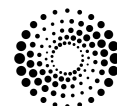


SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Real Estate



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Interactive Self-study CPE
Companion to PPC's Guide to
Real Estate

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INTRODUCTION

Companion to PPC's Guide to Real Estate consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Real Estate* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S GUIDE TO REAL ESTATE**COURSE 1****Sales Other Than Retail Land Sales (ARETG091)****OVERVIEW**

COURSE DESCRIPTION:	This interactive self-study course discusses the requirements of SFAS No. 66 <i>Accounting for Sales of Real Estate</i> as well as issues accountants may face applying it. Lesson 1 explains how to apply the accounting methods used to recognize gains on real estate sales under SFAS No. 66. Lesson 2 addresses the specific concerns that are encountered in real estate sales.
PUBLICATION/REVISION DATE:	September 2009
RECOMMENDED FOR:	Users of <i>PPC's Guide to Real Estate</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting for real estate transactions
CPE CREDIT:	6 QAS Hours, 6 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmarked by September 30, 2010
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES:**Lesson 1—Selecting an Accounting Method for Gains on Real Estate Sales**

Completion of this lesson will enable you to:

- Describe the various methods of accounting for gains on real estate sales.
- Recommend the most appropriate accounting method for recognizing gains on sales of real estate.
- Explain the basic conditions that must be met for full gain recognition on real estate sales.

Lesson 2—Seller Financing and Other Special Real Estate Sales Issues

Completion of this lesson will enable you to:

- Assess if specific conditions are met for constant seller involvement.
- Plan for the specific issues that may be encountered in real estate sales.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

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Lesson 1: Selecting an Accounting Method for Gains on Real Estate

INTRODUCTION

This lesson explains how to apply the accounting methods used to recognize gains on real estate sales under FASB ASC 360-20 (formerly SFAS No. 66).

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the various methods of accounting for gains on real estate sales.
- Recommend the most appropriate accounting method for recognizing gains on sales of real estate.
- Explain the basic conditions that must be met for full gain recognition on real estate sales.

METHODS OF ACCOUNTING FOR GAINS ON REAL ESTATE SALES

Calculating Gains on Real Estate Sales

Under FASB ASC 360-20, the gain on sale of real estate is generally determined by subtracting the book value of the real estate sold from the *sales value* of the property. For that purpose, book value is net of accumulated depreciation and any valuation allowances.

What Is Sales Value? Exhibit 1-1 shows the formula for determining sales value. Sales value consists of the following components:

- a. *Contract Sales Price.* The sales price specified in the sales contract. The contract sales price typically consists of cash, assumption of existing debt, notes payable to the seller, or some combination of the three.
- b. *Additional Proceeds.* Payments that are, in substance, additional sales proceeds include the following:
 - (1) Fees, points, or prepaid interest that are paid in advance and will be applied in the future against the seller's receivable.
 - (2) Proceeds from an option that the buyer exercises to purchase the property.
 - (3) Present value of a land lease in connection with the sale of a building.
- c. *Discount to Reduce Seller's Receivable to Present Value.* Generally, if the seller's receivable does not bear interest at a market rate (or higher), the receivable should be discounted to a market rate. The discount reduces the sales value.
- d. *Present Value of Seller Services to Be Performed without Compensation or at Less Than Prevailing Rates.* If the seller is required to perform such additional services (for example, manage the property for a specific period of time), sales value is reduced by the present value of those services in excess of the compensation that will be received.

Determining Sales Value

Sales Value of Time-shares. FASB ASC 978 (SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*) provides accounting guidance for time-share transactions. To determine the sales value of a time-share transaction, FASB ASC 978 follows the general model presented in FASB ASC 360-20, but also provides guidance specific to time-shares. Under FASB ASC 978, the sales price of a time-share transaction should be—

- FASB ASC 978 states that the above list is not intended to be all-inclusive. However, the Standard specifically excludes certain fees and costs from the sales value calculation. Inducements to attract potential buyers to attend a sales presentation should be recorded as a selling cost. Also, if the seller charges a fee that is related to financing

the time-share transaction, the fee should be recorded as an adjustment to the stated interest rate on the financing in accordance with FASB ASC 310-20, *Receivables—Nonrefundable Fees and Other Costs* (formerly SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.)

Selling Costs. Selling costs generally are charged to expense when incurred, but they ordinarily should be capitalized and charged to expense as revenue is recognized if the costs (a) are incurred for tangible assets used to aid in selling the real estate or to obtain regulatory approval for sales or (b) are for direct selling costs incurred for sales that are accounted for using a method other than the full accrual method. To simplify the illustrations in this lesson, selling costs are ignored.

Accounting Methods for Gains on Real Estate Sales

FASB ASC 360-20 (formerly SFAS No. 660) provides several different methods for recognizing gains on sales of real estate. Those methods include the following:

- Full accrual method.
- Installment method.
- Deposit method.
- Cost recovery method.
- Reduced profit method.
- Percentage-of-completion (performance-of-services) method.
- Other methods (for example, leasing, financing, or profit-sharing arrangements).

Each method is intended to fit specific situations, depending on the collectibility of the sales value and the degree of continuing seller involvement with the property. These methods differ primarily in the timing and manner of income recognition. Under the full accrual method, the entire gain on sale is recognized on the date of sale. Under the installment, cost recovery, and reduced profit methods, a portion of the gain is deferred at the date of sale and recognized in different amounts as payments are received from the buyer. Under the remaining methods, the transaction is accounted for as something other than a sale of real estate (such as, a financing transaction, lease, service contract, or profit-sharing arrangement). Accordingly, income is recognized, if at all, in the form of interest, rent, contract income, or some form other than gain on sale of real estate. This lesson describes and illustrates each method.

Full Accrual Method

When Is It Used? According to FASB ASC 360-20-40-3 (formerly paragraph 3 of SFAS No. 66), the full accrual method is used when (a) the seller no longer has any obligations with respect to the property and (b) the collectibility of the sales price and additional proceeds is reasonably assured (or the uncollectible portion can be reasonably estimated). A list of specific conditions that must be met to use the full accrual method is provided.

How Is Gain Recognized? Under the full accrual method, the entire gain on the sale is recognized at the date of sale.

Example of the Full Accrual Method. To illustrate the full accrual method, consider the following facts:

Buyer (B) agrees to buy a tract of raw land from Seller (S), for \$251,000 in cash. The land has a book value of \$140,000. S records the transaction as follows:

Cash	\$ 251,000	
Land		\$ 140,000
Gain on sale of land		111,000

In the preceding example, sales value is \$251,000, the contract sales price.

Many companies that sell real estate in the ordinary course of business maintain a revenue account (such as, Sales of Real Estate) and a cost of sales account (such as, Cost of Real Estate Sold) to account for real estate sales. Using that approach, the following journal entry would record the sale discussed in the preceding paragraph:

Cash	\$ 251,000	
Cost of real estate sold	140,000	
Land		\$ 140,000
Sales of real estate		251,000

Most of the example journal entries in this lesson use the first approach because it more clearly shows the gain recognized.

Installment Method

When Is It Used? The installment method is commonly used for sales in which the seller provides some of the financing, and either—

- The buyer does not make a sufficient down payment, or
- The payment terms on the seller's receivable are not adequate.

The assumption behind the installment method is that the buyer is not sufficiently committed to the property to ensure that the seller's receivable will be repaid. However, to use the installment method, there should be reasonable assurance that the seller's investment in the property (that is, the book value of the property) is recoverable if the buyer defaults. Also, the installment method may be used to record partial sales of real estate if collection of the sales price is not reasonably assured.

How Is Gain Recognized? Under the installment method, gain is recognized proportionately as the sales value is collected. The formula for determining the gain to be recognized each period under the installment method is as follows:

$$\frac{\text{Total gain on sale}}{\text{Sales value}} \times \frac{\text{Principal payments received}}{\text{Principal payments received}} = \frac{\text{Current period gain}}{\text{Current period gain}}$$

In other words, a gain percentage (that is, total gain on sale divided by the sales value) is normally calculated as of the sale date, and that percentage is applied to the principal payments received. If the seller provides services without compensation, the imputed compensation should be recognized as revenue as the services are performed. In that case, the seller should allocate the principal payments received between those that relate to the sale of real estate and those that relate to the additional services.

FASB ASC 360-20-55-8 (formerly paragraph 57 of SFAS No. 66) states that, under the installment method, it is not necessary to discount sellers' receivables that have below market interest rates. Discounting yields a lower sales value and, therefore, a lower principal balance, a lower gain, and a lower gain percentage. As a result, the gain recognized in each period is lower than if the receivable had not been discounted. However, since interest income on the discounted note is recognized using the market rate, more interest income is recognized in each period than if the receivable had not been discounted because the discount rate is higher than the stated rate. In the earlier years of the term of the note when interest income is highest, interest income using the market rate is generally sufficiently higher than interest using the stated rate that the total of interest income and gain recognized is greater than if the receivable had not been discounted. In the later years, as interest income declines, the total is less than if the receivable had not been discounted.

The "principal payments received" in the preceding formula include both principal payments on the buyer's note to the seller and principal payments made on existing debt assumed by the buyer. However, according to FASB ASC 360-20-40-32 (formerly EITF Issue No. 88-24, "Effect of Various Forms of Financing under FASB Statement No. 66")

those payments should not include any funds obtained from (a) the seller or (b) loans that are secured by the property, even if those loans are provided from third parties. For example, assume that the buyer obtained a second mortgage from a bank to, among other things, finance the first three annual payments on the seller's receivable. In that situation, gain could not be recognized from the first three principal payments because they are funded through other debt on the property.

Additional Gain Recognition. FASB ASC 360-20-40-32 also outlines additional circumstances in which gain should be recognized under the installment method. The EITF concluded that the seller should recognize as income the excess of the deferred gain balance over the sum of the following:

- *Seller's Receivable.* The current balance of the seller's receivable.
- *Contingent Liability.* The amount of contingent liability to the seller for other loans (such as, loans guaranteed or collateralized by the seller or existing debt assumed by the buyer without the seller being released from liability).

The excess deferred gain is recognized as income in addition to any gain recognized based on principal payments received.

The excess deferred gain normally arises because either—

- The seller finances only a small portion of the sales value, and the rest is financed through third-party debt on the property. (In that situation, the deferred gain balance may equal or exceed the seller's receivable balance.)
- The seller's receivable has been reduced significantly through payments funded from third-party debt on the property. (In that situation, the seller's receivable balance is being reduced, but deferred gain has not been recognized because the payments were funded from debt on the property.)

In those situations, the seller is carrying a negative receivable (that is, the deferred gain exceeds the principal balance of the receivable). However, even if there is a negative receivable, the amount of additional gain that can be recognized must be reduced by the amount of the seller's contingent liability on the property.

Limitation on Gain Recognition under the Installment Method. Caution should be used when recognizing gain under the installment method. The conditions that result in the use of the installment method (that is, insufficient initial or continuing buyer investment) pose additional risks to the seller because the buyer may not have the necessary commitment or ability to repay the seller's receivable. Although at the sale date the seller may determine that recovery of the seller's investment in the property is reasonably assured, that initial determination can change based on subsequent circumstances. For example, the buyer could begin experiencing financial difficulties that raise substantial doubt about the buyer's ability to make payments on the seller's receivable. In that case, FASB ASC 310-10 (formerly SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*) provides guidance on determining whether a loan has been impaired and computing specific valuation allowances for impaired loans. Under FASB ASC 310-10, a loan is considered impaired if it is probable that the lender will be unable to collect all principal and interest payments due under the contractual terms of the loan agreement. Considerable judgment is required to determine whether impairment of a loan is probable. A determination of the probability of loan impairment should include an assessment of the loan payment history, the property, and the borrower. The assessment should be made at least annually and should include a number of factors, such as the following:

- General knowledge of the local economy.
- The buyer's payment history. Missed payments or a history of late payments may indicate that the buyer will be unable to continue to make payments.
- The fair value of the property. If the property is income producing, no loss would be incurred if the property is producing sufficient cash flows to cover the loan balance.

- Financial condition of the buyer. Obtaining financial statements from the buyer each year for material receivables is recommended. Often the terms of the buyer's note require the buyer to provide the seller with financial statements.

In addition, comparing the recorded investment in the loan to the fair value of the consideration that the seller would receive in the event of default is also recommended. If the sale was originally accounted for under the installment method, the assets received in foreclosure should be recorded at the lower of fair value (less selling costs, if the assets will be sold) or the recorded investment in the loan. Any excess of the recorded investment in the loan over the fair value of the assets received (less selling costs, if applicable) should be recognized as a loss on foreclosure. When the installment method is used to recognize gain, the gain should continue to be recorded as long as the buyer makes payments on the seller's note, but the probability of impairment on the remaining receivable should continue to be assessed.

Example of the Installment Method. Assume the same facts as described in the full accrued method example earlier in this lesson, except that B makes a \$10,000 down payment and gives S a note for the remaining \$241,000. The note is payable in 20 annual payments of \$12,050, plus interest at prime plus 1%. Assuming the conditions for using the installment method are met, the journal entry to record the sale on 1/1/X1 is as follows:

Cash	\$	10,000	
Note receivable from B		241,000	
Land			\$ 140,000
Gain on sale of real estate ^a			4,400
Deferred gain			106,600

Note:

$$^a \frac{\$111,000}{\$251,000} \times \$10,000 = \$4,400 \text{ rounded}$$

Exhibit 1-2 shows the payments made and the gain recognized after each of the first four payments are made. After the fourth payment on 1/1/X5, B's cumulative payments are sufficient to recognize the remainder of the gain on the full accrual method. The seller's journal entries for those years are as follows:

1/1/X2

Cash	\$	36,050	
Deferred gain		5,300	
Note receivable from B			\$ 12,050
Interest income			24,000
Gain on sale of real estate			5,300

1/1/X3

Cash	\$	35,050	
Deferred gain		5,300	
Note receivable from B			\$ 12,050
Interest income			23,000
Gain on sale of real estate			5,300

1/1/X4

Cash	\$	34,050	
Deferred gain		5,300	
Note receivable from B			\$ 12,050
Interest income			22,000
Gain on sale of real estate			5,300

1/1/X5

Cash	\$	32,050	
Deferred gain		90,700	
Note receivable from B			\$ 12,050
Interest income			20,000
Gain on sale of real estate			90,700

Exhibit 1-2**Example of Gain Recognition under the Installment Method**

Year	Payments			Loan Balance	Cumulative Principal Payments
	Principal	Interest	Total		
X1	\$ —	\$ —	\$ —	\$ 241,000	\$ 10,000 ^a
X2	12,050	24,000	36,050	228,950	22,050
X3	12,050	23,000	35,050	216,900	34,100
X4	12,050	22,000	34,050	204,850	46,150
X5	12,050	20,000	32,050	192,800	58,200

Year	Gain Recognized ^b	Deferred Gain Balance
X1	\$ 4,400	\$ 106,600
X2	5,300	101,300
X3	5,300	96,000
X4	5,300	90,700
X5	90,700	—
Totals	\$ 111,000	

Notes:

^a Consists of the \$10,000 down payment.

^b $\frac{\$111,000 \text{ total gain}}{\$251,000 \text{ sales value}} \times \text{Principal payments for the period}$

* * *

Deposit Method

When Is It Used? The deposit method is typically used in any of the following circumstances:

- The sale has not been completed.

- The seller has merely given the buyer an option to buy the property.
- The seller guarantees a return on the buyer's investment for a limited period and the property is currently experiencing operating deficits.

In those situations, the earnings process is not considered complete, and the sale cannot be recognized.

How Is Gain Recognized? When the deposit method is used, the seller accounts for the transaction as if no sale had occurred. Accordingly, under the deposit method—

- No gain is recognized.
- The seller does not record a receivable from the buyer.
- The seller continues to keep the property (and any existing debt on that property) on the books.
- All payments received from the buyer are recorded as deposits (liability) by the seller, except nonrefundable interest payments received, which can be offset against holding costs paid by the seller on the property (such as, property taxes and interest on existing debt on the property).
- Principal payments by the buyer on existing debt are reflected as reductions of the debt balance and increases in the deposit liability.
- The seller continues to record revenues and expenses relating to the property, including depreciation of buildings and improvements.

Under the deposit method a loss should be recognized when the sales contract is signed if the book value of the property exceeds the sum of the deposit received, the fair value of the seller's unrecorded receivable, and the existing debt assumed by the buyer. Also, if the book value of the property exceeds its fair value less selling costs, an impairment loss should be recorded.

Example of the Deposit Method. The preceding examples in this section are not well suited to the deposit method. Accordingly, the following facts are used in this illustration:

On 1/1/X1, Seller (S) sells raw land with a book value of \$300,000 to Buyer (B) for \$505,000. B makes a token down payment of \$5,000. B also assumes existing debt of \$150,000, but S remains liable on the debt. S finances the remaining sales value of \$350,000 with a second lien mortgage. Payment terms on the assumed debt are \$15,000 per year plus interest at 8%. Terms on the seller's receivable are interest only at 10% for nine years with a balloon payment of \$350,000 plus interest at the end of the 10th year. Recovery of the seller's investment is uncertain, and the deposit method is determined to be the most appropriate accounting method.

Under the deposit method, the sale is not recognized, and the seller's receivable is not recorded. Both the property and existing debt remain on S's books. Thus, the journal entry made on the date of sale is—

Cash	\$ 5,000	
Deposit liability		\$ 5,000

On 1/1/X2, B makes payments of \$27,000 (including interest of \$12,000) on the assumed debt and \$35,000 (interest) on the seller's receivable. S's entries to record those payments include the following:

Assumed debt payment

Liability on property sold	\$ 15,000	
Deposit liability		\$ 15,000

Seller's receivable payment

Cash	\$ 35,000	
Deposit liability		\$ 35,000

Note that no entry was made for the \$12,000 of interest paid on the assumed debt. Under FASB ASC 360-20-55 (formerly SFAS No.66, paragraph 67) the seller only records the principal payments on assumed debt.

Sometimes, the seller may retain the existing debt and the buyer may agree to give the seller an all-inclusive or wraparound loan. In those arrangements, the seller is still responsible for making payments on the existing debt, but the buyer gives the seller the money to make those payments. For example, in the preceding illustration, if the seller received a \$500,000 wraparound loan instead of a \$350,000 second lien, the journal entries to record the payments would be as follows:

Existing debt payment

Interest expense	\$ 12,000	
Notes payable	15,000	
Cash		\$ 27,000

Seller's receivable payment

Cash	\$ 62,000	
Deposit liability		\$ 50,000
Interest expense		12,000

Referring to the previous example, assume that after the first payments were made, B obtained new bank financing, paid off the assumed debt, and obtained an irrevocable letter of credit to back the seller's receivable. The transaction would then qualify for the full accrual method. The journal entry to record the sale and recognize the gain is as follows:

Liability on property sold (\$150,000 – \$15,000)	\$ 135,000	
Note receivable	350,000	
Deposit liability (\$5,000 + \$15,000 + \$35,000)	55,000	
Land		\$ 300,000
Gain on sale (\$505,000 – \$300,000 + \$35,000)		240,000

The gain on the sale consists of sales value of the land less its book value (\$505,000 – \$300,000) or \$205,000 plus the interest income on the seller's receivable of \$35,000 that was originally recorded as an additional deposit.

Cost Recovery Method

When Is It Used? The cost recovery method is commonly used in either of the following circumstances:

- There is uncertainty about the recoverability of the seller's investment in the property sold or collection of the seller's receivable.
- Certain liens on the property are superior to the seller's receivable.

Those circumstances raise doubt about whether the gain on the sale of the real estate will ultimately be realized. Also, FASB ASC 360-20-40-3 (formerly SFAS No. 66, paragraph 22) states that the cost recovery method can be used anytime the installment method is appropriate, which includes partial sales of real estate.

How Is Gain Recognized? Under the cost recovery method, all gains are deferred until the total payments made by the buyer exceed the book value of the property at the sale date. In other words, payments made by the buyer are considered first to be a recovery of cost, then a recovery of profit. For that purpose, payments by the buyer—

a. Include all of the following:

- (1) Buyer's down payment and any additional sales proceeds received in cash.
- (2) Principal and interest payments on the seller's receivable. If the seller is still responsible for existing debt (such as, in a wraparound loan), interest received should be offset against interest expense on the existing debt. In that case, interest received is not included as "payments by the buyer."

(3) Principal and interest payments on existing debt assumed by the buyer.

- b. *Exclude* any payments made by the buyer with funds obtained from loans secured by the property.

Until the seller recovers the book value of the property, the principal payments received are applied to reduce the seller's receivable, and the interest payments increase the deferred gain. When the book value has been recovered, the deferred gain equals the principal outstanding. After that point, deferred gain is recognized as each of the remaining principal payments is received, and the interest payments are recognized as interest income. Consequently, payments made by the buyer are, in effect, recognized as income when received. Any excess deferred gain over the sum of (a) the seller's receivable and (b) any contingent liability to the seller on other debt can be recognized in income, even if the seller's investment has not yet been recovered.

