

## Interpretation of the Emerging Accounting Issues (E) Working Group

### INT 08-02: EITF 06-8: Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums

#### ISSUE NULLIFIED BY SSAP NO. 40

#### INT 08-02 Dates Discussed

March 29, 2008; May 31, 2008

#### INT 08-02 References

*SSAP No. 40—Real Estate Investments (SSAP No. 40)*

*SSAP No. 77—Real Estate Sales, An Amendment to SSAP No. 40, Real Estate Investments (SSAP No. 77)*

#### INT 08-02 Issue

1. *EITF 06-8: Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums* (EITF 06-8) was issued in November 2006 to provide guidance regarding whether the 'continuing involvement test' included within *FAS 66—Accounting for Sales of Real Estate* (FAS 66) should be applied to conclude that the sales price is collectible for individual units in a condominium project being sold separately and to recognize profit under the percentage-of-completion method.

2. As noted within EITF 06-8:

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. 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." 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. Per EITF 06-8, paragraph 3, the issues are:

**Issue 1**—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.

**Issue 2**—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 (that is, the

- date on which an entity that was not previously eligible to recognize profit under the percentage-of-completion method reassesses whether it is now eligible to recognize profit under the percentage-of-completion method by meeting the criteria in paragraph 37 of Statement 66).
4. The FASB Emerging Issues Task Force reached the following consensuses in paragraphs 5-7 of EITF 06-8:
    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 Task Force observed that, consistent with the requirements for sales of other types of real estate, 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 nonrefundable portion of such investments.
    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 an amortizing customary mortgage for the remaining purchase price of the property (excess of the purchase price over the initial investment by the buyer) 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 for the amount of the purchase price less the buyer's initial investment. 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 until the criteria in paragraph 37 are met. On a reassessment date, an entity should reassess all of the criteria in paragraph 37 of Statement 66 to determine whether profit should be recognized under the percentage-of-completion method. The Task Force reached a consensus that in reassessing the collectibility of the sales price, the initial and continuing investment tests should be applied prospectively from the reassessment date (as if the deposit was received on the reassessment date).

#### **INT 08-02 Discussion**

5. The EITF consensus indicates that an entity should evaluate the adequacy of the buyer's initial and continuing investment to conclude whether the sales price is collectible and to recognize profit under the percentage-of-completion method for individual units in a condominium project as depicted within paragraph 37 of FAS 66:

37. If individual units in condominium projects 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:

- a. Construction is beyond a preliminary stage.

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

6. Paragraph 37 refers to paragraph 4 of FAS 66 to determine whether sale prices are collectible. The 'initial and continuing investment' threshold established in paragraph 4 is further defined within paragraph 12 of FAS 66: (The guidance in FAS 66 is adopted by reference within SSAP No. 40, additionally, paragraph 12 of FAS 66 is incorporated within paragraph 53 of *SSAP No. 22—Leases*.)

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.

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.

7. Pursuant to the guidance in SSAP No. 40, paragraph 17, stating that sales of real estate shall be accounted for in accordance with FAS 66, statutory accounting has previously adopted the GAAP guidance permitting the ability to use the percentage-of-completion method for sales of individual units in a condominium project. In considering this previous adoption, and the elements of EITF 06-8, the Working Group reached a consensus to adopt, with modification, the conclusion reached for Issue 1 of EITF 06-8. Thus, the continuing investment criteria in FAS 66 paragraph 12 should be followed in assessing whether sale prices of individual condominiums are collectible pursuant to profit recognition through the percentage of completion method. This conclusion indicates that a continuing investment is met when buyers of individual condominium units (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 an amortizing customary mortgage for the remaining purchase price of the property or (b) increase the maximum initial investment by an equivalent aggregate amount. Similar to the modification adopted within paragraph 19 of SSAP No. 40, continuing investment payments made in the form of buyer's notes must be supported by letters of credit from institutions that are listed by the SVO as meeting credit standards to be included in determining the buyer's initial investment.

8. For Issue 2, the Working Group reached a consensus to adopt the Task Force's conclusion, thus the initial and continuing investment guidance should be assessed prospectively from the reassessment date (date on which an entity not previously eligible to recognize profit under the percentage-of-completion method reassesses whether it is eligible to recognize profit under the percentage-of-completion method) and not on a cumulative basis from the contract date. This requirement ensures that continued construction (i.e., establishment of more units) is considered on the reassessment date in determining whether other characterizes of FAS 66 paragraph 37 have been met (e.g., whether construction is beyond a preliminary stage and if sufficient units have been sold) in determining whether profit can be recognized through the percentage of completion method.

#### **INT 08-02 Status**

9. No further discussion is planned.