic 360-20 should apply only to the transactions that it was intended to address; that is, sales or transfers of real estate. These opponents believe that applying that guidance more broadly is inconsistent with the Board's intent in Update 2010-02. Proponents nonetheless note that the economic events giving rise to this Issue involve the expected transfer of real estate. That is, the default and extinguishment of associated nonrecourse indebtedness is dependent upon the transfer of the real estate.

*View B: A reporting entity is not required to apply the guidance in Subtopic 360-20 to determine whether to derecognize real estate owned by an in-substance real estate subsidiary that the reporting entity is required to deconsolidate for reasons other than a sale or transfer of an ownership interest in the subsidiary.*

18. Proponents of View B believe that Subtopic 360-20 specifically applies only to legal form sales of real estate (including sales of in substance real estate) and should not be applied to

transactions that are not explicitly within its scope. Proponents of View B do not believe that deconsolidation events other than those resulting from sales of real estate or in substance real estate are subject to Subtopic 360-20 and that the provisions of Subtopic 810-10 (including holding period *gains/losses*) should be applied. Proponents of View B believe that the Board intentionally excluded from the decreases in ownership guidance in Subtopic 810-10 situations in which specific guidance existed for particular real estate transactions, such as sales of real estate in Subtopic 360-20. These proponents do not believe that the Board intended for the decreases in ownership exclusion to be applied broadly to any deconsolidation event involving in-substance real estate.

19. Further, proponents of View B observe that deconsolidation of an in-substance real estate subsidiary may result from other changes (for example, a reconsideration event) in the primary beneficiary analysis under Subtopic 810-10. For example, consider a venture between two investors that is a variable interest entity with one venture partner initially deemed to be the primary beneficiary. Subsequently, the venture agreements are modified to provide for sharing of control as a result of additional contributions without change in relative ownership. Proponents of View B believe that subjecting all deconsolidation events involving entities that are in-substance real estate to the requirements of Subtopic 360-20 would mean once the real estate asset is included in the reporting entity's statement of financial position that it would be less likely that such an asset would be derecognized.

20. Proponents of View B are also concerned that applying the guidance in Subtopic 360-20 may inadvertently affect entities that these proponents do not believe were intended to be affected by the sales of real estate guidance. For example, a financial institution may be the primary beneficiary of an in-substance real estate entity during foreclosure or bankruptcy proceedings, resulting in consolidation of the single-purpose entity but control may subsequently revert back to the investor. Proponents of View B believe that the sale or transfer guidance in Subtopic 360-20 was not intended to apply to such transactions and are concerned that financial institutions may have difficulty derecognizing the real estate if Subtopic 360-20 applies to such situations. These proponents believe that requiring the financial institution to retain the real

estate on its consolidated financial statements in these situations would impair an investor's ability to understand the entity's lending activities.

21. Opponents of View B believe that the arrangements discussed in paragraphs 19 and 20 are contemplated in Subtopic 360-20 and that the reporting entity should continue to include the real estate in its statement of financial position until such time that it satisfies the requirements of Subtopic 360-20 (for example, by obtaining an adequate initial and continuing investment or otherwise disposing of its continuing involvement). Opponents of View B believe that it is counterintuitive to have less restrictive criteria to derecognize real estate when there has been no sale as compared to when there is a sale.

### **Recurring Disclosures**

22. The staff does not believe additional recurring disclosures should be required by this Issue. Entities would need to comply with either the sales of real estate or deconsolidation disclosures as applicable.

### **Transition**

23. Presented below are three 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 relevant prior periods beginning from the fiscal year in which Subtopic 810-10 was initially adopted. Retained earnings would be adjusted for the earliest period presented.*

*Alternative B: Entities should apply this Issue on a prospective basis to evaluate whether to derecognize real estate owned by an in-substance real estate subsidiary that the reporting entity is required to deconsolidate. Prior periods would not be adjusted even if the reporting entity has continuing involvement with a previously deconsolidated in-substance real estate subsidiary.*

*Alternative C: Upon adoption of this Issue, entities should apply this Issue by recognizing or derecognizing, at the date of adoption, real estate of in-substance real estate entities that would*

*have been affected by the consensus on this Issue had the Task Force consensus been applied when the events occurred. An entity would recognize the cumulative effect of applying this consensus as an adjustment to beginning retained earnings of the period of adoption.*

24. Proponents of Alternative A observe that the FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Those proponents refer to paragraph B7 of the Basis for Conclusions in FASB Statement No. 154, *Accounting Changes and Error Corrections*, which states that "the Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data."

25. Proponents of Alternative B believe that the information needed to retrospectively apply a consensus under this Issue may not be readily available or determinable in all circumstances. Additionally, those proponents believe that even if such information were available, it would result in implementation difficulties (such as in determining the fair value of the continuing interest) that would outweigh the benefit of improved comparability of financial information. Opponents of Alternative B believe that this approach reduces consistency and comparability in financial reporting. Opponents of Alternative B also note that Section 250-10-45, *Accounting Changes and Error Corrections—Overall—Other Presentation Matters*, includes an impracticability exception provision for those situations in which it is impracticable to restate prior periods upon adopting a new accounting standard.

26. Proponents of Alternative C believe that retrospective application to all prior periods would be too onerous and costly and would outweigh the benefits of consistency and comparability. Proponents of Alternative C believe that applying the consensus from the effective date of the Issue provides some consistency and comparability in a more cost-efficient manner. Opponents of Alternative C are proponents of Alternative A or Alternative B and are concerned with the opportunity to record gain twice for the same transaction.

### ***Transition Disclosures***

27. The other presentation matters guidance in Subtopic 250-10 is applicable for any voluntary change in accounting principle, including a change in the method of applying an accounting principle. The staff recommends that the Task Force require companies to apply the disclosure requirements in Section 250-10-50 for an accounting change required by this Issue. Additionally, the staff recommends that the Task Force not require any additional disclosures other than the requirements in paragraphs 250-10-50-1 to 250-10-50-3.

### ***Effective Date***

28. The staff recommends that the Task Force require this Issue to be effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2010, and to ask constituents whether they believe that the proposed amendments can be efficiently implemented for fiscal years beginning on or after December 15, 2010. If not, the staff plans to ask for a recommended effective date from constituents.