Example of the Cost Recovery Method. Assume the same facts as in the earlier example, except that the cost recovery method is appropriate. The journal entry to record the sale is as follows:

Cash	\$	10,000	
Note receivable from B		241,000	
Land			\$ 140,000
Deferred gain			111,000

Exhibit 1-3 shows the payments made and the deferred gain balance after each of the first four payments is made. After the payment on 1/1/X5, the cumulative payments (\$147,370) exceed the seller's investment in the property (\$140,000) by \$7,370. Authoritative literature does not address whether that excess should be reported as gain or interest income or allocated between the two. It is believed that, since all payments after the investment has been recovered are reported as gain and interest income, it should, if material, be allocated between the two based on the relationship of payments needed to recover the investment and total payments as follows:

Excess of book value (\$140,000) over cumulative payments at the end of X4 (\$114,835)	\$	25,165
% of the excess to total payments during X5 (32,535)		77.35 %
1 – 77.35%		22.65 %
Allocation of excess payments:		
Gain—principal payment of \$12,050 × 22.65%	\$	2,730
Interest income—Interest payment of \$20,485 × 22.65%		<u>4,640</u>
	\$	<u><u>7,370</u></u>

The seller's journal entries for the years X2–X5 are as follows:

1/1/X2

Cash	\$	36,150	
Note receivable from B (principal payment)			\$ 12,050
Deferred gain (interest payment)			24,100

1/1/X3

Cash	\$	34,945	
Note receivable from B (principal payment)			\$ 12,050
Deferred gain (interest payment)			22,895

1/1/X4

Cash	\$	33,740	
Note receivable from B (principal payment)			\$ 12,050
Deferred gain (interest payment)			21,690

1/1/X5

Cash	\$	32,535	
Note receivable from B (principal payment)			\$ 12,050
Deferred gain			13,115
Gain on sale of real estate			2,730
Interest income			4,640

After the 1/1/X5 payment, the deferred gain will be recognized in an amount equal to the principal payments by the buyer. Accordingly, the deferred gain balance after the 1/1/X5 payment is equal to the seller's receivable in each year.

Exhibit 1-3**Example of Gain Recognition under the Cost Recovery Method**

Year	Payments			Loan Balance	Cumulative Payments	Gain Recognized	Deferred Gain Balance
	Principal	Interest	Total				
X1	\$ 10,000 ^a	\$ —	\$ 10,000	\$ 241,000	\$ 10,000	\$ —	\$ 111,000
X2	12,050	24,100	36,150	228,950	46,150	—	135,100
X3	12,050	22,895	34,945	216,900	81,095	—	157,995
X4	12,050	21,690	33,740	204,850	114,835	—	179,685
X5	12,050	20,485	32,535	192,800	147,370	2,730	192,800
X6	12,050	19,280	31,330	180,750	178,700	12,050	180,750
X7	12,050	18,075	30,125	168,700	208,825	12,050	168,700
X8	12,050	16,870	28,920	156,650	237,745	12,050	156,650
X9	12,050	15,665	27,715	144,600	265,460	12,050	144,600
Y0	12,050	14,460	26,510	132,550	291,970	12,050	132,550
Y1	12,050	13,255	25,305	120,500	317,275	12,050	120,500
Y2	12,050	12,050	24,100	108,450	341,375	12,050	108,450
Y3	12,050	10,845	22,895	96,400	364,270	12,050	96,400
Y4	12,050	9,640	21,690	84,350	385,960	12,050	84,350
Y5	12,050	8,435	20,485	72,300	406,445	12,050	72,300
Y6	12,050	7,230	19,280	60,250	425,725	12,050	60,250
Y7	12,050	6,025	18,075	48,200	443,800	12,050	48,200
Y8	12,050	4,820	16,870	36,150	460,670	12,050	36,150
Y9	12,050	3,615	15,665	24,100	476,335	12,050	24,100

Year	Payments			Loan Balance	Cumulative Payments	Gain Recognized	Deferred Gain Balance
	Principal	Interest	Total				
Z0	12,050	2,410	14,460	12,050	490,795	12,050	12,050
Z1	12,050	1,205	13,255	—	504,050	12,050	—

Note:

- ^a Consists of the \$10,000 down payment.

* * *

Reduced Profit Method

When Is It Used? The reduced profit method is typically used instead of the installment method when the buyer's down payment is adequate, but the loan will be repaid over a longer period than normal bank financing would allow. In those situations, the seller financing is considered to be more favorable than customary bank financing, and the gain on sale is discounted for the effect of the favorable financing.

How Is Gain Recognized? Under the reduced profit method, the seller's receivable is discounted to equal the present value of the lowest level of annual payments due under the sales agreement (excluding lump sum payments). The gain to be recognized at the date of sale is the total gain on sale less the discount. The portion of the gain equal to the discount is deferred. The period SFAS No. 66 requires to be used in the present value calculation is as follows:

- For sales of land, 20 years.
- For sales of other real estate (for example, land and buildings sold together), the normal term for a first mortgage loan from an independent financial institution.

FASB ASC 360-20-55-16 (formerly paragraph 68 of SFAS No. 66) requires that the interest rate used in the calculation be the greater of (a) a market interest rate or (b) the rate specified in the sales agreement.

None of the deferred gain (that is, the discount) is recognized until the end of the period used in the present value calculation. After that, the deferred gain is recognized as payments are collected. Although not addressed in FASB ASC 360-20, it is believed the deferred gain should be recognized in proportion to the principal reduction. The payments considered in recognizing the deferred gain should not include payments that were funded from loans secured by the property, even if the loans were obtained from third parties. However, any excess deferred gain over the sum of (a) the seller's receivable and (b) any contingent liability to the seller on other debt can be recognized in income, even if the period used in the present value calculation has not ended.

Example of the Reduced Profit Method. To illustrate the method, assume the same facts as in the earlier example, except that—

- The down payment is \$51,000.
- The \$200,000 seller's receivable bears interest at 12% and the payment terms are 25 annual installments of \$25,500 (principal and interest). A current market interest rate would be 10%.

The present value of the annual payments over 20 years (SFAS No. 66 requirement for raw land) at a rate of 12% would be approximately \$190,500. Thus, the profit to be recognized on the date of sale is as follows:

Sales value	\$ 251,000
Less: discount on seller's receivable (\$200,000 – \$190,500)	<u>(9,500)</u>
Adjusted sales value	241,500
Cost of land sold	<u>(140,000)</u>
 GAIN RECOGNIZED at DATE of SALE	 <u>\$ 101,500</u>
 DEFERRED GAIN	 <u>\$ 9,500</u>

Total payments due over the last five years of the note amount to \$127,500 ($5 \times \$25,500$), of which \$91,900 will be applied to principal. As shown below, the deferred gain is recognized in proportion to the principal reduction. For example, in Year 21, \$14,400, or approximately 16%, of the remaining principal balance of \$91,900 will be collected and \$1,500 of the deferred gain would be recognized (total deferred gain of \$9,500 $\times$ 16%).

	<u>Principal balance</u>	<u>Principal reduction</u>	<u>Interest income</u>	<u>Gain recognized</u>
End of Year 20	\$ 91,900			(rounded)
Year 21	77,500	\$ 14,400	\$ 11,100	\$ 1,500
Year 22	61,200	16,300	9,200	1,700
Year 23	43,100	18,100	7,400	1,900
Year 24	22,800	20,300	5,200	2,100
Year 25	—	<u>22,800</u>	<u>2,700</u>	<u>2,300</u>
		<u>\$ 91,900</u>	<u>\$ 35,600</u>	<u>\$ 9,500</u>

The seller's journal entries to record the sale and payments in Years 21–25 are as follows:

Sale date

Cash	\$ 51,000	
Note receivable	200,000	
Land		\$ 140,000
Gain on sale of real estate		101,500
Deferred gain		9,500

Year 21

Cash	\$ 25,500	
Deferred gain	1,500	
Note receivable		\$ 14,400
Interest income		11,100
Gain on sale of real estate		1,500

Year 22

Cash	\$ 25,500	
Deferred gain	1,700	
Note receivable		\$ 16,300
Interest income		9,200
Gain on sale of real estate		1,700

Year 23

Cash	\$ 25,500	
Deferred gain	1,900	
Note receivable		\$ 18,100
Interest income		7,400
Gain on sale of real estate		1,900

Year 24

Cash	\$	25,500	
Deferred gain		2,100	
Note receivable			\$ 20,300
Interest income			5,200
Gain on sale of real estate			2,100

Year 25

Cash	\$	25,500	
Deferred gain		2,300	
Note receivable			\$ 22,800
Interest income			2,700
Gain on sale of real estate			2,300

Percentage-of-completion (Performance-of-services) Method

When Is It Used? The percentage-of-completion method is commonly used when the seller is obligated to develop the property or build additional facilities as a condition of the sale. The performance-of-services method is normally used when the seller is obligated to manage the property or provide other services. Gain recognition is calculated similarly under both methods.

How Is Gain Recognized? Under the percentage-of-completion method, the total gain on sale is the difference between the sales value and the total costs of the property, including future development costs. The gain to be recognized each period is calculated as follows:

$$\left(\frac{\text{Total costs incurred through end of current period}}{\text{Estimated completed cost of the property}} \times \text{Total gain on sale} \right) - \text{Gain previously recognized} = \text{Current period gain}$$

The gain should be allocated to the sale of the land and to the development or construction activities based on the relative estimated costs of each. To use the percentage-of-completion method, the seller must be able to estimate future development costs. Otherwise, the completed-contract method should be used. *PPC's Guide to Construction Contractors* provides detailed guidance on applying the percentage-of-completion method.

Example of the Percentage-of-completion Method. To illustrate the percentage-of-completion method, assume the following:

- Seller (S), a developer, owns a large tract of raw land with a book value of \$800,000.
- Buyer (B) agrees to buy the land for \$2 million if S adds roads and utilities costing \$700,000. B pays S a down payment of \$400,000, and gives S a note for \$1.6 million, which requires interest payments during the construction period and payment of the principal at the end of construction. For simplicity, the calculations ignore interest income.
- By the end of Year 2, S has incurred development costs of \$400,000. The project is completed in Year 3, and B pays S the remaining \$1.6 million.

In this example, the estimated gain on sale is \$500,000 [\$2,000,000 – (\$800,000 + \$700,000)]. The journal entries to record the transactions are as follows:

Year 1

Cash	\$ 400,000	
Note receivable from B	1,600,000	
Land		\$ 800,000
Gain on sale of real estate ^a		267,000
Deferred revenue		933,000

Year 2

Deferred revenue	\$ 533,000	
Cash		\$ 400,000
Gain on sale of real estate ^b		133,000

To record development costs incurred and the gain to be recognized in Year 2.

Year 3

Cash	\$ 1,300,000	
Deferred revenue	400,000	
Gain on sale of real estate ^c		\$ 100,000
Note receivable from B		1,600,000

To record cash received, development costs incurred, and recognize remaining deferred gain.

Notes:

$$a \quad \frac{\$800,000}{(\$800,000 + \$700,000)} \times \$500,000 = \$267,000 \text{ (rounded)}$$

$$b \quad \left[\frac{(\$800,000 + \$400,000)}{(\$800,000 + \$700,000)} \times \$500,000 \right] - \$267,000 = \$133,000$$

$$c \quad \$500,000 - (\$267,000 + \$133,000) = \$100,000$$

Sometimes it is difficult to determine which costs to include in estimated costs to complete. As a general rule, it is believed that only those costs that are necessary to bring the property into the condition that the buyer expects should be considered. For example, in the preceding case, if S promised to plant trees along the road only if cash flow was sufficient, the additional cost for the trees should be excluded because it is optional.

Other Accounting Methods

FASB ASC 360-20 (formerly SFAS No. 66, states that some sale transactions should be accounted for as financing, leasing, or profit-sharing arrangements. Those methods are commonly used when the seller continues to be involved with the property after the sale. However, FASB ASC 360-20 does not explain how to account for a transaction as a financing, leasing, or profit-sharing arrangement. The following paragraphs discuss some of the ways that those methods may be applied.

Financing Arrangement. There are two primary ways to account for a transaction as a financing arrangement. The first is simply to use the deposit method. In effect, that treatment is used when the seller is obligated to support the operations of an unprofitable property for an extended period.

The second approach may be used when the seller is required to repurchase the property at a price higher than the sales value. In those situations, the accounting is as follows:

- No gain is recognized.

- The seller does not record a receivable from the buyer.
- The seller continues to keep the property on the books.
- All payments received from the buyer are recorded as a liability by the seller.
- Interest expense is accrued on the payments received from the buyer so that the liability to the buyer at the repurchase date is equal to the repurchase price. (The interest rate is the internal rate of return needed to make the liability grow to equal the repurchase price.)
- The seller continues to record revenues and expenses relating to the property, including depreciation of buildings and improvements.

Leasing Arrangement. Sometimes the seller may have an option to repurchase the property at a bargain price (that is, the repurchase price is sufficiently lower than the expected fair value of the property at the repurchase date that exercise of the option appears to be reasonably assured). Or the seller may have a put option that can require the seller to repurchase the property at a specified price that is less than the initial sales value. The transaction may be in substance a leasing arrangement. The accounting is similar to the deposit method, except that the difference between the sales value and the repurchase price should be amortized as rent income through the repurchase date. Although the arrangement is not covered by FASB ASC 840 (formerly SFAS No. 13, *Accounting for Leases*) it is possible that the amortization will yield the same results as if the arrangement were an operating lease. Accordingly, it should be amortized using the straight-line method.

Profit-sharing Arrangement. Typically, transactions are accounted for as profit-sharing arrangements when the seller (a) owns an interest in the buyer and (b) has extensive support obligations or other continuing involvement with the property. Those situations also fit the description in FASB ASC 360-20 (formerly SFAS No. 66) of partial sales. In fact, most of the FASB ASC 360-20 examples to which the profit-sharing method applies can also be considered partial sales with excessive seller involvement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Stanley decided he wanted to sell the 100 acres of land he bought from Stuey. The land will not be used for retail sales. Which of the following GAAP pronouncement should Stanley refer to when determining the proper accounting method to apply to the transaction?
 - a. FASB ASC 310-20 *Receivables—Nonrefundable Fees and Other Costs*.
 - b. FASB ASC 310-10.
 - c. FASB ASC 360-20.
 - d. FASB ASC 360-20-40-31.
2. FASB ASC 978 (formerly SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*) provides accounting guidance for time-share transactions. According to FASB ASC 978, which of the following statements regarding the sales price of a transaction is most accurate?
 - a. The sales price of a time-share transaction should be increased by any buyer's fees not related to financing.
 - b. The sales price of a time-share transaction should be increased by at least two estimated reduction of future payments.
 - c. The sales price of a time-share transaction should be increased by the entire portion of the transaction that is fully financed by the seller at rates more than the prevailing market rate for a purchase of similar credit quality in a similar transaction.
 - d. The sales price of a time-share transaction should be increased by the excess of the fair value over the amount charged the buyer for products or services that the seller, as part of consummating the sale, has provided or is committed to provide to the buyer.
3. Which of the following conditions must exist to use the full accrual method of accounting?
 - a. The collectibility of the sale is reasonably assured.
 - b. There is an extremely high probability of uncollectible payments.
 - c. The seller continues to reflect the property and related debt in the seller's financial statements.
 - d. When reliable estimates of the degree-of-completion are possible.
4. Under which of the following accounting methods is the gain percentage calculated as of the sales date?
 - a. Installment.
 - b. Deposit.
 - c. Cost recovery.
5. Which of the following accounting methods is used when the payment terms on the seller's receivables are **not** adequate?
 - a. Reduced profit.
 - b. Installment.
 - c. Cost recovery.

6. According to FASB ASC 360-20 (formerly SFAS No. 66), which of the following methods of accounting is used to record partial sales of real estate?
- a. Installment.
 - b. Deposit.
 - c. Percentage-of-completion.
7. No gain is recognized under which of the following accounting methods?
- a. Deposit.
 - b. Full accrual.
 - c. Cost recovery.
 - d. Reduced profit.
8. The cost recovery method can be used **anytime** the _____ is appropriate?
- a. Percentage-of-completion.
 - b. Full accrual.
 - c. Deposit.
 - d. Installment.
9. Which of the following statements is most accurate when recognizing gain using the reduced profit method of accounting?
- a. It is determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales agreement.
 - b. It is used when the seller is obligated to manage the property.
 - c. Income is recorded when the sale occurs.
10. Which of the following methods of accounting is most commonly used when the seller is obligated to build additional facilities as a condition of the sale?
- a. Deposit.
 - b. Percentage-of-completion.
 - c. Full accrual.

11. Which of the following conditions is necessary to use the percentage-of-completion accounting method?
- a. The proposed project has been formally documented.
 - b. Project improvements have been identified and a plan developed to implement improvements.
 - c. The developer is able to reasonably estimate the cost to complete the project.
 - d. The total amount of collections is highly uncertain.

12. The following illustration is an example of which accounting method?

Stuey is a developer who owns 100 acres of land with a book value of \$800,000. Stanley agrees to buy the land for \$2 million if Stuey adds roads and utilities costing \$700,000. Stanley pays Stuey a down payment of \$400,000, and gives Stuey a note for \$1.6 million, which requires interest payments during the construction period and payment of the principal at the end of construction. By the end of Year 2, Stuey has incurred developmental costs of \$400,000. The project is completed in Year 3, Stanley pays Stuey the remaining \$1.6 million.

- a. Percentage-of-completion.
 - b. Reduced profit.
 - c. Installment.
 - d. Deposit.
13. Stanley, in question 12, owns interest in the buyer of his 100 acres. Which of the following methods should Stanley use to account for this transaction?
- a. Leasing arrangement.
 - b. Profit-sharing arrangement.
 - c. Financing arrangement.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Stanley decided he wanted to sell the 100 acres of land he bought from Stuey. The land will not be used for retail sales. Which of the following GAAP pronouncements should Stanley refer to when determining the proper accounting method to apply to the transaction? **(Page 3)**
 - a. FASB ASC 310-20 *Receivables—Nonrefundable Fees and Other Costs*. [This answer is incorrect. If the seller charges a fee that is related to financing the time-share transaction, the fee should be recorded as an adjustment to the stated interest rate on the financing in accordance with FASB ASC 310-20, *Receivables—Nonrefundable Fees and Other Costs*, (formerly SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).]
 - b. FASB ASC 310-10. [This answer is incorrect. FASB ASC 310-10 (formerly SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*,) provides guidance on determining whether a loan has been impaired and computing specific valuation allowances for impaired loans.]
 - c. **FASB ASC 360-20. [This answer is correct. FASB ASC 360-20 (formerly SFAS No. 66) establishes accounting standards for recognizing profit or loss on sales of real estate and applies to all sales of real estate.]**
 - d. FASB ASC 360-20-40-31. [This answer is incorrect. FASB ASC 360-20-40-3 (formerly SFAS No. 66, paragraph 22), states that the cost recovery method can be used anytime the installment method is appropriate, which includes partial sales of real estate.]
2. FASB ASC 978 (formerly SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*) provides accounting guidance for time-share transactions. According to FASB ASC 978, which of the following statements regarding the sales price of a transaction is most accurate? **(Page 4)**
 - a. **The sales price of a time-share transaction should be increased by any buyer's fees not related to financing. [This answer is correct. The sales price of a time-share transaction should be increased by any buyer's fees not related to financing, such as a document preparation fee, unless the fee is ultimately passed through to a third party.]**
 - b. The sales price of a time-share transaction should be increased by at least two estimated reduction of future payments. [This answer is incorrect. The sales price of a time-share transaction should be reduced by any estimated reductions of future payments due to pre-payment acceleration programs.]
 - c. The sales price of a time-share transaction should be increased by the entire portion of the transaction that is fully financed by the seller at rates more than the prevailing market rate for a purchase of similar credit quality in a similar transaction. [This answer is incorrect. The sales price of a time-share transaction should be reduced by any portion of the transaction that is fully or partially financed by the seller at rates less than the prevailing market rate for a purchase of similar credit quality in a similar transaction. (The sales value and note receivable should be reduced in accordance with FASB ASC 835-30, *Interest—Imputation of Interest* (formerly APB Opinion No. 21, *Interest on Receivables and Payables*).)]
 - d. The sales price of a time-share transaction should be increased by the excess of the fair value over the amount charged the buyer for products or services that the seller, as part of consummating the sale, has provided or is committed to provide to the buyer. [This answer is incorrect. The sales price of a time-share transaction should be reduced by the excess of the fair value over the amount charged the buyer for products or services that the seller, as part of consummating the sale, has provided or is committed to provide to the buyer. Generally, such products and services represent sales incentives. This follows the guidance in FASB ASC 605-50, *Revenue Recognition—Customer Payments and Incentives* (formerly EITF Issue No. 01-9).]

3. Which of the following conditions must exist to use the full accrual method of accounting? **(Page 5)**
- a. **The collectibility of the sale is reasonably assured. [This answer is correct. According to FASB ASC 360-20-40-3 (formerly paragraph 3 of SFAS No. 66), the full accrual method is used when (a) the seller no longer has any obligations with respect to the property and (b) the collectibility of the sales price and additional proceeds is reasonably assured (or the uncollectible portion can be reasonably estimated).]**
 - b. There is an extremely high probability of uncollectible payments. [This answer is incorrect. The cost recovery method is used under these conditions.]
 - c. The seller continues to reflect the property and related debt in the seller's financial statements. [This answer is incorrect. Under the deposit method of accounting, the seller continues to reflect the property and related debt in the seller's financial statements.]
 - d. When reliable estimates of the degree-of-completion are possible. [This answer is incorrect. The percentage-of-completion method should be used in this situation.]
4. Under which of the following accounting methods is the gain percentage calculated as of the sales date? **(Page 6)**
- a. **Installment. [This answer is correct. For the installment method, gain percentage is normally calculated as of the sale date, and that percentage is applied to the principal payments received.]**
 - b. Deposit. [This answer is incorrect. For the deposit method, principal payments by the buyer on existing debt are reflected as reductions of the debt balances and increases in the deposit liability.]
 - c. Cost recovery. [This answer is incorrect. For the cost recovery method, all gains are deferred until the total payments made by the buyer exceed the book value of the property by the sale date.]
5. Which of the following accounting methods is used when the payment terms on the seller's receivables are **not** adequate? **(Page 6)**
- a. Reduced profit. [This answer is incorrect. The reduced profit method is typically used when the seller financing is considered to be more favorable than customary bank financing.]
 - b. **Installment. [This answer is correct. The assumption behind the installment method is that the buyer is not sufficiently committed to the property to ensure that the seller's receivable will be repaid. Therefore, the installment method is commonly used for sales in which the seller provides some of the financing, and the buyer does not make a sufficient down payment.]**
6. According to FASB ASC 360-20 (formerly SFAS No. 66), which of the following methods of accounting is used to record partial sales of real estate? **(Page 6)**
- a. **Installment. [This answer is correct. Authoritative literature states that the installment method of accounting may be used to record partial sales of real estate if collection of the sales price is not reasonably assured.]**
 - b. Deposit. [This answer is incorrect. The deposit method does not recognize even a partial sale of real estate, because the deposit method is a recognized method for recording a completed sale.]
 - c. Percentage-of-completion. [This answer is incorrect. The percentage of completion method is an accounting method for recording a completed sale of real estate.]

7. No gain is recognized under which of the following accounting methods? **(Page 10)**
- a. **Deposit.** [This answer is correct. Under the deposit method the seller does not recognize any profits, does not record a note receivable, and continues to reflect the property and related debt in the seller's financial statements, recording the buyer's initial investment and subsequent payments as a deposit.]
 - b. Full accrual. [This answer is incorrect. The entire gain on the sale is recognized at the date of sale on the full accrual method.]
 - c. Cost recovery. [This answer is incorrect. Profits are recognized after costs are completely recovered.]
 - d. Reduced profit. [This answer is incorrect. Under the reduced profit method, revenue is recognized at closing based on the sales profit less discount, and the discounted portion is deferred and recognized at the end of the discount period.]
8. The cost recovery method can be used **anytime** the _____ is appropriate. **(Page 11)**
- a. Percentage-of-completion method. [This answer is incorrect. This method should be used when receivables are collectible.]
 - b. Full accrual method. [This answer is incorrect. Profit shall be recognized in full when real estate is sold under the full accrual method. This method is used when cost recovery is not a concern.]
 - c. Deposit method. [This answer is incorrect. If recovery of the cost of the property is not reasonably assured if the buyer defaults or if cost has already been recovered and collection of additional amounts is uncertain, the deposit method can be used.]
 - d. **Installment method.** [This answer is correct. FASB ASC 360-20-40-3 (formerly SFAS No. 66, paragraph 22) states that the cost recovery method can be used anytime the installment method is appropriate, which includes partial sales of real estate.]
9. Which of the following statements is most accurate when recognizing gain using the reduced profit method of accounting? **(Page 14)**
- a. **It is determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales agreement.** [This answer is correct. Under the reduced profit method, the seller's receivable is discounted to equal the present value of the lowest level of annual payments due under the sales agreement (excluding lump sum payments). The gain to be recognized at the date of sale is the total gain on sale less the discount.]
 - b. It is used when the seller is obligated to manage the property. [This answer is incorrect. The performance-of-services method is normally used when the seller is obligated to manage the property or provide other services.]
 - c. Income is recorded when the sale occurs. [This answer is incorrect. Under the accrual method, business income is recorded when a sale occurs, whether it is the delivery of a product or the rendering of a service.]
10. Which of the following methods of accounting is most commonly used when the seller is obligated to build additional facilities as a condition of the sale? **(Page 16)**
- a. Deposit. [This answer is incorrect. Under the deposit method, the seller is not obligated to develop the property. However, the buyer does have the option to buy the property.]
 - b. **Percentage-of-completion.** [This answer is correct. The percentage-of-completion method is commonly used when the seller is obligated to develop the property or build additional facilities as a condition of the sale.]

- c. Full accrual. [This answer is incorrect. Under the cost recovery method, the seller is not obligated to develop the property.]
11. Which of the following conditions is necessary to use the percentage-of-completion accounting method? **(Page 16)**
- a. The proposed project has been formally documented. [This answer is incorrect. Documentation of the proposed project is not a necessary condition when using the percentage-of-completion method.]
- b. Project improvements have been identified and a plan developed to implement improvements. [This answer is incorrect. The developer must be obligated to develop the property or implement improvements.]
- c. The developer is able to reasonably estimate the cost to complete the project. [This answer is correct. The percentage-of-completion method should be used when reliable estimates of the degree of completion are possible.]**
- d. The total amount of collections is highly uncertain. [This answer is incorrect. Generally, the cost recovery method is used only when the total amount of collections is highly uncertain.]
12. The following illustration is an example of which accounting method? **(Page 16)**

Stuey is a developer who owns 100 acres of land with a book value of \$800,000. Stanley agrees to buy the land for \$2 million if Stuey adds roads and utilities costing \$700,000. Stanley pays Stuey a down payment of \$400,000, and gives Stuey a note for \$1.6 million, which requires interest payments during the construction period and payment of the principal at the end of construction. By the end of Year 2, Stuey has incurred developmental costs of \$400,000. The project is completed in Year 3, Stanley pays Stuey the remaining \$1.6 million.

- a. **Percentage-of-completion. [This answer is correct. The percentage-of-completion method recognizes profit on a long-term construction contract as it is earned gradually during the construction period. In the above illustration, the remaining \$1.6 million is not paid until the project is completed in Year 3. A ratio of the percentage of completion is determined and applied to the expected gross profit on the contract to determine the gross profit and revenue to be recognized in the financial statements.]**
- b. Cost recovery. [This answer is incorrect. When the cost-recovery method is used, no profit is recognized until all costs have been recovered.]
- c. Installment. [This answer is incorrect. The installment method is used when the criteria for using the full accrual method or the percentage-of-completion method are not met.]
- d. Deposit. [This answer is incorrect. In the above illustration, the sale has been completed and the sale can be recognized, which is not the case when using the deposit method.]
13. Stanley, in question 12, owns interest in the buyer of his 100 acres. Which of the following methods should Stanley use to account for this transaction? **(Page 18)**
- a. Leasing arrangement. [This answer is incorrect. Stanley does not have the option to repurchase the property at a reduced price; therefore, the transaction is not considered a leasing arrangement.]
- b. Profit-sharing arrangement. [This answer is correct. Stanley should use the profit-sharing arrangement since he owns interest in the buyer of his 100 acres. The profit-sharing arrangement is typically used if the seller continues to have a direct or indirect ownership interest in the property.]**
- c. Financing arrangement. [This answer is incorrect. Transactions are commonly accounted for as financing arrangements if the seller has an obligation to repurchase the property at a price higher than the sales value. Stanley does not have that obligation.]

CHOOSING THE RIGHT METHOD

There are relatively few instances in which the accountant is free to choose between two or more of the methods provided in FASB ASC 360-20 (formerly SFAS No. 66). The method to be used is normally prescribed by FASB ASC 360-20 based on the circumstances. This lesson outlines a practical approach to selecting the right accounting method.

The Primary Conditions

FASB ASC 360-20 is based on the principle that gains on sales of real estate should be fully recognized only when the earnings process is complete and the collectibility of the sales price and additional proceeds is reasonably assured (or when the uncollectible portion can be estimated). Accordingly, four following primary conditions are provided for using the full accrual method:

- a. *Completed sale.* The sale must have been *completed*. (FASB ASC 360-20 uses the term *consummated*.)
- b. *Adequate investment.* The buyer's investments (both initial and continuing investments) must meet the minimum guidelines established by FASB ASC 360-20.
- c. *Superior lien.* The seller's lien on the property must be superior to all other liens on the property, with certain exceptions.
- d. *Risks and rewards transferred.* The sale must transfer the risks and rewards of ownership to the buyer, and the seller must be free from continuing involvement with the property.

If all those conditions are met, the full accrual method should be used. Otherwise, an alternate method must be selected.

To choose the right accounting method, FASB ASC 360-20 provides dozens of additional rules and requirements. However, only two or three rules may actually apply to any given transaction, which makes the accounting guidance complex and difficult to apply.

A Practical Approach to Selecting the Right Accounting Method

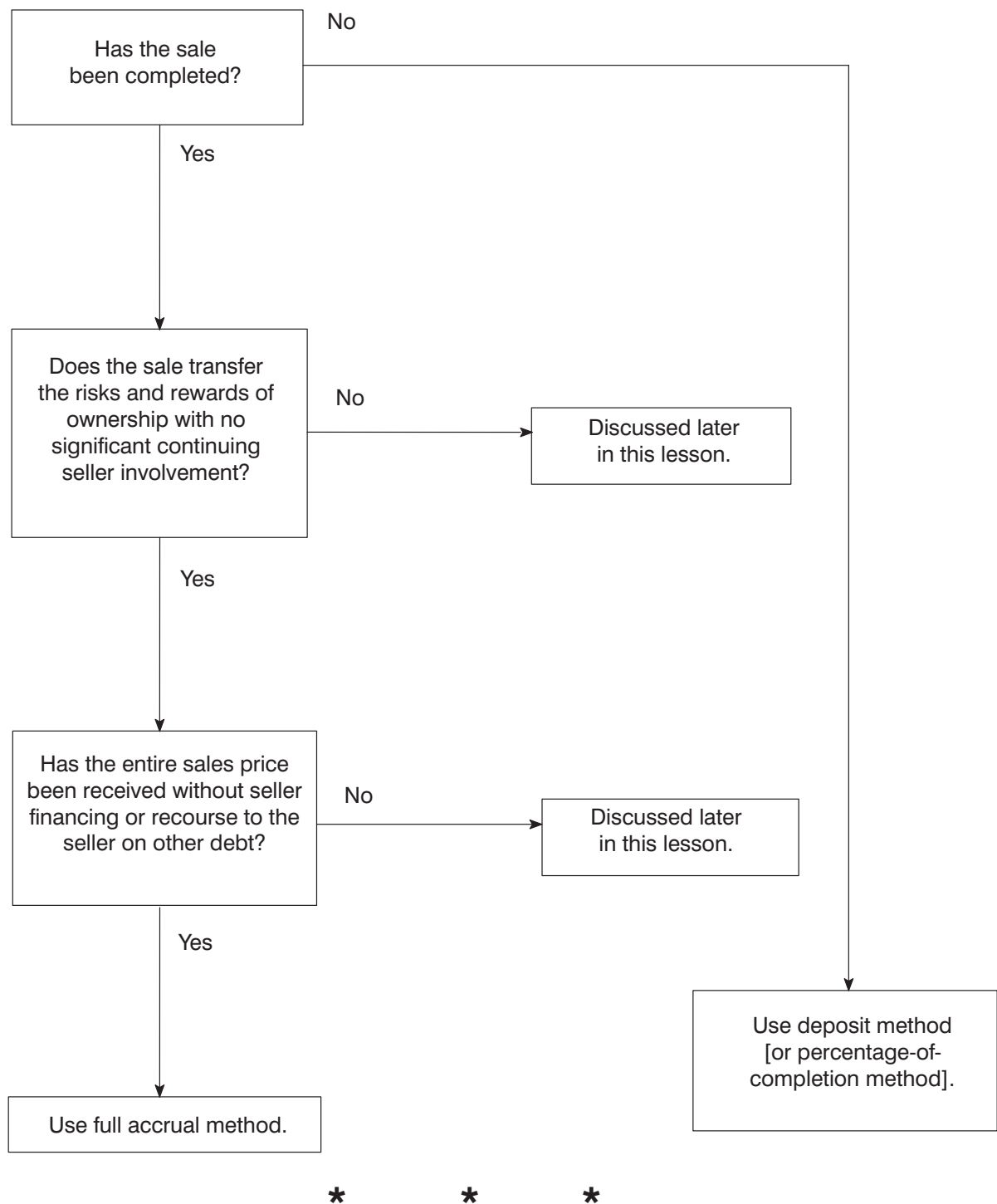
Basis for the Approach. From a practical perspective, two steps can be taken to streamline and simplify the process of finding the right accounting method:

- *Change the order of the conditions* and consider the completed sale and risk and reward transfer conditions first. When one of those two conditions is not met, the other conditions (buyer's investments and lien superiority) normally do not affect the selection of accounting methods.
- *Consider whether seller financing is involved* before assessing the buyer's investments and lien superiority conditions. Those conditions only apply when seller financing is involved.

Using that approach, the selection process starts with the following three basic conditions:

- a. Has the sale been completed?
- b. Does the sale transfer the risks and rewards of ownership without continuing seller involvement?
- c. Has the entire sales value been received without seller financing (or recourse to the seller on other debt)?

The basic steps in that approach are highlighted in Exhibit 1-4.

Exhibit 1-4**A Practical Approach for Selecting Accounting Methods
for Sales of Real Estate**

Has the Sale Been Completed?

Generally, a sale is considered completed when it is closed. FASB ASC 360-20 (formerly SFAS No. 66) specifies the following criteria for determining whether a sale has been completed:

- a. *Binding contract.* There is a contract that binds both parties.
- b. *Exchange of consideration.* All consideration (such as cash, notes, and deeds) has been exchanged.
- c. *Financing arrangements.* If the seller is responsible for arranging financing for the buyer, that financing has been arranged.
- d. *Closing requirements.* All of the conditions needed to close the sale (such as title policy, surveys, inspections, permits) have been met.

What If the Sale Has Not Been Completed? If the sale has not been completed (that is, if all of the preceding conditions are not met), the transaction should generally be accounted for using the deposit method. However, a special exception is allowed when the seller is building office buildings, retail centers, or similar buildings. In those cases, the seller normally will not be able to get a certificate of occupancy, which is a requirement for closing. In such cases, assuming all other conditions for a completed sale are met, the transaction should be accounted for.

Does the Sale Transfer the Risks and Rewards of Ownership?

One of the primary conditions for gain recognition is that the seller must have transferred substantially all the risks and rewards of owning the property. Or simply stated, has the seller retained most of the risk on the property (for example, risk of unprofitable operations, obsolescence, or decline in value)?

FASB ASC 360-20 does not provide any detailed rules for determining whether the risks and rewards of ownership have been transferred. Instead, it gives specific examples of continuing involvement and discusses how those situations should be accounted for. Consequently, the accountant must consider those examples and use judgment to determine whether the risks and rewards of ownership have been transferred.

FASB ASC 360-20 (formerly paragraph 25 of SFAS No. 66) states, "Generally, profit shall be recognized at the time of sale if the amount of the seller's loss of profit because of continued involvement with the property is limited by the terms of the sales contract. The profit recognized shall be reduced by the maximum exposure to loss." If the seller's loss because of continued involvement is not limited, the seller generally retains substantially all of the risk of ownership of the property, and the substance of the transaction is that a sale has not occurred. If the seller's loss is limited, the risks are less than ownership, and the substance of the transaction is that a sale has occurred. However, recognition of the full gain at the date of sale is inappropriate; instead, the gain is recognized in future periods as the seller fulfills its obligations for continued involvement. In other words, revenue relating to future obligations is deferred initially and recognized as the costs of fulfilling those obligations are incurred.

In a *plain vanilla sale*, it is easy to determine the extent of seller involvement. More complex transactions, however, require a careful analysis of the terms of the sale. In fact, determining all of the seller's obligations may require more than just reading the sale contract because the seller may have made side agreements or oral commitments beyond the terms of the written contract.

The following discussion summarizes the accounting issues when the seller continues to be involved with the property:

- a. If the economic substance of the transaction is that a sale has not occurred, a sale is not recorded. Accordingly, the seller does not record any notes receivable from the buyer, continues to report the real estate and any debt assumed by the buyer, and records a liability for the cash received from the buyer. The following are examples of continuing involvement that indicate a sale has not occurred:
 - (1) The buyer can require the seller to repurchase the property.

- (2) The seller is a general partner in a limited partnership that acquires an interest in the property and holds a significant receivable from the partnership.
 - (3) The seller guarantees that the buyer will be able to recover all of its investment (that is, sales value) or guarantees the buyer a return on its investment for a long period.
- b. If the economic substance of the transaction is that a sale has occurred, a sale is recorded. Accordingly, the seller records any notes receivable from the buyer, removes the real estate and any debt assumed by the buyer from its balance sheet, defers the revenue related to future performance, and recognizes the gain for the remaining revenue. The following are examples of continued involvement that indicate a sale has occurred:
- (1) The seller agrees to develop the property or construct facilities on it. The sales value and the consideration received at the date of sale relate to performance before and after the date of sale. Generally, the excess of the consideration received over the revenue that relates to performance through the date of sale is deferred initially and recognized as the seller develops or constructs the facilities.
 - (2) The seller agrees to provide management services at no charge. In that case, part of the consideration received at the date of sale is, in effect, compensation to the seller for providing those services. Thus, the fair value of those services is recorded as deferred revenue and recognized as the management services are provided.
 - (3) The seller agrees to support operations for a short period, and there is reasonable assurance that future rental income will cover operating expenses and debt payments. A part of the consideration received at the date of sale relates to that support, and the related revenue is deferred and recognized as the support is provided.

Exhibit 1-5 presents examples of certain types of seller involvement and indicates how those arrangements might be accounted for. The detailed accounting for a variety of types of seller involvement is discussed later in this lesson.

Exhibit 1-5

Examples of Accounting for Continuing Seller Involvement

Financing, Leasing, or Profit-sharing Arrangement	Percentage-of-completion or Performance-of-services	Deposit Method or Other Methods
• Seller guarantees a return of the buyer's investment or a return on that investment for an <i>extended</i> period. • Seller has option or obligation to repurchase property. • Buyer has an option to force seller to repurchase the property. • Seller is a general partner in a partnership that buys the property, and the seller holds a significant receivable.	• Seller guarantees a return on the buyer's investment for a <i>limited</i> period, and current operations cover all expenses and other payments. • Seller is required to support operations of the property for a <i>limited</i> period. • Seller is required to develop the property or build facilities or amenities, and development costs can be reasonably estimated.	• Seller guarantees a return on the buyer's investment for a <i>limited</i> period, and current operations do <i>not</i> cover all expenses and other payments. • Seller, in substance, issues an option. • Seller is required to develop the property, etc., but development costs cannot be estimated.
*	*	*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. A sale is considered complete when it is closed. Which of the following is **not** considered criteria for determining whether a sale has been completed?
 - a. Financing arrangement.
 - b. Exchange of consideration.
 - c. Binding contract.
 - d. Transfer of risks and rewards.
15. Which of the following is one of the primary conditions for gain recognition?
 - a. Binding contract.
 - b. Financing arrangements.
 - c. Transfer of risks and rewards.
 - d. Closing requirements.
16. Which of the following statements regarding the FASB ASC 360-20 list of primary conditions for gain recognition is accurate?
 - a. FASB ASC 360-20 does not designate the specific criteria for determining when a sale has been completed.
 - b. FASB ASC 360-20 does not provide detailed regulations for determining if the risks and rewards of ownership have been transferred.
 - c. The Statement specifically addresses changing accounting methods other than the installment and cost recovery methods.
17. If the economic substance of a transaction is that a sale has occurred, a sale is recorded. Which of the following examples of continued involvement indicates a sale has **not** occurred?
 - a. The seller agrees to develop the property.
 - b. The seller agrees to provide management services at no charge.
 - c. The seller guarantees that the buyer will be able to recover all of their investment.
 - d. The seller agrees to support operations for a short period.
18. Which of the following statements regarding a change in accounting method is most accurate?
 - a. Once an accounting method has been adopted for a project that method must be kept throughout the project.
 - b. Once an accounting method has been adopted for a project, the developer may choose to switch to another accounting method, but only if all conditions are met for the accounting method to which the developer chooses to switch to.
 - c. Once the conditions for an accounting method are met, it is recommended the developer switch to the new accounting method.

19. If a sale does not meet all the conditions for full accrual until sometime after the sale date, the sale must be accounted for using which of the following accounting methods?
- a. Reduced profit.
 - b. Installment.
 - c. Percentage-of-completion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. A sale is considered complete when it is closed. Which of the following is **not** considered criteria for determining whether a sale has been completed? **(Page 28)**
- a. Financing arrangement. [This answer is incorrect. If the seller is responsible for arranging financing for the buyer, that financing has been arranged and this is one of the criterion for determining if a sale has been completed.]
 - b. Exchange of consideration. [This answer is incorrect. If all consideration (such as cash, notes, and deeds) has been exchanged, the sale has been completed.]
 - c. Binding contract. [This answer is incorrect. A contract that binds both parties is one criterion for determining if a sale has been completed.]
 - d. **Transfer of risks and rewards. [This answer is correct. One of the primary conditions for gain recognition is that the seller must have transferred substantially all the risks and rewards of owning the property.]**
15. Which of the following is one of the primary conditions for gain recognition? **(Page 28)**
- a. Binding contract. [This answer is incorrect. A binding contract is a contract that binds both parties. A binding contract is one criterion for determining if a sale has been completed.]
 - b. Financing arrangements. [This answer is incorrect. According to SFAS No. 66, financing arrangements is one of the bases for determining if a sale has been completed.]
 - c. **Transfer of risks and rewards. [This answer is correct. One of the primary conditions for gain recognition is that the seller must have transferred substantially all the risks and rewards of owning the property.]**
 - d. Closing requirements. [This answer is incorrect. The closing requirements are one of the bases for determining if a sale has been met.]
16. Which of the following statements regarding the FASB ASC 360-20 list of primary conditions for gain recognition is accurate? **(Page 28)**
- a. FASB ASC 360-20 does not designate the specific criteria for determining when a sale has been completed. [This answer is incorrect. FASB ASC 360-20 simply states that a sale shall not be considered consummated until the parties are bound by the terms of a contract and the sale is complete.]
 - b. **FASB ASC 360-20 does not provide detailed regulations for determining if the risks and rewards of ownership have been transferred. [This answer is correct. FASB ASC 360-20 does not provide any detailed rules for determining whether the risks and rewards of ownership have been transferred. Instead, it gives specific examples of continuing involvement.]**
 - c. The Statement specifically addresses changing accounting methods for all of the following methods: deposit, installment, percentage of completion and cost recovery. [This answer is incorrect. FASB ASC 360-20 does not specifically address changing from accounting methods other than the installment and cost recovery methods.]

17. If the economic substance of a transaction is that a sale has occurred, a sale is recorded. Which of the following examples of continued involvement indicates a sale has **not** occurred? **(Page 29)**
- a. The seller agrees to develop the property. [This answer is incorrect. This is an example indicates a sale has occurred. The sales value and the consideration received at the date of sale relate to performance before and after the date of sale.]
 - b. The seller agrees to provide management services at no charge. [This answer is incorrect. This example also indicated a sale has occurred. If a seller agrees to provide management services at no charge part of the consideration received at the date of sale is compensation to the seller for providing the services.]
 - c. **The seller guarantees that the buyer will be able to recover all of their investment. [This answer is correct. If the seller guarantees that the buyer will be able to recover all of their investment , that is, sales value, or guarantees the buyer a return on their investment for a long period, this is an indication that a sale has not occurred.]**
 - d. The seller agrees to support operations for a short period. [This answer is incorrect. If the seller] agrees to support operations for a short period, and there is reasonable assurance that future rental income will cover operating expenses and debt payments then a sale has occurred.]
18. Which of the following statements regarding a change in accounting method is most accurate? **(Page 30)**
- a. Once an accounting method has been adopted for a project that method must be kept throughout the project. [This answer is incorrect. Often a real estate sale may not meet all the full accrual method conditions until sometime after the sale date. In those cases, the sale is initially accounted for using the appropriate method as of the sale date.]
 - b. Once an accounting method has been adopted for a project, the developer may choose to switch to another accounting method, but only if all conditions are met for the accounting method to which the developer chooses to switch to. [This answer is incorrect. Accounting Standards do not specifically address changing from accounting methods other than the installment and cost recovery methods.]
 - c. **Once the conditions for an accounting method are met, it is recommended the developer switch to the new accounting method. [This answer is correct. The developer is not required to change accounting methods once the conditions for an accounting method are met. However, if a transaction is accounted for by the deposit method because it has not yet closed, it is appropriate to change to the full accrual method after closing provided all the other conditions for full accrual gain recognition are met.]**
19. If a sale does not meet all the conditions for full accrual until sometime after the sale date, the sale must be accounted for using which of the following accounting methods? **(Page 30)**
- a. Reduced profit. [This answer is incorrect. Accounting Standards do not specifically address changing from the reduced profit method.]
 - b. **Installment. [This answer is correct. In the case where a real estate sale does not meet all the full accrual method conditions until after the sale, the sale is initially accounted for using the appropriate method. The appropriate method may be the installment method or the cost recovery method.]**
 - c. Percentage-of-completion. [This answer is incorrect. The percentage-of-completion is not recognized as a method used when a sale does not meet all conditions for full accrual.]

Has the Entire Sales Value Been Received without Seller Financing or Recourse to the Seller on Other Debt?

FASB ASC 360-20 (formerly SFAS No. 66) provides specific rules regarding sales in which the seller provides some or all of the financing. However, not all sales involve seller financing. In fact, some companies do not have the resources to provide any seller financing. Thus, the conditions in FASB ASC 360-20 relating to the buyer's investments do not apply if both the following criteria are met:

- The seller receives the entire sales value in the form of cash, the buyer's assumption of existing debt on the property, or a combination of the two.
- The seller is released from all recourse provisions, contingent liabilities, and any other obligations relating to existing debt and any debt used to finance the sale.

Changing Accounting Methods

Often a real estate sale may not meet all the full accrual method conditions until sometime after the sale date. In those cases, the sale is initially accounted for using the appropriate method as of the sale date. If the installment method or cost recovery method is initially used and later all the full accrual conditions are met, paragraphs 55-12 and 55-15 of FASB ASC 360-20 (formerly paragraphs 61 and 64 of SFAS No. 66) state that the accounting method may be changed to the full accrual method, and any remaining deferred gain should be recognized at that time.

For example, assume that a sale of land meets all the conditions for using the full accrual method except the initial investment test, and that the sale is accounted for under the installment method. When the buyer has made cumulative payments equal to the amount necessary to meet the initial investment test (for example, 20% for land, as shown in Exhibit 2-3), the remaining deferred gain should be recognized.

Accounting Standards do not specifically address changing from accounting methods other than the installment and cost recovery methods. However, it is believed that the preceding guidance may also be applied when other methods are initially used to account for sales. For example, if a transaction is accounted for by the deposit method because it has not yet closed, it is appropriate to change to the full accrual method after closing provided all the other conditions for full accrual gain recognition are met.

Should the Change Be Accounted for as a Change in Accounting Principle? Another troublesome issue is whether changing to the full accrual method is an accounting change as defined under FASB ASC 250, *Accounting Changes and Error Corrections* (formerly SFAS No. 154, *Accounting Changes and Error Corrections*). The significant accounting policies in the notes to the financial statements would normally disclose the different methods used by the seller for recording gains on the sale of real estate. This would include the policy that the seller would change to the full accrual method once the requirements have been met. If the change to the full accrual method is material, the amount of the income recognized as a result of the change should be disclosed in the notes to the financial statements.

EXAMINATION FOR CPE CREDIT**Lesson 1 (ARETG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following determines the gain on sale of real estate?
 - a. Subtracting the contract sales price from the book value of the real estate.
 - b. Subtracting the book value of the real estate sold from the sales value of the property.
 - c. Subtracting the contract sales price from the current value of the property.
 - d. Subtracting the current value of the property from the contract sales price.
2. In which of the following methods is a portion of the gain deferred at the date of sale and recognized in different amounts as payments are received from the buyer?
 - a. Installment, reduced profit, deposit.
 - b. Percentage-of-completion, reduced profit, full accrual.
 - c. Cost recovery, reduced profit, installment.
 - d. Deposit, installment, cost recovery.
3. The following scenario is an example of which of the following accounting methods?

Prudence agrees to buy 10 acres of raw land from Fred for \$251,000 in cash. The land has a book value of \$140,000. Fred records the transactions as follows:

Cash			\$251,000	
	Land			\$140,000
	Gain on sale of land			\$111,000

- a. Full accrual.
 - b. Reduced profit.
 - c. Cost recovery.
 - d. Installment.
4. According to FASB ASC 360-20-55-8 (formerly paragraph 57 of SFAS No. 66), it is not necessary to discount sellers' receivables when using which of the following methods?
 - a. Installment.
 - b. Reduced profit.
 - c. Leasing arrangement.
 - d. Cost ratio.

5. Under which of the following methods does the seller continue to keep the property on the books?
- a. Full accrual.
 - b. Installment.
 - c. Reduced profit.
 - d. Deposit.

6. All of the following statements apply to the deposit method **except**?
- a. The seller has merely given the buyer the option to purchase the property.
 - b. The seller accounts for the transaction as if no sale occurred.
 - c. The seller guarantees a return on the buyer's investment.
 - d. The sale has been completed.

7. The following illustration is an example of which of the following accounting methods?

In 2009, Triple A developer completes a shopping center, leases it, and sells it to Silver Shadow entity for \$10 million. Triple A has a cost basis in the center of \$6 million, resulting in a profit of \$4 million. As part of the sales contract, developer receives cash of \$2 million and Silver Shadow entity's note of \$8 million, which is collateralized by the shopping center. Its terms are 25 years with interest at the rate of 10% for annual payments of \$872,400. A regional commercial bank lender would issue a first mortgage of \$8 million over 20 years with interest at the rate of 8% for annual payments of \$803,000.

- a. Full accrual.
 - b. Installment.
 - c. Reduced profit.
 - d. Deposit.
8. Which of the following accounting methods should be used when a buyer's down payment is adequate, but the loan must be repaid over a longer period than if the buyer financed through a bank?
- a. Reduced profit.
 - b. Percentage-of-completion.
 - c. Cost recovery.
 - d. Deposit.

9. Which of the following accounting methods should be used in the illustration below?

Lola sells raw land with a book value of \$300,000 to Izzie for \$505,000. Izzie makes a token down payment of \$5,000. Izzie also assumes existing debt of \$150,000, but Lola remains liable on the debt. Lola finances the remaining sales value of \$350,000 with a second lien mortgage. Payment terms on the assumed debt are \$15,000 per year plus interest at 8%. Terms on the seller's receivable are interest only at 10% for nine years with a balloon payment of \$350,000 plus interest at the end of the 10th year.

- a. Reduced profit.
 - b. Percentage-of-completion.
 - c. Cost recovery.
 - d. Deposit.
10. Which of the following accounting methods should be used when certain liens on the property are superior to the seller's receivable?
- a. Cost recovery.
 - b. Deposit.
 - c. Percentage-of-completion.
 - d. Reduced profit.
11. Which of the following methods of accounting is most commonly used when the seller continues to be involved with the property after the sale?
- a. Cost recovery.
 - b. Profit-sharing arrangement.
 - c. Percentage-of-completion.
 - d. Reduced profit.
12. Which of the following methods of accounting should be used if the sale has **not** been completed?
- a. Cost recovery.
 - b. Deposit.
 - c. Reduced profit.
 - d. Do not select this answer choice.
13. Which of the following methods of accounting should be used if the seller is required to support operations of the property for a limited period?
- a. Leasing.
 - b. Deposit.
 - c. Percentage-of-completion.
 - d. Financing.

14. Izzie is a general partner in a partnership that buys property from Lola's Land Inc. Izzie holds a significant receivable on the property. This is an example of which of the following methods of accounting?
- Deposit.
 - Percentage-of-completion.
 - Financing arrangement.
 - Reduced profit.
15. Which of the following combination of accounting methods are most commonly used when the seller has significant continuing involvement with the property?
- Deposit, financing, cost recovery.
 - Percentage-of-completion, deposit, and profit.
 - Financing, deposit, reduced profit.
 - Reduced profit, percentage-of-completion, cost recovery.
16. Which of the following accounting methods should be used if a sale agreement gives the seller a repurchase option and the repurchase price is lower than the sale price?
- Leasing arrangement.
 - Installment method.
 - Financing arrangement.
 - Reduced profit.
17. Lola is selling Izzie 1,000 acres of land she recently inherited. In the sales agreement, Izzie has the option to buy the land and makes only a token down payment, but is not required to make any other payments until zoning changes have been made. This transaction should be accounted for using which of the following accounting methods?
- Financing arrangement.
 - Deposit.
 - Performance-of-services.
 - Leasing arrangement.
18. Which of the following accounting methods should be used if Izzie, in the example above, guarantees a return on Lola's investment for an extended period?
- Leasing.
 - Deposit.
 - Installment.
 - Cost recovery.

Lesson 2: Seller Financing and Other Special Real Estate Sales Issues

INTRODUCTION

Accounting for Continuing Seller Involvement

A key aspect of determining whether the risks and rewards have been transferred is determining the extent of the seller's continuing involvement with the property. The nature and extent of that involvement determine the accounting method used to account for the sale. Methods commonly used when the seller has significant continuing involvement include the following:

- Financing, leasing, or profit-sharing arrangement.
- Percentage-of-completion (performance-of-services) method.
- Deposit method.

Learning Objectives:

Completion of this lesson will enable you to:

- Assess if specific conditions are met for constant seller involvement.
- Plan for the specific issues that may be encountered in real estate sales.

Seller Has a Repurchase Obligation or Option

Some sales contracts require or allow the seller to repurchase the property at a specified price at some future date. A similar arrangement exists if the buyer has the option (for example, a put option) to force the seller to repurchase the property. Such arrangements are considered repurchase obligations or options. On the other hand, the following arrangements are not considered repurchase options or obligations:

- *Right of First Refusal.* A right of first refusal based on a bona fide offer from a third party.
- *Antispeculation Clauses.* Antispeculation clauses typically either (a) require the buyer to develop the property (usually land) in a specific way or within a certain period or (b) prohibit the buyer from using the property for some specified purpose. If the buyer fails to comply with such clauses, the seller has the right to repurchase the property. According to FASB ASC 360-20-40-39 (formerly EITF Issue No. 86-6, "Antispeculation Clauses in Real Estate Sales Contracts") such clauses are not considered repurchase options (and sale recognition is not precluded) if the likelihood of the buyer's failure to comply is considered remote.

Accounting Considerations. If a sale agreement gives the seller a repurchase option or obligation, the transaction should generally be accounted for as follows:

- *Financing Arrangement*, if the repurchase price is higher than the sale price.
- *Leasing Arrangement*, if the repurchase price is lower than the sale price.

Buy-sell Clauses. When two investors enter into a corporate joint venture (or other jointly-owned entity) and one investor sells land to that entity, a buy-sell clause may be included in the terms of the agreement. A buy-sell clause gives both investors the ability to buy the other investor's interest. Generally, a buy-sell clause can be executed at any time, but it may also be restricted to a specified date. When executed, the buy-sell clause provides the ability to (a) buy the other investor's interest or (b) sell the held interest to the other investor, but once an offer is made, both parties are contractually required to buy/sell the interest at the amount offered—generally at a contractually

specified amount, fair value, or at an amount determined by the offeror. If the investor who sold the land (seller) to the corporate joint venture is able to repurchase the land through use of a buy-sell provision, is the seller prohibited from recognizing profit on the sale under SFAS No. 66 due to continued involvement?

FASB ASC 360-20-55-21A (formerly EITF Issue No. 07-6, "Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66 When the Agreement Includes a Buy-Sell Clause") states that a buy-sell clause is not automatically considered a prohibited form of continuing involvement, but that provisions of the clause should be evaluated with respect to the relevant facts and circumstances of the transaction at the time the real estate is sold. However, upon evaluation, if the buy-sell clause either (a) gives the seller an *in-substance option* to acquire the other investor's interest in the corporate joint venture or (b) gives the other investor an *in-substance option* to put its interest in the corporate joint venture back to the seller, the seller is considered to have significant continuing involvement, precluding partial sale and profit recognition

Buyer Merely Has an Option to Buy the Property

Some sales agreements are structured as sales but, in effect, only give the buyer an option to buy the property. For example, the buyer may make only a token down payment and is not required to make any more payments until certain contingencies are resolved (such as, zoning changes are made or building permits are obtained). Such transactions generally should be accounted for using the deposit method, and, accordingly, the proceeds of the sale should be credited to a deposit liability account and recognized in income either when the option is exercised or when it expires. To illustrate, assume that an option to buy land for \$500,000 is sold for \$50,000. The sale of the option is recorded by debiting cash and crediting the deposit liability for \$50,000. If the land cost \$400,000, the following entry would record the exercise of the option:

Cash	\$	450,000	
Deposit liability		50,000	
Gain on sale of land			\$ 100,000
Land			400,000

If the option expired, the following entry would be made:

Deposit liability	\$	50,000	
Revenue from sale of option			\$ 50,000

Seller Guarantees the Buyer's Investment or a Specific Return

If the seller guarantees the buyer's investment (that is, guarantees the return of the buyer's investment) or guarantees a specific return on the buyer's investment (for example, guarantees cash flows or tax benefits), FASB ASC 360-20 (formerly SFAS No. 66) specifies the following accounting:

- a. Financing, leasing, or profit-sharing arrangement if the seller either—
 - (1) Guarantees a return of the buyer's investment, even if the guarantee is only for a specified period of time, or
 - (2) Guarantees a return on the buyer's investment for an extended period.
- b. Deposit method if the seller guarantees a return on the buyer's investment for a limited period. However, if the net cash flows from the property are adequate to cover operating expenses, debt service payments, and other contractual payments (such as management fees), the performance-of-services method should be used.

Thus, if the seller guarantees a specific return on the buyer's investment, the accounting method to be used depends on the length of the guarantee period. FASB ASC 360-20 does not explain how to distinguish between an extended and a limited period in those circumstances; that matter is left to the accountant's judgment. Conceptually, the accounting method used should reflect the economic substance of the transaction. In other words, if the transaction is in substance a sale, the transaction should be accounted for following the requirements for a

limited-period guarantee; otherwise, the transaction should be accounted for following the requirements for an extended-period guarantee. Generally, the longer the guarantee period, the less likely the transaction is, in substance, a sale.

Seller Continues to Support or Operate the Property

A seller may sometimes agree to continue to support the property after the sale rather than guarantee the buyer's investment or a specific return. The support obligation may not necessarily be stated in the sales agreement. It may be imposed on the seller in other ways, such as the following:

- a. *Management Contract.* The seller agrees to manage the property under a noncancelable, long-term management contract, and the terms of the contract impose obligations on the seller beyond those of a typical property manager (for example, funding operating deficits). (Also, similar to a management contract, if the seller of a time-share operates a points program or similar program on behalf of the buyer, the operation of the program represents continuing involvement by the seller.) When the sale is recognized, the sales value is reduced by the value of the management services (in excess of the compensation to be received) so that the value of the services is recognized in future periods when they are provided.
- b. *Partial Ownership.* The seller retains a partial ownership interest in the property, and the seller will be required to support operations to an extent greater than its proportionate interest.
- c. *Significant Receivable.* The seller holds a significant receivable from the buyer, and collection of the receivable depends on the operations of the property (for example, when the note is payable as operations permit).
 - (1) A receivable is considered significant if it exceeds 15% of the maximum first mortgage loan that could be obtained from an independent financial institution.
 - (2) To determine whether the seller's receivable is significant, all funds provided directly or indirectly by the seller should be considered, including:
 - (a) *Construction Loans* made or committed to by the seller. If the buyer has a permanent loan commitment from an independent financial institution and the seller has no liability on the loan commitment, the amount of the construction loan should be reduced by the minimum amount of that loan commitment in determining "significance."
 - (b) *All-inclusive (Wraparound) Loans Receivable* held by the seller in excess of loans secured by the property for which the seller is not liable. It is believed that all of the seller's receivable generally will be subjected to the 15% test to determine whether it is significant because, in the customary wraparound arrangement, the seller holds a note receivable from the buyer, and a portion of the buyer's payments on that note are restricted to payments on a note that is secured by the property and recorded by the seller.
 - (c) *Present Value of a Land Lease* if the seller is the lessor.

When sellers have substantial support or similar obligations, they generally retain most of the risk of owning the property. The accounting method to be used in such instances depends primarily on whether the support period is extended or limited.

Extended Support Period. If the seller has a support or management obligation for an extended period, FASB ASC 360-20-40-43 (formerly SFAS No. 66, paragraph 29) states that the transaction should be accounted for as a financing, leasing, or profit-sharing arrangement. (Thus, the accounting required for an obligation to support operations for an extended period is the same as the accounting required for a guarantee of a return on the buyer's investment for an extended period.)

The following criteria is recommended for determining which of the three methods to use:

- *Profit-sharing Arrangement*, if the seller continues to have a direct or indirect ownership interest in the property.

- *Leasing Arrangement*, if the transaction is primarily a lease of the land and other part of the property.
- *Financing Transaction*, in other cases.

It is believed that profit-sharing, leasing, or financing accounting should be used until the remaining support period would be considered to be limited period of time. When that condition is met, the guidance in the following paragraphs regarding limited support periods applies.

Limited Support Period. If the support obligation is for a limited period, the gain on sale should be recognized using the performance-of-services method over the support period. However, before any profit can be recognized, there should be reasonable assurance that future rent receipts will be sufficient to cover operating expenses, debt payments (including payments on the seller's receivable), and other contractual obligations. The deposit method should be used until that point (that is, reasonable assurance of future break-even operations) is reached. For purposes of that test, future rent receipts should be determined using the greater of the following:

- *Signed Leases.* Future rent receipts may be computed based on signed leases currently in effect.
- *Market Data.* Future rent receipts may be estimated based on current occupancy and rental rates in the area. However, FASB ASC 360-20 requires such estimated receipts to be reduced by $\frac{1}{3}$ as a "safety factor."

Thus, the accounting required for a guarantee to support operations for a limited period differs from the accounting required for a guarantee of a return on the buyer's investment for a limited period. If the guarantee is for support of operations, the performance-of-services method is used immediately, provided that there is reasonable assurance of future break-even operations. If the guarantee is for a return on the buyer's investment, the deposit method is used until operations actually break even; then the performance-of-services method is used.

Determining Whether the Support Period Is Extended or Limited. Similar to the instances involving seller guarantees, FASB ASC 360-20 does not state specifically how to distinguish between extended and limited support periods. Thus, if the transaction is in substance a sale, it should be accounted for following the requirements for guarantees of support for a limited period; otherwise, the transaction should be accounted for following the requirements for guarantees of support for extended periods. Generally, the longer the support period, the less likely the transaction is in substance a sale.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. The antispeculation clause requires which of the following?
- a. The buyer to develop the property in a specific way.
 - b. The seller to repurchase the property.
 - c. The seller to develop the property in a specific way.
 - d. The buyer to pay an amount each year that is equal to the annual principal.
21. Which of the following statements regarding what happens when a seller continues to support or operate the property after a sale is most accurate?
- a. If a seller continues to support or operate the property after the sale, the support obligation must be stated in the sales agreement.
 - b. The buyer generally will retain most of the risk of owning the property, even if the seller continues to operate the property.
 - c. The seller can continue to manage the property under a noncancelable long-term management contract.
22. Which of the following statements best describes continuing seller involvement?
- a. If the seller has the right of first refusal when the buyer sells the property, it is considered to be a repurchase option.
 - b. The transaction should be accounted for as a financing arrangement if the buyer has an option to repurchase the property for a price higher than the original sale price.
 - c. If the seller guarantees an 8% return from the property for an extended period, the deposit should be used to account for the transaction.
 - d. If a transaction is in substance a sale, it should be accounted for following the requirements for guarantees of support for a limited period.
23. Which of the following accounting methods should be used if the seller has support or management obligation for a limited period?
- a. Leasing arrangement.
 - b. Performance-of-services.
 - c. Deposit.
 - d. Financing.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. The antispeculation clause requires which of the following? **(Page 41)**
- a. **The buyer to develop the property in a specific way. [This answer is correct. The antispeculation clauses typically either require the buyer to develop the property in a specific way or within a certain period, or prohibit the buyer from using the property for some specified purpose.]**
 - b. The seller to repurchase the property. [This answer is incorrect. Clauses like the antispeculation clauses are not considered repurchase options.]
 - c. The seller to develop the property in a specific way. [This answer is incorrect. For the seller to develop the property in a specific way, the percentage-of-completion method of accounting is typically used. The antispeculation clauses do not support the seller developing the property.]
 - d. The buyer to pay an amount each year that is equal to the annual principal. [This answer is incorrect. This is the definition of an installment sale.]
21. Which of the following statements regarding what happens when a seller continues to support or operate the property after a sale is most accurate? **(Page 43)**
- a. If a seller continues to support or operate the property after the sale, the support obligation must be stated in the sales agreement. [This answer is incorrect. The seller is not required to state the support obligation in the sales agreement. This is only an option.]
 - b. The buyer generally will retain most of the risk of owning the property, even if the seller continues to operate the property. [This answer is incorrect. When sellers continue to substantially support property after a sale, the seller generally will retain most of the risk of owning the property.]
 - c. **The seller can continue to manage the property under a noncancelable long-term management contract. [This answer is correct. The seller can agree to manage the sold property under a noncancelable, long-term management contract. The terms of the contract impose obligations on the seller beyond those of a typical property manager.]**
22. Which of the following statements best describes continuing seller involvement? **(Page 43)**
- a. If the seller has the right of first refusal when the buyer sells the property, it is considered to be a repurchase option. [This answer is incorrect. Some sales contracts require or allow the seller to repurchase the property at a specified price at some future date. The right of refusal is an arrangement that is not considered a repurchase option or obligation.]
 - b. The transaction should be accounted for as a financing arrangement if the buyer has an option to repurchase the property for a price higher than the original sale price. [This answer is incorrect. If the repurchase price is higher than the sale price, the financing arrangement should be used.]
 - c. If the seller guarantees an 8% return from the property for an extended period, the deposit should be used to account for the transaction. [This answer is incorrect. If the seller has a support or management obligation for an extended period, FASB ASC 360-20-40-43 (formerly SFAS No. 66, paragraph 29) states that the transaction should be accounted for as a financing, leasing, or profit-sharing arrangement.]
 - d. **If a transaction is in substance a sale, it should be accounted for following the requirements for guarantees of support for a limited period. [This answer is correct. If the transaction is in substance a sale, it should be accounted for following the requirements for guarantees of support for a limited period; otherwise, the transaction should be accounted for following the requirements for**

guarantees of support for extended periods. Generally, the longer the support period, the less likely the transaction is in substance a sale. As a rule of thumb, some accountants define an extended period as one that is longer than five years.]

23. Which of the following accounting methods should be used if the seller has support or management obligation for a limited period? **(Page 44)**
- a. Leasing arrangement. [This answer is incorrect. The leasing arrangement method of accounting is used for management obligation for an extended period.]
 - b. Performance-of-services. [This answer is correct. If the support obligation is for a limited period, the gain on sale should be recognized using the performance-of-services method over the support period.]**
 - c. Deposit. [This answer is incorrect. Before any profit can be recognized, there should be reasonable assurance that future rent receipts will be sufficient to cover operating expenses, payments on the seller's receivable (debt payments), and other contractual obligations. The deposit method should be used until reasonable assurance of future break-even operations is reached.]
 - d. Financing. [This answer is incorrect. The financing method of accounting should be used when the seller has a support or management obligation for an extended period.]

What If No Support Period Is Stated in the Contract? If the contract does not specify the support period, FASB ASC 360-20-40-43 (formerly paragraph 30 of SFAS No. 66) states that the performance-of-services method should be used to recognize the gain over a period at least two years beyond the date that rental operations begin. However, if *actual* rent receipts become sufficient to cover operating expenses, debt service, and other contractual payments before the two-year period ends, profit may be recognized at the earlier date.

Seller Is Obligated for Development or Construction

Transactions that obligate the seller to develop the property, build facilities on the land, or provide off-site improvements or amenities are similar to those involving support obligations. The development or construction obligation may be directly written into the contract, or it may be presumed if either—

- The buyer cannot repay the seller for the work to be done.
- The buyer has the right to delay payments on the seller's receivable until the work is done.

Recognizing Gain. When the seller is obligated for development or construction, the accounting method to be used for the arrangement depends on whether the development or construction costs can be reasonably estimated.

- a. *Costs Can Be Reasonably Estimated.* If development or construction costs can be reasonably estimated from the seller's previous experience, FASB ASC 360-20 (formerly SFAS No. 66) states that the gain should be recognized as follows:
 - Step 1** Allocate the gain attributable to the land and to the development or construction activities based on the relative estimated costs of each. Allocate the gain attributable to development or construction activities between work done before the sale and work to be done after the sale.
 - Step 2** Recognize the gains allocated to the land sale and the development or construction work done before the sale when the sale of the land meets the conditions for using the full accrual method.
 - Step 3** Recognize the gain allocated to the development or construction activities to be done after the sale using the percentage-of-completion method.
- b. *Costs Cannot Be Reasonably Estimated.* FASB ASC 360-20-40-43 (formerly paragraph 42 of SFAS No. 66) states only that no profit should be recognized at the date of sale. It does not state what method should be used. The situation is similar to that of a construction contractor who is unable to estimate the costs of a construction contract, and the authors believe that similar accounting should apply.

Special Considerations for Land Developers. Developers who develop land tracts into residential or commercial lots for individual sale may have either the intent or the obligation to build amenities (such as a park or artificial lake) or off-site improvements (such as access roads or utility connections) to make the lots usable or to enhance their value. Normally, lots are not sold before the off-site improvements are substantially complete, but lots may be sold before the amenities are complete. In fact, some large amenities (such as, a golf course and country club) may not be completed until a certain number of lots are sold. When remaining costs and potential risks are insignificant, some developers may use alternative methods that are similar to the percentage-of-completion method.

Seller Retains a Partial Ownership Interest

What Are Partial Sales? Partial sales are those in which the seller keeps an ownership interest in the property or has an ownership interest in the buyer. Examples of partial sales include the following:

- Sale of property to a joint venture owned 50% by the seller.
- Sale of an undivided interest in a wholly-owned property to a third party.

- Sale of property to a limited partnership in which the seller is a general partner.

The guidance on partial sales does not apply to sales between companies under common control (such as brother-sister companies).

Accounting for Partial Sales. The method for recognizing the gain on partial sales depends on the following factors:

- Relationship between the buyer and seller.
- Extent of post-sale involvement by the seller.
- Collectibility of the sales value.

The first factor primarily determines the amount of gain to be recognized, and the other two factors determine how that gain is recognized. (The following guidance assumes that the sale has been completed as discussed earlier in this lesson.)

Relationship between Buyer and Seller. The relationship between the buyer and seller primarily affects the amount of gain to be recognized. The accounting issues involve the seller's accounting for the sale and the seller's accounting for its interest in the buyer. FASB ASC 320-20 (formerly SFAS No. 66) prescribes the accounting for the partial sale. The accounting for the seller's investment depends on whether the investor has control or the ability to exercise significant influence over the financial and operating policies of the investee. If the seller controls the buyer, consolidation is required. However, if the seller does not control the buyer, but is able to exercise significant influence over operating and financial policies of the buyer, the seller must use the equity method of accounting to account for its investment. Equity method accounting guidance is segregated by the legal form of the investee as follows:

FASB ASC 323, *Investments—Equity Method and Joint Ventures*, provides equity method accounting guidance for investments in corporate entities that was formerly in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

FASB ASC 970-323, *Real Estate—General—Investments—Equity Method and Joint Ventures*, provides equity method accounting guidance for investments in undivided interests in real estate and in general and limited partnerships that was formerly in SOP 78-9, *Accounting for Investments in Real Estate Ventures*.

FASB ASC 810, *Consolidation*, provides consolidation accounting guidance for investments in corporate entities and primarily consists of the former accounting pronouncements: ARB No. 51, *Consolidated Financial Statements* (as amended by SFAS No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*), and FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*.

The following examples summarize the accounting required in various scenarios:

- The Seller Is Independent of the Buyer (But Still Owns an Interest in the Property).* If the real estate is subject to the joint control of the owners, which is the most common form, the accounting is the same as for an equity method investment. Therefore, the real estate is removed from the seller's assets, the seller records an investment in the venture for its basis in the remaining real estate, and the gain to be recognized is the sales value less a pro rata portion of the cost of the property. See Example 1-1.
- The Seller Has a Noncontrolling Ownership Interest in the Buyer.* Generally the equity method to be used to account for the investment. Accordingly, the seller recognizes gain for the pro rata portion of the total gain on the sale based on the extent of third-party ownership and defers the remainder. The deferred gain is recognized in future years as the investee recognizes earnings from the land. (For example, if the investee develops the land and sells lots, the investor recognizes its deferred gain as the investee sells the lots.)

FASB ASC 360-20-40-40 (formerly SFAS No. 66, paragraph 27) provides an exception to the preceding rules, however, if the seller is a general partner in a limited partnership that acquires an interest in the

property sold (or has an extended, noncancelable management contract requiring similar obligations) and holds a significant receivable from the buyer for part of the sales price. In that case, the transaction should be accounted for as a financing, leasing, or profit-sharing arrangement. See Example 1-2.

- c. *The Seller Controls the Buyer.* If the seller controls the buyer, no gain should be recognized until it is realized through either (1) sale to an independent third party or (2) profits from continuing operations. The seller is required to record the sale at the seller's book value and to consolidate the financial statements of controlled entities. See Example 1-3.

Example 2-1: The seller is independent of the buyer but still owns an interest in the property.

A realtor sells a 40% interest in land that has a book value of \$500,000 to a developer. The land is to be developed as residential lots and sold to homebuilders. All decisions regarding the development and sale of the land are to be made jointly. The selling price is \$250,000. If the other gain recognition conditions are met, the seller would recognize a gain on the sale to the outside interests of \$50,000 [$\$250,000 - (\$500,000 \times 40\%)$] and record the sale through the following entry:^a

Cash	\$ 250,000	
Investment in joint venture	300,000	
Land		\$ 500,000
Gain on sale		50,000

Note:

- ^a In the rare situation when an undivided interest is sold without joint control or joint liability, the sale is recorded as a sale of real estate, and the remaining land is reported by the seller at its book value. In this example, the sale would have been recorded as follows:

Cash	\$ 250,000	
Land		\$ 200,000
Gain on sale		50,000

Example 2-2: The seller has a noncontrolling ownership interest in the buyer.

The seller sells land with a book value of \$100,000 for \$400,000 cash to a partnership in which the seller has a noncontrolling $\frac{1}{3}$ interest. Assuming the conditions for gain recognition are met, the seller would recognize a gain of \$200,000 [$(\$400,000 - \$100,000) \times \frac{2}{3}$], and the remaining gain would be deferred. The following entry would record the sale:

Cash	\$ 400,000	
Land		\$ 100,000
Gain on sale		200,000
Deferred gain		100,000

The deferred gain would be recognized as the investee recognizes revenue from the land. For example, if the partnership sells 30% of the land during the first year, the seller would recognize 30% of the deferred gain.

Example 2-3: The seller controls the buyer.

Seller sells land with a book value of \$200,000 for \$300,000 to a limited partnership in which the seller is the sole general partner, is assigned control by the partnership agreement, and is allocated 30% of the profits. The seller would defer all of the gain and record the sale as follows:

Cash	\$ 300,000	
Land		\$ 200,000
Deferred gain		100,000

No sale would be recorded by the consolidated entity, which would report the land at its book value of \$200,000 by making the following elimination entry:

Deferred gain	\$ 100,000	
Land		\$ 100,000

If 40% of the land is sold in Year 1 for a gain of \$60,000, the investor would be allocated \$18,000, which is 30% (the investor's allocation percentage) of \$60,000. The investor also would recognize \$40,000 of the deferred gain, which is 40% of the total deferred gain of \$100,000, since 40% of the gain is realized through sales to third parties. The investor would record the following entry:

Investment in partnership	\$ 18,000	
Deferred gain	40,000	
Earnings on investment in partnership		\$ 18,000
Gain		40,000

The consolidated entity would report a total gain of \$100,000 in Year 1, of which \$42,000 would be assigned to the limited partners as noncontrolling interests (70% of the \$60,000 gain on the sale to third parties). The remaining land would be recorded at \$120,000, which is 60% of its original book value of \$200,000. Thus, the consolidated entity would make the following elimination entry:

Deferred gain	\$ 60,000	
Equity in earnings of partnership	18,000	
Land		\$ 60,000
Investment in partnership		18,000

Generally there is a presumption that ownership of more than 20% of the investee provides it with the ability to exercise significant influence. FASB ASC 325-10 (formerly FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*) provides guidance on determining whether the investor has the ability to exercise significant influence over corporate investees, and FASB ASC 970-323 (formerly SOP 78-9) provides guidance on determining whether the investor controls or has the ability to exercise significant influence over noncorporate investees.

Extent of Seller Involvement. In a partial sale, the seller may be required to provide support after the sale. The accounting considerations are the same as for sales that are not considered to be partial sales. The following summarizes the general considerations that are discussed earlier in this lesson:

- If the seller's post-sale involvement is limited, the sale may be recognized, but the portion of the sales value related to future involvement should be deferred and recognized when the costs of that involvement are incurred. The gain recognized at the date of sale is the remaining sales value less the costs incurred through the date of sale.
- If the seller's post-sale involvement is not limited, the transaction is not in substance a sale. The transaction should be accounted for as a financing, leasing, or profit-sharing arrangement.

According to FASB ASC 360-20 (formerly SFAS No. 66), sellers may provide support to the extent of their ownership interest, and it is reasonable that only the excess should be considered to be seller involvement. For example, if the seller retains a 20% interest in the property, only a support obligation in excess of 20% of the property's operating deficits should be considered seller involvement.

Seller Is Independent of the Buyer but Owns an Interest in the Property. If a seller owns an interest in the property but has no support obligations, full accrual accounting is appropriate provided the other conditions for full accrual gain recognition are met. For example, if a developer sells a realtor a 40% interest in a developed tract, the developer can recognize its gain at the date of sale using the full accrual method, providing the other conditions are met. Seller involvement in excess of its 40% interest may either preclude sale recognition or require deferral of a portion of the sales value.

Seller Has a Noncontrolling Interest in the Buyer. If the seller has a noncontrolling interest in the buyer and has no support obligations, gain equal to the majority interest in the buyer is recognized at the date of sale. To illustrate, assume that land with a book value of \$300,000 is sold for \$500,000 to a partnership in which the seller is a limited partner and is allocated 20% of partnership profits. The partnership expects that operating deficits will total

\$400,000 over the next two years, which must be funded proportionately by each partner. After two years, the general partner will cover any deficits. Thus, the seller is expected to cover operating deficits of \$80,000 (total expected deficits of \$400,000 $\times$ 20%), but the seller's responsibility for those deficits is as an investor rather than a seller that has agreed to provide support. Accordingly, the seller's responsibility for deficits is not considered in calculating the gain on the sale. The gain on the sale is \$200,000, which is the excess of the sales value of \$500,000 over the book value of the land of \$300,000. However, 20% of the gain, or \$40,000, should be deferred until it is realized from transactions with outside parties through sale or operations of the property. The following journal entry would be made to record the sale:

Cash	\$ 500,000	
Gain on sale of land		\$ 160,000
Deferred gain		40,000
Land		300,000

If the seller has the ability to exercise significant influence over the partnership, the equity method should be used to account for its investment, and the payments to cover operating deficits should be recorded through a debit to the seller's share of partnership loss and a credit to cash for \$80,000. Otherwise, the cost method should be used to account for the investment, and payments will be recorded through a debit to the investment and a credit to cash for \$80,000.

If the seller's obligation for support is greater than its responsibility as an investor, the rules in FASB ASC 360-20 for support obligations should be considered. If the support is for an extended period of time, the transaction is accounted for as a financing, leasing, or profit-sharing arrangement.

To illustrate, assume that land with a book value of \$300,000 is sold for \$500,000 to a partnership in which the seller is a limited partner and is allocated 20% of partnership profits. The partnership expects that operating deficits will total \$400,000 over the next two years, of which 45% must be funded by the seller. After two years, the general partner will cover any deficits. Thus, the seller is expected to cover operating deficits of \$180,000 (total expected deficits of \$400,000 $\times$ 45%). The seller would normally be expected to absorb only operating deficits of \$80,000, which is 20% of the total deficit. The \$100,000 excess should be considered to relate to seller involvement. Total costs of the sale are \$400,000, consisting of the book value of \$300,000 plus the excess deficit responsibility of \$100,000. Based on the ratio of costs incurred to total estimated costs, the sales value should be allocated \$375,000 to costs incurred and \$125,000 to future support obligations. A gain of \$75,000 should be recognized at the date of sale, which is the difference between the allocated sales value of \$375,000 and the book value of \$300,000. However, 20% of the gain, or \$15,000, should be deferred until it is realized from transactions with outside parties through sale or operations of the property. The following journal entry would be made to record the sale:

Cash	\$ 500,000	
Gain on sale		\$ 60,000
Deferred gain		15,000
Deferred revenue		125,000
Land		300,000

If the seller has the ability to exercise significant influence over the partnership, the equity method should be used to account for its investment as follows:

Cost of support obligations	\$ 100,000	
Share of partnership loss	80,000	
Deferred revenues	125,000	
Revenue		\$ 125,000
Cash		180,000

If the seller does not have the ability to exercise significant influence, the cost method should be used to account for its investment in the partnership, and the following entry would be made to record the payments:

Cost of support obligations	\$	100,000	
Investment in partnership		80,000	
Deferred revenues		125,000	
Revenue			\$ 125,000
Cash			180,000

Seller Controls the Buyer. If the seller has a controlling interest in the buyer and no support obligations, no gain is recognized at the date of sale, and deferred gain is recognized as the buyer recognizes revenue from the property. If the seller is obligated to provide support, the accounting treatment depends on whether the support obligation is for a limited or extended period. If the seller's support obligation is for a limited period, there are two deferrals: (a) the sales value related to the support obligation is deferred and (b) the excess of the remaining sales value over costs incurred through the date of sale is recorded as a deferred gain. The deferred sales value related to the support obligation is recognized when the costs of fulfilling the obligation are incurred, and the deferred gain is recognized when the buyer recognizes income from the property.

To illustrate, assume that land with a cost of \$100,000 is sold for \$180,000 to a partnership that is controlled by the seller. The seller agrees to fund excess operating deficiencies for the first two years at an estimated cost of \$50,000. The gain on the sale is \$30,000, which is the total sales value of \$180,000 less the cost of the land of \$100,000 and estimated future costs of \$50,000. Costs of the support obligation are one-third of total costs; thus, revenue of \$60,000 should be deferred (total sales value of \$180,000 $\times$ $\frac{1}{3}$). The deferred revenue should be recognized as the costs of the support obligation are incurred. However, the revenue recognized by the partnership for the payments would be eliminated against the related seller's cost in the consolidated financial statements, so the intercompany support would have no effect on the consolidated financial statements. The gain on the sale of the land is \$20,000 (total sales value of \$180,000 less sales value of \$60,000 allocated to the future support obligation and less the cost of the land of \$100,000). The entire \$20,000 gain on the sale should be deferred and recognized as the partnership recognizes income from the property (that is, when the consolidated entity would recognize the income). The following journal entry would be made to record the sale:

Cash	\$	180,000	
Deferred revenue			\$ 60,000
Deferred gain			20,000
Land			100,000

The following entry would be made to record the fulfillment of the support obligation:

Deferred revenue	\$	60,000	
Cost of support obligations		50,000	
Revenue			\$ 60,000
Cash			50,000

If the support obligation is for an extended period, a sale is not reported, and the transaction is accounted for as a financing, leasing, or profit-sharing arrangement.

CONSIDERATIONS WHEN THE SELLER PROVIDES FINANCING

Choosing the right method to account for a real estate sale is more complex when either:

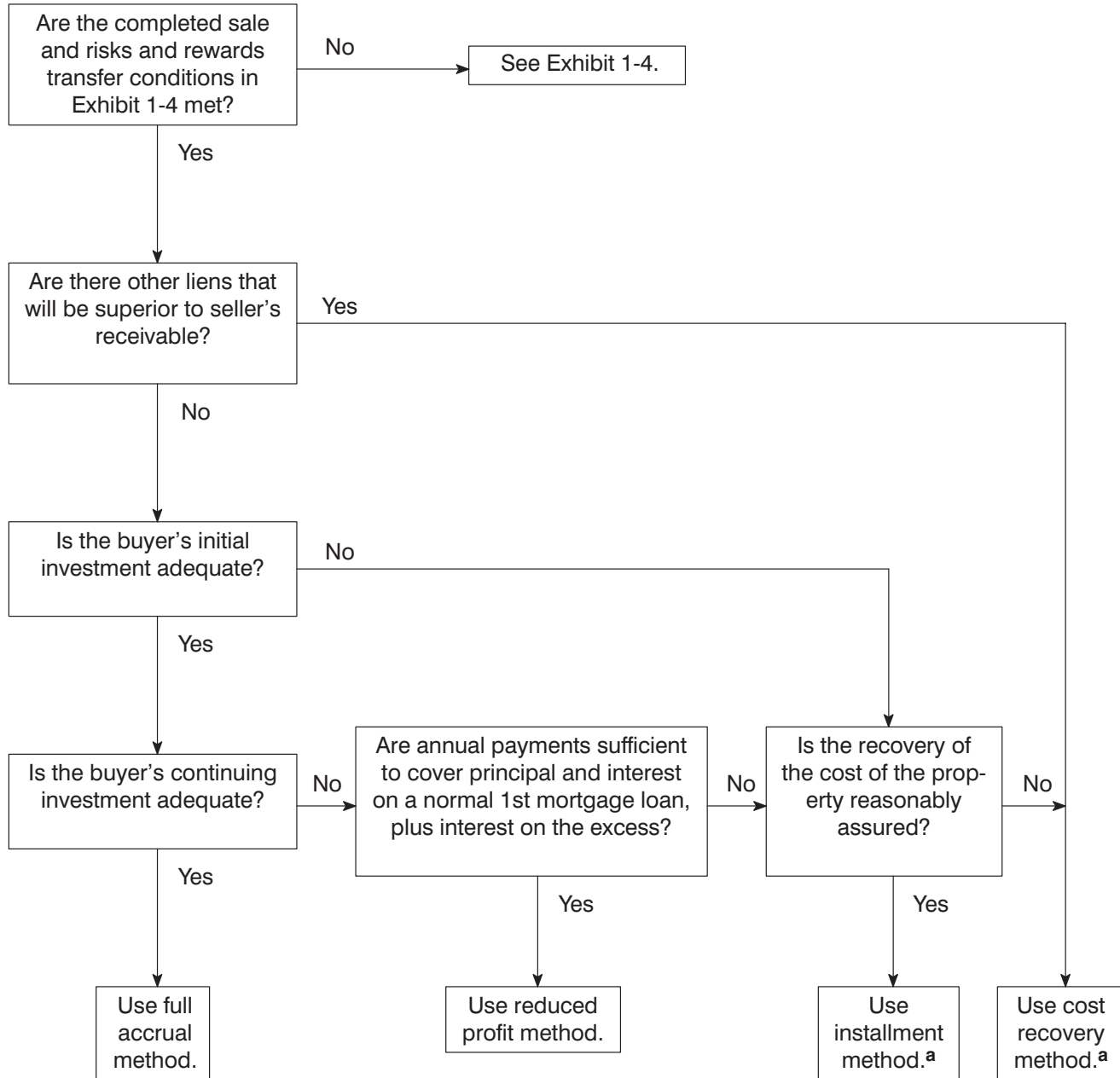
- The seller finances a portion of the sales value through direct loans or by guaranteeing or collateralizing loans from third parties.
- The seller has liability (either direct or contingent) for existing debt on the property that is assumed by the buyer (for example, existing debt assumed by the buyer without the seller being released from liability).

Those circumstances raise the issues of whether the sales value will be collected and whether the seller's investment in the property is recoverable. FASB ASC 360-20 (formerly SFAS No. 66) provides for different accounting methods to be used depending on the degree of uncertainty about the collectibility of the sales value and the recoverability of the seller's investment.

Exhibit 2-1 shows the considerations required by FASB ASC 360-20 in the preceding situations. Those considerations are discussed in more detail in the following paragraphs.

Exhibit 2-1

Considerations When the Seller Provides Financing



Note:

- ^a According to FASB ASC 360-20 (formerly SFAS No. 66), the cost recovery method may be used anytime the installment method is appropriate, and the deposit method can be used either (a) if recovery of the seller's investment is uncertain if the buyer defaults or (b) if the seller recovers its investment at closing, but collection of additional amounts is uncertain.

* * *

Does the Seller Have a Superior Lien?

According to FASB ASC 360-20 (formerly SFAS No. 66), the seller should have a superior lien to all other debt on the property, except the following:

- An *existing loan* at the date of sale.
- Any *future loan* that is provided for in the sales agreement, *if* the proceeds of that debt will be applied first to pay the seller's receivable.

Generally, the seller has a superior lien if it has a bona fide first lien that has been filed with the appropriate government officials. That condition is not met, however, in either of the following circumstances:

- The seller has a second lien behind other loans, except those listed above.
- The seller has agreed to allow a future loan to have a first lien (or other lien ahead of the seller's receivable), except for the loans listed above.

If the lien superiority condition is not met, the seller's receivable is considered to be "subject to future subordination." In such cases, the seller does not have the first right to the property if the buyer defaults. Consequently, recoverability of the seller's investment in the property is not assured. FASB ASC 360-20 requires the cost recovery method to be used when the lien superiority condition is not met.

Considering the Buyer's Investments

The collectibility of the sales value is assessed primarily based on the buyer's investments. FASB ASC 360-20 (formerly SFAS No. 66) states that the buyer's initial and continuing investments must be adequate to show that the buyer is committed to pay for the property. The Standards establish both the required form and size of those investments. The requirements were based on normal lending standards of financial institutions at the time the original accounting standards were developed. The rationale is that the buyer's investment on seller financed sales should be at least equal to the investment required under sales financed by independent, established lenders.

What Constitutes the Buyer's Investment? Normally, the initial investment is the buyer's down payment, and the continuing investment represents the payments made on the seller's receivable over the loan term. But those payments can be made in forms other than cash. Exhibit 2-2 shows the forms of investment that can be considered part of the buyer's investment under FASB ASC 360-20 as well as forms of investment that cannot be included.

Exhibit 2-2**Forms of the Buyer's Investment^a**

Forms That CAN Be Considered Part of the Buyer's Investment	Forms That CANNOT Be Considered Part of the Buyer's Investment
• Cash. [¶ 40-10; ¶ 9] • Payments by the buyer to third parties to reduce existing debt against the property. [¶ 40-10; ¶ 9] • Additional proceeds paid in cash that are part of sales value. • Notes payable to the seller, backed by letters of credit from an independent financial institution. [¶ 40-10; ¶ 9] • Notes payable to the seller, backed by surety bonds that have all the rights and obligations of irrevocable letters of credit (that is, if surety bonds give the seller the same rights of collection, place the same obligation to pay on the surety, and give the surety the same recourse to the buyer if the buyer defaults). [¶ 40-10; ¶ 9] • Other consideration that has been converted to cash without recourse to the seller. [¶ 40-10; ¶ 9]	• Payments by the buyer for improvements to the property. [¶ 40-13; ¶ 10] • A permanent loan commitment by an independent third party to replace a loan made by the seller. [¶ 40-13; ¶ 10] • Any funds that have been loaned or otherwise provided (directly or indirectly) by the seller.^b [¶ 40-13; ¶ 10] • Loans obtained from third parties that have been guaranteed or secured by the seller for the buyer.^b [¶ 40-13; ¶ 10] • Loans obtained by the buyer from third parties, either directly or through assumption, and secured by the property. (It also includes payments to the seller that are funded by such loans.)^b [¶ 40-13; ¶ 10] • Notes payable to the seller backed by private mortgage insurance. [¶ 40-12; EITF 87-9] • Assets securing the buyer's note payable to the seller. [¶ 55-67; EITF 88-12] • Any portion of the buyer's down payment that is considered to apply toward payment of an incentive.^c FASB ASC 978-605-25-10;

Notes:

- ^a References in brackets are to paragraphs in FASB ASC 360-20 (formerly SFAS No. 66) unless otherwise noted.
- ^b FASB ASC 360-20-40-20 (formerly SFAS No. 66, paragraph 12) specifies that funds to be provided (directly or indirectly) by the seller should be subtracted from the buyer's investment in determining the adequacy of the buyer's initial and continuing investments. However, a future loan from an established lending institution need not be subtracted from the buyer's investment if (a) the loan has market terms, and (b) the loan proceeds are conditional on specified development or construction on the property.
- ^c FASB ASC 978 (formerly SOP 04-2) is only applicable for real estate time-sharing transactions.

* * *

Is the Initial Investment Adequate?

The minimum initial investment required under FASB ASC 360-20 (formerly SFAS No. 66) depends on whether there has been a recent permanent loan or loan commitment placed on the property for the maximum amount of financing available (that is, the largest amount that the institution normally would lend on that type of property). If

there has been no recent loan or commitment, the minimum required investment is a specified percentage of the sales value (defined in Exhibit 1-1). Exhibit 2-3 lists the percentage requirements specified in FASB ASC 360-20.

Exhibit 2-3

Table of Minimum Initial Investment

Type of Property	Percentage of Sales Value (See Exhibit 1-1)
<i>LAND</i> to be developed beginning:	
Within 2 years from sale date.	20%
After 2 years.	25
<i>SINGLE FAMILY HOMES, CONDOMINIUM UNITS, TOWNHOMES, AND 1–4 FAMILY RESIDENCES^{a, b}</i>	
Buyer's primary residence.	5
Buyer's secondary or recreational residence. ^c	10
<i>MULTI-FAMILY RESIDENTIAL PROPERTY</i>	
Primary residence:	
Current cash flow is adequate to cover all debt payments.	10
Cash flow is not adequate (including start-up situations).	15
Secondary or recreational residence:	
Current cash flow is adequate to cover all debt payments.	15
Cash flow is not adequate (including start-up situations).	25
<i>OFFICE BUILDINGS, SHOPPING CENTERS, INDUSTRIAL BUILDINGS, AND SIMILAR PROPERTIES</i>	
Current cash flow is adequate to cover all debt payments; property is subject to long-term leases to parties with good credit ratings.	10
Single-tenant properties sold to a buyer with a good credit rating.	15
All other.	20
<i>HOTELS, MOBILE-HOME PARKS, MARINAS, AND OTHER INCOME- PRODUCING PROPERTIES</i>	
Current cash flow is adequate to cover all debt payments.	15
Cash flow is not adequate (including start-up situations).	25

Notes:

- ^a If the sale is financed under an FHA or VA insured program, the normal down payment requirement can be used to determine the required initial investment.
- ^b If the remaining portion of the sales value is financed by the seller and collectibility of the seller's receivable cannot be supported by reliable evidence of collection experience, then the minimum initial investment must be at least 60% of the difference between the sales value and the maximum amount of financing available through FHA or VA insured programs or through independent financial institutions.
- ^c Although not stated in FASB ASC 360-20 (formerly SFAS No. 66) FASB ASC 978 (formerly or SOP 04-2), best practices indicate that time-share properties would fall under this category.

* * *

FASB ASC 360-20 (formerly SFAS No. 66) does not explain what a recent loan or commitment is. It is believed that a loan or commitment made over a year before the sale generally would not be considered recent. However, even a loan made within a year of the sale may not be recent if there have been significant changes in interest rates or lending conditions since the loan or commitment was made.

If an independent financial institution has recently placed a permanent loan or made a firm permanent loan commitment for the maximum amount of financing available, the initial investment requirement is the *greater* of the following:

- a. The value determined using the table in Exhibit 2-3
- b. The *lesser* of:
 - (1) 25% of sales value.

$$(2) \quad \text{Sales value} - \left[1.15 \times \begin{array}{l} \text{amount of the} \\ \text{recent permanent} \\ \text{loan or commitment} \end{array} \right]$$

As a general rule, the initial investment requirement will not be less than the table value determined using Exhibit 2-3, and it will not be larger than 25% of sales value.

What If the Initial Investment Test Is Not Met? If the initial investment test is not met, one of the following accounting methods generally should be used to recognize gain on the sale:

- a. *Installment Method.* The installment method is used when recovery of the seller's investment in the property is *reasonably assured*.
- b. *Cost Recovery Method.* The cost recovery method is used when either:
 - (1) Recovery of the seller's investment is uncertain.
 - (2) The seller's investment has already been recovered, and the recovery of the rest of the sales value is uncertain. (That situation normally occurs when the book value of the property sold is very small in relation to the sales value.)

FASB ASC 360-20-40-31 (formerly SFAS No. 66, paragraph 22) also states that the cost recovery method may be used anytime that the installment method is appropriate and that the deposit method may be used if either (a) the recovery of the seller's investment if the buyer defaults is not reasonably assured or (b) the seller recovers its investment at closing, but collection of additional amounts is uncertain. In practice, the preceding alternatives are seldom used, however, for the following reasons:

- Under the deposit method, a sale is not recorded; thus, the deposit method is used primarily only when the substance of the transaction is that a sale has not occurred.
- If the seller recovers its investment at closing, the profit recognized for future collections under the installment and cost recovery methods will not differ significantly.

Determining When Recovery Is Reasonably Assured. FASB ASC 360-20 does not explain how to determine when recovery of the seller's investment is reasonably assured. Determination should be based on the following factors:

- *Likelihood of Default.* This consideration should be based on the buyer's financial condition and credit history as well as the terms of the seller's receivable. For example, if the buyer has a strong financial condition, has a good credit history, and is unconditionally and fully liable on the note, the likelihood of default would be considered remote. In that situation, the buyer's financial condition and credit history

indicate that the buyer has the ability to make the required payments, and the recourse (or liability) provisions indicate that the buyer is legally obligated to perform on the note. Thus, recovery of the seller's investment can be considered reasonably assured.

- *Fair Value of the Property.* If the buyer defaults, the seller would recover its investment through repossessing the property. Accordingly, provided that the value of the property, after considering estimated costs to sell, is at least equal to the seller's investment (that is, the property's undepreciated cost at the time of sale), recovery of the seller's investment can be considered reasonably assured, and use of the installment method is appropriate.

Is the Continuing Investment Adequate?

FASB ASC 360-20 (formerly SFAS No. 66) requires the buyer to pay an amount each year that is at least equal to the annual principal and interest payment needed to amortize the total debt for the purchase of the property over the following period:

- For sales of land, 20 years.*
- For sales of other real estate (for example, land and a building sold together), the normal term of a first mortgage loan by an independent financial institution.*

The initial and continuing investment tests should be applied cumulatively when the sale is consummated and annually afterward. In other words, the total of the buyer's investment at the date of sale and at the end of each year thereafter must be adequate. If the initial investment is adequate and the continuing investment test is met on an annual basis, the requirements also will be met cumulatively.

In determining whether the continuing investment requirements are met, any excess of the initial investment over the required amount can be considered part of the buyer's continuing investment. Also, the excess continuing investment for one year can be carried over to the next year. However, as noted in Exhibit 2-2, the following amounts should be subtracted in determining the buyer's actual continuing investment:

- Funds directly or indirectly provided by the seller (for example, loans from the seller or loans guaranteed by the seller).
- Funds obtained through debt that is secured by the property.

What Interest Rate Should Be Used? FASB ASC 360-20 does not specify what interest rate to use in determining the annual interest payments required under the continuing investment test. It is believed that the goal of the continuing investment test is to compare the actual terms of the sale with those that would have been required if the buyer had obtained third-party financing.

What Constitutes a Normal Term? Another difficult area is determining what loan term should be used in applying the continuing investment test to property other than raw land. Real estate loans vary widely in length and payment terms. There are acquisition loans, construction loans, mini-perm loans (short or medium-term loans covering the period after construction is completed but before long-term financing is obtained), and permanent loans. Those loans typically have terms ranging from 20 to 30 years for new office or retail buildings and are amortized in regular loan payments rather than large balloon payments. However, it is generally good practice to talk to financial institutions in the area to determine the appropriate loan term for a given property.

Example of the Continuing Investment Test. To illustrate how to apply the continuing investment test, assume the following facts:

- Raw land is sold for \$500,000.
- Terms are:
 - \$150,000 down, interest only at 8% (\$28,000 per year) for nine years, which approximates a market rate of interest.

(2) The balance of \$350,000 plus interest due in the 10th year.

c. Development of the land will begin within two years from the sale date.

Exhibit 2-4 shows two alternative methods for comparing the cumulative required payments with the cumulative actual payments. Since the buyer's investment in Years 7–9 is less than the amount required under FASB ASC 360-20, the continuing investment test is not met. Accordingly, the total gain cannot be recognized on the accrual basis at the date of sale, and one of the accounting methods must be used. Note that a deficiency at the end of any year means that the continuing investment test is not met. Thus, if a schedule of required and actual payments is prepared, it is not necessary to extend it beyond the first negative year. (In other words, the schedules in Exhibit 2-4 would not need to extend beyond Year 7, the first year that the cumulative required payments exceed the cumulative actual payments.) As a practical matter, however, if the actual annual payments are level, it is possible to easily determine whether the continuing investment test is met without scheduling required and actual payments, as follows:

Excess of actual initial investment of \$150,000 over required initial investment of \$100,000	\$ 50,000
Divided by the excess of required annual payments of \$35,600 over actual annual payments of \$28,000	77,600
Number of years before the required investment exceeds the actual investment	6.58

Since 6.58 years is less than the actual payout terms of the note (10 years), the continuing investment test is not met.

Exhibit 2-4

Example of the Continuing Investment Test

Alternative 1

Year	Required Investment		Actual Investment		Excess (Deficiency)
	Annual	Cumulative	Annual	Cumulative	
Sale		\$ 100,000		\$ 150,000	\$ 50,000 ^a
1	\$ 35,600 ^b	135,600	\$ 28,000	178,000	42,400
2	35,600	171,200	28,000	206,000	34,800
3	35,600	206,800	28,000	234,000	27,200
4	35,600	242,400	28,000	262,000	19,600
5	35,600	278,000	28,000	290,000	12,000
6	35,600	313,600	28,000	318,000	4,400
7	35,600	349,200	28,000	346,000	(3,200)
8	35,600	384,800	28,000	374,000	(10,800)
9	35,600	420,400	28,000	402,000	(18,400)
10	35,600	456,000	378,000	780,000	324,000

Alternative 2

Year	Required Payments ^b	Contractual Payments	Prior Excess Investment	Total Continuing Investment	Excess (Deficiency)
1	\$ 35,600	\$ 28,000	\$ 50,000 ^a	\$ 78,000	\$ 42,400
2	35,600	28,000	42,400	70,400	34,800
3	35,600	28,000	34,800	62,800	27,200
4	35,600	28,000	27,200	55,200	19,600
5	35,600	28,000	19,600	47,600	12,000

Alternative 2

Year	Required Payments^b	Contractual Payments	Prior Excess Investment	Total Continuing Investment	Excess (Deficiency)
6	35,600	28,000	12,000	40,000	4,400
7	35,600	28,000	4,400	32,400	(3,200)
8	35,600	28,000	(3,200)	28,000	(10,800)
9	35,600	28,000	(10,800)	28,000	(18,400)
10	35,600	378,000	(18,400)	378,000	324,000

Notes:

- ^a The \$50,000 excess initial investment is the excess of the down payment of \$150,000 over the required down payment under FASB ASC 360-20 (formerly SFAS No. 66) of \$100,000 (20% of \$500,000).
- ^b The required payment under FASB ASC 360-20 is the payment required to amortize \$350,000 over 20 years at 8%.

* * *

Importance of Collectibility. Even if the buyer's investments are adequate under SFAS No. 66, that only suggests that the buyer intends to pay the entire sales value. It does not necessarily indicate that the buyer is *able* to make the required payments. If collectibility of the sales value is uncertain as of the sale date, the continuing investment test is not considered to be met. That evaluation is based on the facts and circumstances of the transaction. For example, if raw land is sold for development as residential lots and security is limited to the tract sold, the seller may evaluate whether revenues from lot sales will be sufficient to enable the buyer to make the required payments, and the seller may require one or more individuals to personally guarantee the debt. On the other hand, the seller of an income-producing office building may primarily consider anticipated changes to the current income stream in evaluating collectibility.

Special Considerations for Release Provisions. Sometimes sales contracts (especially land sales) contain release provisions that require the seller to release the lien on a portion of the property after receiving specified payments from the buyer. For example—

- If raw land is sold for development as residential lots, liens on the land will need to be released before the developed lots can be sold. The seller might require payments as the developed lots are sold. In that arrangement, the payments often are stipulated as a percentage of the sales value of the developed lots, and they are often designed so that the seller is fully paid before the development is sold out.
- If raw land is sold to a partnership through a syndication, the seller may agree to release the lien on a portion of the land in exchange for a special payment, often within a relatively short period of time after closing, or the seller may apply substantially all of the release payments first to the land for which the lien will be released. The advantage to the buyer is that it effectively owns land that is unencumbered and can be pledged for other financing.

The seller will normally release its lien only if it has recovered a sufficient amount to indicate that its risk on its remaining financing is acceptable. FASB ASC 360-20 effectively requires applying the initial and continuing investment criteria separately to property subject to release and property not subject to release, which may result in using different methods to account for the sale for each portion. For example, the full accrual method might be used for property subject to release, and the installment method might be used for property not subject to release. In addition, if the requirements for the full accrual method are not met at the time of sale for property subject to release, they may be met after some of the release payments have been made.

What If the Continuing Investment Test Is Not Met? If the continuing investment test is not met, the method used to recognize profit should be one of the following, depending on the circumstances:

- a. *Reduced Profit Method.* Use the reduced profit method when the following conditions are met:
 - (1) The initial investment requirement is met.
 - (2) Annual payments by the buyer will be enough to cover the following:
 - (a) Principal and interest (at the greater of the contract interest rate or the current market rate) on the maximum first mortgage loan that could be obtained on the property from an independent financial institution.
 - (b) Interest at market rates on the excess of the actual total debt on the property over such maximum first mortgage loan.

If either of the preceding conditions is not met, one of the following methods should be used.

- b. *Installment Method.* Use the installment method if recovery of the seller's investment in the property is reasonably assured.
- c. *Cost Recovery Method.* Use the cost recovery method if either:
 - (1) Recovery of the seller's investment is uncertain.
 - (2) The seller's investment has already been recovered, and the recovery of the rest of the sales value is uncertain. (That situation normally occurs when the book value of the property sold is very small in relation to the sales value.)

The cost recovery method may be used whenever the installment method is appropriate, and the deposit method may be used if either (a) recovery of the seller's investment if the buyer defaults is not reasonably assured or (b) the seller recovers its investment at closing, but collection of additional amounts is uncertain.

Additional Guidance for Time-share Transactions. FASB ASC 978 (formerly SOP 04-2) provides additional guidance for determining the adequacy of the buyer's investment in the time-share property. The Standards require a reduction to the initial and continuing investment in a time-share property for the excess of fair value over the amount charged the buyer for any sales incentives that the seller has provided or is committed to provide to the buyer.

A possible exception to this general rule occurs when the sales incentive is conditional on sufficient future performance, such as the buyer meeting contractual obligations for a certain period of time. In this situation, if the buyer's future contractual obligations to obtain the sales incentive are at least equal to the fair value of the sales incentive, the buyer's initial and continuing investment is not reduced by the fair value of the sales incentive received.

For example, assume a buyer purchases a \$15,000 time-share interval with a \$1,750 down payment. The contract provides for monthly (principal and interest) payments of \$200 and offers a sales incentive of two first-class airline vouchers if the buyer timely submits a certain number of monthly payments. The fair value of the sales incentive is \$1,000. For simplicity, assume no other items (fees, accelerated payment provisions, etc.) affect the sales value of the transaction and the required level of buyer commitment is 10%. In scenario 1, the buyer is required to submit six monthly payments to receive the airline vouchers, and in scenario 2, the buyer is only required to submit three monthly payments.

	<u>Scenario 1</u>	<u>Scenario 2</u>
Sales price	\$ 15,000	\$ 15,000

Down payment	1,750	1,750
FV of sales incentive	1,000	1,000
Monthly payment	200	200
Incentive period (mos.)	6	3
Sales value (sales price – FV of sales incentive)	14,000	14,000
Initial investment	1,750	1,350
Percentage of initial investment to sales value	12.5 %	9.6 %
Is the initial investment adequate?	Yes	No

In scenario 1, the buyer's required \$1,200 of contractual payments to receive the sales incentive (\$200 monthly payment x six month incentive period) is greater than the fair value of the sales incentive, so the buyer's initial investment (\$1,750) is not reduced by the sales incentive. Because the buyer's 12.5% initial level of commitment (\$1,750 initial investment ÷ \$14,000 sales value) is greater than the 10% required minimum level, the seller may qualify for the full accrual method of accounting. However, in scenario 2, the buyer's required \$600 of contractual payments to receive the sales incentive (\$200 monthly payment x three month incentive period) is less than the fair value of the sales incentive. Thus, the buyer's initial investment must be reduced by the \$400 excess of the sales incentive's fair value over the buyer's contractual payments required to receive the sales incentive (\$1,000 fair value of sales incentive – \$600 required payments to receive the sales incentive). Because of the reduction in the buyer's initial investment, the buyer's initial level of commitment decreases to 9.6% [(\$1,750 down payment – \$400 excess fair value of sales incentive) ÷ \$14,000 sales value], and since the initial level of commitment is less than the 10% minimum level, the seller does not qualify for the full accrual method of accounting.

Upgrade and Reload Transactions. FASB ASC 978-605-20 defines a reload transaction as a time-sharing transaction where the buyer purchases a second time-share interval from the same seller but does not relinquish the right to the first time-share interval. In an upgrade transaction, the buyer relinquishes the right to a currently held time-share interval and obtains a higher-priced time-share interval from the same seller. A reload transaction is considered to be a separate transaction, requiring the buyer to provide additional cash or qualifying consideration to satisfy the buyer's initial and continuing investment requirement of FASB ASC 360-20 (formerly SFAS No. 66). In contrast, an upgrade transaction is considered a modification and continuation of the original transaction, so the buyer's initial and continuing investments from the original time-share interval may be applied toward meeting the buyer's initial and continuing investment requirements of the higher-priced interval.

Accounting for Uncollectibility. FASB ASC 978 recognizes that the collection of notes receivable is an important task for the sellers of time-shares. Because some level of uncollectibility is common to the industry, the Standards specifically provide accounting guidance for the uncollectibility of receivables. Uncollectibility is defined as the receivable becoming totally uncollectible or being modified in a fashion that results in less than total collection of the original note.

When profit is recognized under the full accrual method or percentage-of-completion method, an estimate of uncollectibility should be made from a historical and statistical perspective. The measurement should be based on actual receivables collection experience from similar projects, including the experience from using third parties to collect the receivables. However, the amounts the seller receives from receivables sales or securitizations should not be included in the collections experience data.

The revenue from the profit recognition should be reduced by the estimated uncollectible receivables (which is considered a contra-revenue account), with an offsetting entry to the allowance for uncollectible accounts. This treatment differs from that of most other industries that utilize bad debt expense (which is not a contra-revenue account). The treatment differs because foreclosed time-share intervals generally are resold, and the seller would record revenue for more than the total intervals constructed if foreclosed intervals were essentially sold twice. To avoid the potential overstatement of revenue, any uncollectible receivables should be written-off directly against revenues (as opposed to bad debt expense). Also, under the relative sales value method, any change to the uncollectible sales estimate will affect the cost of sales and inventory balances. Any accrued interest income receivable associated with an uncollectible receivable should be charged against interest income at the time the receivable is deemed uncollectible.

Once established, treatment of the allowance account follows typical accounting principles except that periodic adjustments to the allowance account for future estimates of uncollectibility are offset against that current period's revenue using the contra-revenue account. Also, as discussed in the previous paragraph, any change to the uncollectible sales estimate will affect the cost of sales and inventory balances under the relative sales value method.

FASB ASC 978 requires the time-share seller to evaluate its receivables on a quarterly basis, estimating the amount expected to be collected and evaluating the adequacy of the uncollectible account following the guidance in FASB ASC 450 (formerly SFAS No. 5). The allowance for uncollectibles should be determined based on the uncollectibles by year of sale, the aging of notes receivables, and other specific factors of the current project such as the location of the time-sharing units, contract terms, collection experience, economic conditions, and other qualitative factors, if applicable.

FASB ASC 978 also clarifies the accounting treatment for the assumption of receivables (when the original buyer is replaced by an unrelated party). The assumption of the receivable should be treated as two separate transactions. The initial transaction is treated as a termination of the contract with the original buyer, resulting in the uncollectibility of the remaining receivable. The remaining receivable should be written-off with a corresponding reduction to the allowance for uncollectible accounts. The second transaction is considered a sales transaction with the new buyer and should be accounted for following the guidance in FASB ASC 360-20.

Transfers of Receivables

A seller's ability to finance some or all of the sales value often depends on the amount of capital the seller has. A note receivable from the buyer may be used to raise cash by selling it without recourse or transferring it with recourse under an arrangement that has some of the characteristics of a sale and a loan. Sometimes the note is sold shortly after the real estate is sold. For example, a homebuilder that has financed a substantial portion of the cost of a home through a construction loan normally is required to pay the loan when the home is sold. Converting the construction loan to long-term financing generally is not feasible, and the homebuilder will be able to provide the buyer with financing only if it can sell the note quickly. Often the loan to the buyer of the home is written under a preestablished arrangement with a financial institution to conform with the institution's requirements. The homebuilder might receive a fee from the institution in connection with the arrangement. The fee varies depending on the risk of loss retained by the homebuilder. It increases as the amount of risk retained by the homebuilder increases because the loan becomes more attractive to the financial institution. Transferring receivables to third parties raises two primary accounting issues: (a) how to account for the transfer and (b) whether the transfer affects the recognition of gain from the real estate sale when profit on the sale is recognized using a method other than the full accrual method.

How to Account for the Transfer. In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets*, which amends the guidance in FASB ASC 860, *Transfers and Servicing*, (formerly SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, for transfers occurring on or after the beginning of the reporting entity's first annual reporting period beginning after November 15, 2009. However, for the purposes of the transfers of receivable discussion in this *Guide*, the differences between the Standards are not material. Thus, the remainder of the section discusses the accounting treatment of transfers of receivables originating from real estate sales under FASB ASC 860, but will identify relevant SFAS No. 166 amendments when applicable., depends on whether the transferor (that is, the seller) surrenders control over the transferred receivables. Under FASB ASC 860, a transfer of receivables in which the seller surrenders control over the receivables should be accounted for as a sale to the extent that consideration (other than beneficial interests in the receivables) is received in exchange. Control over transferred receivables has been surrendered if and only if all of the following conditions have been met:

- a. The transferred receivables have been isolated from the seller (that is, put beyond the reach of the seller and its creditors, even if the seller is in bankruptcy or receivership).
- b. Each transferee (or holder of beneficial interests, if the transferee is a qualifying SPE) has the right to pledge or exchange the receivables (or beneficial interests) it received, and no condition both (1) constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and (2) provides more than a trivial benefit to the transferor. (For transfers occurring on or after the beginning of the reporting entity's

first annual reporting period beginning after November 15, 2009, SFAS No. 166 eliminates the concept of *qualifying special-purpose entity* (SPE) from GAAP. Instead of qualifying SPE, SFAS No. 166 refers to entities whose sole purpose is to engage in securitization or asset-backed financing activities and that are constrained from pledging or exchanging received assets.)

- c. The seller does not maintain effective control over the transferred receivables through either (1) an agreement that both entitles and obligates the seller to repurchase the receivables before their maturity or (2) the ability to cause the holder to return the specific receivable, except through a cleanup call. (For transfers occurring on or after the beginning of the reporting entity's first annual reporting period beginning after November 15, 2009, SFAS No. 166 clarifies that items (1) and (2) are only non-inclusive examples of means of a transferor's effective control over the transferred receivables. It also adds one more example: an agreement that allows the transferee to require the transferor to repurchase the transferred receivables at a price that is so favorable that it is probable that the transferee will require the repurchase.)

Transfers That Qualify for Sales Treatment. For transfers that meet the conditions to be accounted for as a sale, the transferor (seller) should:

- a. Derecognize (that is, remove from the balance sheet) all receivables sold.
- b. measure at fair value and record all assets received and liabilities incurred in the sale.
- c. Recognize any gain or loss on the sale.

The transferee should record any receivables obtained and liabilities incurred at fair value (which in total should generally equal the price paid). To illustrate, if a \$100,000 note is sold for \$95,000 and recognized as a sale, the seller would debit cash for \$95,000, credit the note receivable for \$100,000 and recognize a loss on the sale of \$5,000. If a fee is received for the transfer, it should be included in income.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Which of the following generally requires the equity method of accounting to be used to account for an investment?
- a. When the seller controls the buyer.
 - b. When the seller is independent of the buyer (but still owns an interest in the property).
 - c. The seller has a noncontrolling ownership interest in the buyer.
25. The collectibility of the sales value is assessed **primarily** on which of the following?
- a. The buyer's credit history.
 - b. Loan obtained by the buyer from third parties.
 - c. The buyer's investments.
26. Which of the following statements regarding the initial minimum investment required under FASB ASC 360-20 (formerly SFAS No. 66) is most accurate?
- a. The installment method is one method used to recognize gain if the initial investment test is not met.
 - b. The initial investment requirement cannot be larger than 20% of the sales value.
 - c. The minimum initial investment depends on whether there are other liens that are superior to the seller's receivables.
 - d. The deposit method is another method used to recognize gain if the initial investment test is not met.
27. With regard to time-share transactions, which of the following statements most accurately describes a reload transaction?
- a. A modification and continuation of the original transaction.
 - b. A sale of an additional interval to an existing owner.
 - c. When the buyer's initial and continuing investment from the original interval is be applied toward meeting the buyer's initial commitment criteria on the upgraded interval.
28. A seller's ability to finance some or all of the sales value often depends on which of the following?
- a. The operations of the property.
 - b. The amount of capital the seller has.
 - c. Whether there has been a recent permanent loan or loan commitment placed on the property.
 - d. Collectibility of the sales value.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. Which of the following generally requires the equity method of accounting to be used to account for an investment? **(Page 49)**
- a. When the seller controls the buyer. [This answer is incorrect. No gain is recognized until it is realized through either the sale to an independent party or profits from continuing operations if the seller controls the buyer.]
 - b. When the seller is independent of the buyer (but still owns an interest in the property). [This answer is incorrect. When the seller is independent of the buyer, but still owns interest in the property, the real estate is subject to the joint control of the owners; the accounting is the same as for an equity method investment.]
 - c. **The seller has a noncontrolling ownership interest in the buyer. [This answer is correct. Generally the equity method to be used to account for the investment when the seller has a noncontrolling ownership interest in the buyer. The seller recognizes gain for the pro rata portion of the total gain on the sale based on the extent of third-party ownership and defers the remainder.]**
25. The collectibility of the sales value is assessed **primarily** on which of the following? **(Page 55)**
- a. The buyer's credit history. [This answer is incorrect. Although the buyer's credit history is considered when determining when recovery is reasonably assured, it is not the primary concern when determining the collectibility of the sales value.]
 - b. Loan obtained by the buyer from third parties. [This answer is incorrect. Loans obtained by the buyer from third parties, either directly or through assumption, and secured by the property are forms that cannot be considered part of the buyer's investment.]
 - c. **The buyer's investments. [This answer is correct. 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.]**
26. Which of the following statements regarding the initial minimum investment required under FASB ASC 360-20 (formerly SFAS No. 66) is most accurate? **(Page 58)**
- a. **The installment method is one method used to recognize gain if the initial investment test is not met. [This answer is correct. The installment method is one of two methods used to recognize gain if the initial investment test is not met. The installment method is used when recovery of the seller's investment in the property is reasonably assured.]**
 - b. The initial investment requirement cannot be larger than 20% of the sales value. [This answer is incorrect. The initial investment requirement will not be less than the table value determined using Exhibit 4-8, and it will not be larger than 25% of the sales value.]
 - c. The minimum initial investment depends on whether there are other liens that are superior to the seller's receivables. [This answer is incorrect. The minimum initial investment required under FASB ASC 360-20 (formerly SFAS No. 66) depends on whether there has been a recent permanent loan or loan commitment placed on the property for the maximum amount of financing available.]
 - d. The deposit method is another method used to recognize gain if the initial investment test is not met. [This answer is incorrect. The other method used to recognize gain if the initial investment test is not met, is the cost recovery method. The cost recovery method is used when either recovery of the seller's investment is uncertain, or the seller's investment has already been recovered, and the recovery of the rest of the sales value is uncertain.]

27. With regard to time-share transactions, which of the following statements most accurately describes a reload transaction? **(Page 63)**
- a. A modification and continuation of the original transaction. [This answer is incorrect. An upgrade transaction is considered a modification and continuation of the original transaction, so the buyer's initial and continuing investments from the original time-share interval may be applied toward meeting the buyer's initial and continuing investment requirements of the higher-priced interval.]
 - b. A sale of an additional interval to an existing owner. [This answer is correct. The sale of the new interval should be treated as a separate transaction for accounting purposes. Therefore, the buyer is required to pay additional cash to meet the buyer's initial commitment criteria. The buyer's initial and continuing investment from the first interval would not be applied to the second interval.]**
 - c. When the buyer's initial and continuing investment from the original interval is be applied toward meeting the buyer's initial commitment criteria on the upgraded interval. [This answer is incorrect. This type of transaction is considered an upgrade transaction.]
28. A seller's ability to finance some or all of the sales value often depends on which of the following? **(Page 64)**
- a. The operations of the property. [This answer is incorrect. Occasionally the sales agreement may be imposed on the seller through the operations of the property. This occurs when the seller holds a significant receivable from the buyer, and collection of the receivable depends on the operations of the property (for example, when the note is payable as operations permit).]
 - b. The amount of capital the seller has. [This answer is correct. A seller's ability to finance some or all of the sales value often depends on the amount of capital the seller has. A note receivable from the buyer may be used to raise cash by selling it without recourse or transferring it with recourse under an arrangement that has some of the characteristics of a sale and a loan.]**
 - c. Whether there has been a recent permanent loan or loan commitment placed on the property. [This answer is incorrect. The minimum initial investment required under FASB ASC 360-20 (formerly SFAS No. 66) depends on whether there has been a recent permanent loan or loan commitment placed on the property for the maximum amount of financing available (that is, the largest amount that the institution normally would lend on that type of property).]
 - d. Collectibility of the sales value. [This answer is incorrect. The method for recognizing the gain on partial sales depends on the collectibility of the sales value.]

Transfers That Do Not Qualify for Sales Treatment. If receivables are exchanged, but the transfer does not meet the criteria for sale, the transferor and transferee should account for the transfer as a secured borrowing and pledge of collateral. The seller should continue to report the transferred receivables in its balance sheet without remeasuring them. The accounting for noncash collateral (that is, the transferred receivable) depends on whether the transferee has the right to sell or repledge the transferred receivable and on whether the transferor has defaulted on the loan as follows:

- a. If the transferee is allowed (by contract or custom) to sell or repledge the receivables, the transferor should report them separately as a restricted asset in its balance sheet.
- b. A transferor that defaults under the terms of the secured borrowing and is no longer entitled to redeem the collateral should remove the receivables from its balance sheet.

To illustrate, assume that a developer transfers a \$100,000 note to the bank and receives \$95,000 and a \$1,000 fee. However, as part of the agreement the bank is not allowed to pledge, transfer, or sell the note. The conditions for a sale under FASB ASC 860 are not met because the bank does not have the right to pledge or exchange the note free of constraints. As a result, the developer should account for the transfer as a secured borrowing and pledge of collateral. The developer should debit cash for \$96,000, credit a liability to the bank for \$95,000, and credit income for \$1,000 for the fee. The \$100,000 note (the collateral) should remain on the developer's books as a restricted asset.

Transfers with Recourse. When a seller transfers receivables to another entity (the transferee), it often does so with recourse. In that case, the transferee has the right to receive payment from the seller or the seller must repurchase the receivables if the debtor defaults. In some jurisdictions, the transfer of receivables with full recourse may not place the transferred receivables beyond the reach of the seller and its creditors. However, transfers with limited recourse may. When accounting for a transfer of receivables with recourse as a sale, the proceeds of the sale should be reduced by the fair value of the recourse obligation. To illustrate how to record a transfer of receivables with recourse that is recognized as a sale, assume that (a) a \$100,000 note is sold for \$95,000, with the seller retaining recourse for \$25,000; (b) there is no fee for the transfer; and (c) the seller estimates that losses under the recourse provision will total \$15,000. The seller would debit cash for \$95,000, credit the note receivable for \$100,000, credit a liability for the fair value of the recourse obligation for \$15,000, and recognize a loss on the sale of \$20,000 [$\$100,000 - (\$95,000 \text{ proceeds} - \$15,000 \text{ probable loss on recourse obligation})$]. If the transfer of receivables with recourse does not meet the conditions to be accounted for as a sale, the transfer should be accounted for as a secured borrowing and pledge of collateral.

Accrued Interest. If a transfer of receivables is treated as a sale under FASB ASC 860, the transferor should treat any subsequent accrued interest receivables (AIRs), including late payment fees or other finance charges, that are billed and uncollected (or accrued but unbilled) as a retained beneficial interest. In this situation, FASB ASC 860 (formerly FASB Staff Position FAS 140-1, "Accounting for Accrued Interest Receivable Related to Securitized and Sold Receivables under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*") states that the AIRs are not required to be subsequently measured like an investment in debt securities under FASB ASC 320, *Investments—Debt and Equity Securities*, (formerly SFAS Nos. 115) and FASB ASC 860 because the AIR cannot be contractually prepaid or settled in such a way that prevents the owner from recovering substantially all of its recorded investment. Thus, entities should subsequently measure the AIR following the guidance in FASB ASC 450 (formerly SFAS No. 5), which addresses loss contingencies for the collectibility of receivables.

New Guidance for Transfers of Partial Interests in Receivables. For transfers occurring on or after the beginning of the reporting entity's first annual reporting period beginning after November 15, 2009, SFAS No. 166 establishes the conditions for reporting a transfer of a portion (or portions) of a receivable (or other financial asset) as a sale. Under SFS No. 166, the transferred portion (or portions) of a receivable and any portion that continues to be held by the transferor must qualify as *participating interests* in the entire receivable to qualify for the sales treatment under FASB ASC 860 (formerly SFAS No. 140). To qualify as, a participating interest, the partial interests must possess the following characteristics from the date of transfer:

- a. The interest in the receivable represents a proportionate (pro rata) ownership interest in the entire receivable. This requirement applies regardless of the number of interests transferred. That is, the

transferor's interest must represent a proportionate interest in the entire receivable both before and after any subsequent interest transfers, and the transferor's interest must continue to meet the other characteristics of a participating interest.

- b. All cash flows from the entire receivable are divided proportionately among the participating interest holders. The applicable cash flows for this requirement exclude cash flows allocated as compensation for services performed and any proceeds received by the transferor for the transferred portion. The compensation exclusion only applies if the cash flows allocated to compensation are not (1) subordinate to the proportionate cash flows and (2) significantly higher than an amount necessary to fairly compensate a substitute service provider. The proceeds exclusion applies as long as the transferor does not receive an ownership interest that permits it to receive disproportionate cash flows.
- c. The rights of each interest holder have equal priority and no interest is subordinated to another interest in the entire receivable. For example, participating interest holders have no recourse to each other. Bankruptcy or other receivership proceedings do not affect the priority.
- d. The entire financial asset may not be pledged or exchanged without approval of all participating interest holders.

If a transferred interest (or interests) in an entire financial asset meets the characteristics of a participating interest, the transferor should analyze the transfer(s) to determine if they satisfy the conditions for surrendered control. For transfers of participating interests that meet the conditions to be accounted for as a sale, the transferor should—

- a. Allocate the previous carrying amount of the entire receivable between the participating interests sold and the participating interest retained by the transferor on the basis of their relative fair values at the date of the transfer.
- b. Derecognize (that is, remove from the balance sheet) the participating interests sold.
- c. Recognize and initially measure at fair value all assets received and liabilities incurred in the sale.
- d. Recognize earnings in any gain or loss on the sale.
- e. Report any participating interest or interests that continue to be held by the transferor as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

If a transferred interest (or interests) in an entire receivable does not meet the conditions to be accounted for as participating interest, the transferor should account for the transfer as a secured borrowing and pledge of collateral. However, if the transferor transfers the *entire* receivable in multiple interests that do not individually qualify as participating interests, the participating interest requirement for sale treatment no longer applies. Thus, the transferor would evaluate whether the entire receivable transferred should qualify for sales treatment under the conditions for surrendered control.

Effect of the Transfer on Gain Recognition. If the seller used a method other than the full accrual method to account for profit on a real estate sale, sale of the receivable from the buyer to a third party may affect the method that the seller uses to recognize gain on the transaction. According to FASB ASC 360-20-40-10 (formerly SFAS No. 66, paragraph 9), if the receivable is sold without recourse to the seller, the cash received from the transfer should be considered as part of the buyer's investment. Thus, the transaction may meet the conditions for full accrual gain recognition after the receivable is sold. For example, if the seller sells the entire receivable for cash and has no risk of loss on any other debt relating to the property, full accrual gain recognition would be appropriate. Furthermore, even if full accrual gain recognition is not appropriate, the transaction should be evaluated to determine whether additional gain recognition under FASB ASC 360-20-40-32 (formerly EITF Issue No. 88-24) is appropriate.

If the seller retains recourse on a transfer of the buyer's receivable that is recognized as a sale, best practices indicate that the excess of the transferred note over the maximum recourse obligation should be considered as additional buyer's investment. The buyer's cumulative investment after the transfer should be evaluated to determine whether additional gain recognition is appropriate.

Sale of a Note That Warrants a Change to the Full Accrual Method. To illustrate, assume the following facts for a sale of land:

Sales value	
Down payment	\$ 50,000
Buyer's note	<u>450,000</u>
	500,000
Book value of land	<u>300,000</u>
Gain on sale (40% of sales value)	<u>\$ 200,000</u>

The installment method was used to recognize gain on the sale because the buyer's initial investment of \$50,000 was insufficient for full accrual recognition, but recovery of the \$300,000 book value was reasonably assured.

Gain recognized (\$50,000 down payment × 40%)	<u>\$ 20,000</u>
Deferred gain (\$200,000 total gain less \$20,000 gain recognized)	<u>\$ 180,000</u>

The note is sold to a bank under an arrangement that meets the FASB ASC 860 (formerly SFAS No. 140 requirements for sale accounting). The seller retained recourse of \$90,000 and was paid a fee of \$4,500. Accordingly, the buyer's cumulative investment is \$410,000 (down payment of \$50,000 + \$360,000), which is sufficient to warrant a change to the full accrual method.

The seller estimates that it will be required to reimburse the bank \$20,000 under the recourse provisions for uncollectible principal and to refund \$1,500 of the fee. The loss on the sale of the note is as follows:

Proceeds from sale (\$450,000 from note + \$4,500 fee)	\$ 454,500
Provision for losses:	
Fair value of recourse obligation	\$ 20,000
Refund of fee	1,500
	<u>(21,500)</u>
	433,000
Carrying amount of note	<u>(450,000)</u>
Loss	<u>\$ 17,000</u>

The following entry would record the sale of the note and the change from the installment method of accounting for the sale to the full accrual method:

Cash	454,500	
Deferred gain	180,000	
Loss on sale of note	21,500	
Note receivable		450,000
Liability for recourse obligation		21,500
Gain		180,000
Fee income		4,500

In practice, many accountants record the loss on the sale of the note net of the fee income (\$21,500 – \$4,500 = \$17,000) rather than reporting gross amounts.

Actual payments under the recourse provision are debited to the liability and credited to cash with the difference recognized as a gain or loss. For example, if the seller was ultimately required to pay only \$10,000 under the recourse provisions, cash would be credited for \$10,000, the liability would be eliminated, and a gain of \$11,500 would be recognized for a change in the estimated losses.

Sale of a Note That Does Not Warrant a Change to the Full Accrual Method. To illustrate, assume the following facts for a sale of land:

Sales value	
Down payment	\$ 20,000
Buyer's note	50,000
Assumption of debt (guaranteed by seller)	<u>430,000</u>
	500,000
Book value of land	<u>300,000</u>
Gain on sale (40% of sales value)	<u>\$ 200,000</u>

The installment method was used to recognize gain on the sale because the buyer's initial investment of \$50,000 was insufficient for full accrual recognition, but recovery of the \$300,000 book value was reasonably assured.

Gain recognized (\$20,000 down payment × 40%)	<u>\$ 8,000</u>
Deferred gain (\$200,000 total gain less \$8,000 gain recognized)	<u>\$ 192,000</u>

The note is sold to a bank under an arrangement that meets the FASB ASC 860 (formerly SFAS No. 140) requirements for sale accounting. The seller retained recourse of \$10,000 and was paid a fee of \$500. In the authors' opinion, the excess of the \$50,000 balance of the note over the \$10,000 recourse obligation or \$40,000 should be considered an additional buyer's investment under FASB ASC 360-20 (formerly SFAS No. 66). Accordingly, the buyer's cumulative investment is \$60,000 (down payment of \$20,000 + \$40,000), which is not sufficient to warrant a change to the full accrual method. However, additional profit of \$16,000 would be recognized under the installment method when the note is sold (additional buyer's investment × gross profit of 40%).

The seller estimates that it will be required to reimburse the bank \$5,000 under the recourse provisions for uncollectible principal. Losses from refund of the fee are not considered to be significant. The loss on the sale of the note is as follows:

Proceeds from sale (\$50,000 from note + \$500 fee)		\$ 50,500
Provision for losses:		
Fair value of recourse obligation	\$ 5,000	
Deferred gain related to uncollectible principal (\$5,000 × 40%)	(2,000)	<u>(3,000)</u>
		47,500
Carrying amount of note		<u>(50,000)</u>
Loss		<u>\$ 2,500</u>

Since gain has been deferred on the sale, the authors believe that the portion of the deferred gain relating to the estimated uncollectible principal should be considered. Ignoring the deferred gain artificially recognizes losses in one period that are offset in a subsequent period when the deferred gain is eliminated.

The following entry would record the sale of the note:

Cash	\$ 50,500	
Deferred gain	16,000	
Loss on sale of note	3,000	
Note receivable		\$ 50,000
Liability for recourse obligation		3,000
Gain		16,000
Fee income		500

In practice, many accountants record the loss on the sale of the note net of the fee income rather than report gross amounts. The remaining deferred gain of \$176,000 is 40% of the seller's contingent liability for debt assumed by the buyer and its \$10,000 obligation under the recourse provision of the transfer arrangement (40% × \$440,000).

Subsequent payments by the seller under the recourse provision are debited to the liability and credited to cash, and the deferred gain on the uncollectible portion of the note is eliminated. Any difference is recognized as additional gain or loss. For example, if \$5,000 of the note subsequently becomes uncollectible, the following entry would be made:

Deferred gain		
(uncollectible receivable of \$5,000 × 40%)	\$ 2,000	
Liability for recourse obligation	3,000	
Cash		\$ 5,000

Guidance for Time-share Transactions. If a time-share seller sells a portfolio of receivables without recourse, the gain or loss should be recorded as an adjustment of either interest income or revenue. If the gain or loss is attributable to a change in market interest rates between the date the receivables originated and when they were sold, the gain or loss should be recorded as an adjustment of interest income. If the gain or loss is attributable to something other than a change in market interest rates (such as a perceived change in the credit quality of the portfolio between the origination date and the date of sale), the gain or loss should be recorded as an adjustment to revenue. The guidance in FASB ASC 978 (formerly in SOP 04-2) does not address the accounting for a sale of receivables with recourse or the transfer of receivables not treated as a sale. The authors believe the guidance in FASB ASC 860-10-20 (formerly SFAS No. 140) is applicable to such transactions.

Effect of Certain Repurchase Financing Transactions. FASB ASC 860 (formerly SFAS No. 140) states that repurchase agreements occur when a security (or financial asset) is transferred in exchange for cash and the transferor concurrently agrees to reacquire that security from the transferee at a future date for an amount equal to the cash exchanged plus a stipulated “interest” factor. Although FASB ASC 860-10-20 (formerly SFAS No. 140) addresses repurchase financing transaction not directly covered in the Statement. Specifically, if a transferor transfers financial assets and at the same time enters into a repurchase financing with the transferee (or if both transactions are considered together at the initial transfer), would the transfer and repurchase financing ever be considered separate transactions? In February 2008, the FASB Issued FSP to address this question. The FSP is effective for initial transfers and repurchase financings reported in financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

The FSP No. FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, defines *repurchase financing* as a repurchase agreement for previously transferred financial assets between the same parties. Also, repurchase financing generally involves the return of the transferred financial asset (or substantially the same asset) from the initial transferor to the initial transferee when the financing is repaid on a stated date. Thus, repurchase financing generally involves three transfers of the financial asset.

FASB ASC 860-10-40-42 presumes that an initial transfer of a financial asset and a related repurchase financing are considered part of the same transaction unless:

- The financial asset and repurchase financing have a valid and distinct business or economic purpose for being entered into separately and
- The repurchase financing does not result in the initial transferor regaining control over the financial asset.

A transaction structured to circumvent an accounting standard or achieve a specific accounting result does not have a valid business or economic purpose.

Subsequent Accounting for Transferred Receivables Retained by the Transferee. For transfers of receivables that meet the definition of a sale as noted earlier in this lesson, FASB ASC 325-40 (formerly EITF Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets”) provides additional accounting guidance for the subsequent measurement and recognition of interest income and impairment for *certain* securitized receivables. Generally, a receivable may fall within the scope of this guidance if the securitized receivable:

- Is accounted for like a debt security pursuant to FASB ASC 860-20-35-2 (formerly paragraph 14 of SFAS No. 140),

- Has contractual cash flows,
- Does not result in consolidation of the transferor by the transferee,
- Is *not* within the scope of FASB ASC 310-30, *Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality*, (formerly SOP 03-3 and AICPA Practice Bulletin No. 6), and
- Is *not* of high credit quality (guaranteed by the US government) *and* is eligible for prepayment.

The transferee should recognize the excess of all estimated cash flows from the receivable over the initial investment as interest income over the life of the receivable using the effective yield method.

The transferee also should continue to update all cash flows expected to be collected over the life of the receivable. If upon evaluation, the transferee determines that:

- a. A change (favorable or adverse) has occurred in the receivable's cash flows expected to be collected, an adjustment should be accounted for prospectively as a change in estimate based on FASB ASC 250-10 (formerly SFAS No. 154), with the amount of periodic accretion adjusted over the remaining life of the receivable.
- b. The fair value of the receivable has declined below its carrying value; the transferee should conduct a securities impairment test following the guidance in FASB ASC 320-10-35, *Investments—Debt and Equity Securities—Overall—Subsequent Measurement* (formerly SFAS No. 115, paragraph 16 and FSP No. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*).
- c. An adverse change has occurred in the receivable's cash flows expected to be collected and the fair value of the receivable has declined below its carrying value (items a and b have both occurred), the transferee should reduce the receivable's carrying value to its fair value as an other-than-temporary impairment with the resulting charge to income. The transferee should also make the change in estimate described in item a.

Accounting for Transferred Receivables if Transferor Regains Control. A transferor may regain control of assets it previously transferred and reported as sold. In such cases, the retransfer should be accounted for as if the receivables were purchased from the original transferee. That is, the original transferor should recognize the receivable and related liabilities of the original transferee at their fair value as of the date of retransfer and the original transferee should remove the receivable and related liabilities as if the items were sold. This treatment also applies to transfers of portions of an entire receivable occurring on or after the beginning of the reporting entity's first annual reporting period beginning after November 15, 2009. That no longer meet the conditions of a participating interest.

FASB ASC 860-20 (formerly EITF Issue No. 02-9, "Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold") provides additional accounting guidance for instances when the transferor regains control of receivables previously transferred in a sale. The guidance address the situations when transferor regains control of previously transferred receivables because (a) the transferee, a qualifying SPE, becomes a non-qualifying SPE or (b) the transferor holds a contingent call option on the transferred receivable and the contingency has occurred. For transfers occurring on or after the beginning of the reporting entity's first annual reporting period beginning after November 15, 2009, SFAS No. 166 eliminates the concept of *qualifying special-purpose entity* (SPE) from GAAP. Thus, once SFAS No. 166 is effective, the guidance is only applicable when control is regained, because the transferor holds a contingent call option on the receivable and the contingency has occurred. If the control is required because the transferor is subsequently required to consolidate the transferee, the rules for consolidation accounting in FASB ASC (formerly ARB No. 51 and FIN 46(R)) should be followed. (SFAS No. 166 has yet to be included in the FASB Accounting Standards Codification (FASB ASC), but will remain authoritative until it is integrated into the FASB ASC, which is expected during the third or fourth quarter of 2009.

If control over the transferred receivable is regained by the transferor due to a call option that is no longer contingent, the transferor must account for the retransfer (repurchase) even if the transferor does not intend to

exercise the call option. The transferor may recognize a gain or loss on the receivable and related liabilities that were originally transferred, but not for any remaining value of the call option. However, gain or loss recognition on the "repurchased" assets is allowed only if the contingent call option is not (a) accounted for as a derivative under FASB ASC 815-10 (formerly by SFAS No. 133) and (b) "at-the-money."

To illustrate, assume that a business community developer sells a piece of land to a company that plans to build an office building in conformity with the developer's specifications. The buyer's note for the land is \$250,000, and the developer immediately sells the note to a bank. The transfer of the note meets the control conditions of FASB ASC (formerly SFAS No. 140), and the developer properly accounts for the transaction. To protect the design and specifications of the planned business community, the developer includes a contingent call option clause in the contract with the bank that is not considered a derivative. Upon default on the loan by the company, the developer's contingent option provides the developer with the right (but not the obligation) to repurchase the note from the bank.

After unexpected complications, the company becomes delinquent on the loan. At the time of default, the developer evaluates the contingent option for possible impairment and determines that the option is out-of-the-money. Now that the option is not contingent, the developer regains control over the note and must treat the note as repurchased. Due to the repurchase, the developer must recognize the current fair value of the note and the liability associated with the note (probable amount of the loan that will not be recovered). Since the option is not a derivative and it is out-of-the-money, the developer may recognize a gain or loss for the difference between the note and the related liability.

As long as the developer does not exercise the option, the note, related liabilities, and option should remain on the developer's financial statements and be reviewed periodically for impairment. However, if the developer subsequently exercises its option, the note and related liabilities will remain unchanged on the developer's financial statements (not considering loan payments or impairment recognized since the implied repurchase), but the consideration paid by the developer for the note will affect the gain or loss recognized on the transaction.

SPECIAL ISSUES IN REAL ESTATE SALES

This section covers the following issues that may be encountered in real estate sales:

- Losses on real estate sales.
- Condominium and time-share unit sales.
- Sales by homebuilders.
- Net profits interests (equity kickers).
- Sales of options on real estate.
- Combinations of sales and land leases.
- Sales between companies under common control.

Losses on Sales of Real Estate

FASB ASC 360-20 (formerly SFAS No. 66) provides little guidance on accounting for losses on sales of real estate. FASB ASC 360-20-40-29 and 40-30 (formerly paragraph 21 of SFAS No. 66) (which is discussed earlier in this lesson) provides guidance for recognizing losses when the deposit method is used. Best practices indicate that guidance can also be applied to losses on other real estate sales. Accordingly, the loss on sale of real estate can generally be calculated as follows:

- Book value of the property sold
- Book value of existing debt assumed by the buyer

$$\begin{array}{rcl}
 & - & \text{Fair value of cash or other consideration received by the seller} \\
 & = & \underline{\underline{\text{Loss on sale of real estate}}}
 \end{array}$$

Losses on sales of real estate should be recognized on the date that a firm sales agreement is reached. Even if no firm agreement is reached, however, an impairment loss may still be recognized if it is evident that the book value of the property exceeds its fair value less selling costs.

Sales of Condominium Projects and Time-share Interests

When condominium or time-share units are sold separately, either the percentage-of-completion or deposit method should be used. To use the percentage-of-completion method, all of the following conditions must be met:

- a. *Construction Is Past a Preliminary Stage.* According to FASB ASC 360-20 (formerly SFAS No. 66), that condition is considered to be met if all the following have been accomplished:
 - (1) The engineering and design work is done.
 - (2) The construction contracts have been executed.
 - (3) Site clearance, preparation, and excavation work is done.
 - (4) The foundation has been completed.
- b. *The Buyer Is Committed and Cannot Require a Refund except for Nondelivery of the Unit.* The point when the refund period expires depends on applicable state and federal law. For example, in some states, sales contracts are voidable until a "Declaration of Condominium" is filed.
- c. *Enough Units Have Been Sold to Ensure That the Entire Project Will Not Be Converted into Rental Property.* Conversion depends on factors such as applicable state laws and the terms of the condominium or time-share contract and financing agreement. For example, the condominium contract may specify that a certain percentage of the proposed units must be sold, or the project will be converted into rental property.
- d. *Sales Value Is Collectible.* Best practices indicate that collectibility is assessed primarily based on the buyer's investments in the property and superiority of the seller's lien on the property. FASB ASC 360-20-40-54 and 40-55 (formerly EITF Issue No. 06-8, "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") generally confirm that the seller should evaluate the adequacy of the buyer's initial and continuing investment to determine that the sales price is collectible. However, any reassessments of sales price collectibility should be applied prospectively (instead of cumulatively) from the reassessment date. That is, if the entity is using the deposit method to account for its sales of individual condominium units because the original assessment failed one of the conditions in this paragraph, any later reassessments of sales value collectibility would assume all prior initial and continuing investments were received on the reassessment date. EITF Issue No. 06-8, "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," generally confirms that the seller should evaluate the adequacy of the buyer's initial and continuing investment to determine that the sales price is collectible.
- e. *Total Sales Proceeds and Costs Can Be Reasonably Estimated.* To make those estimates, the seller should consider all the relevant factors, including the following:
 - (1) Past and current sales volume.
 - (2) Trends in unit prices.
 - (3) Location.

- (4) Market demand (including seasonal factors).
- (5) The seller's experience with this project and similar projects.
- (6) Environmental factors.

Until all the preceding conditions are met, the deposit method should be used.

Guidance for Time-share Transactions. FASB ASC 978 (formerly SOP 04-2) provides additional guidance for a seller's accounting of real estate time-share transactions. This guidance affirms that the sales and profit recognition guidance for other than retail land sales in FASB ASC 360-20 (formerly SFAS No. 66) is applicable to real estate time-share transactions.

However, FASB ASC 978 may change the sales recognition accounting for certain types of time-share transactions. Certain types of time-share arrangements, commonly referred to as right-to-use (RTU), transfer title for several years (generally a minimum of 20 years), but after such time, the title reverts back to the seller. RTU time-share arrangements have been used for many decades and have traditionally been treated as sales transactions. These types of transactions have used the sales and profit recognition model for many years.

However, FASB ASC 978 requires that the transfer of title on time-share transactions must be nonreversionary for purposes of recognizing profit under FASB ASC 360-20. If the title transfer is reversionary, the seller is required to account for the transaction as an operating lease. Thus, RTU time-share transactions, which have been traditionally treated as a sale, now must be treated as an operating lease with the revenue recognition deferred over the term of the contract. Also, differences between accounting for an operating lease (as opposed to a sale) may also present other financial statement implications for the seller/lessor of an RTU time-share such as asset recognition and related depreciation of the time-share units.

Incidental Operations. FASB ASC 978 provides guidance for such operations. Paragraphs 49-52 of SOP 04-2 provide guidance for incidental operations that occur during the holding period—the point at which the time-share intervals (time periods for a particular unit) are held for and are available for sale. The incidental operations referred to in SOP 04-2 primarily include rental activities, including *sampler programs* and *mini-vacations*.

Holding period costs, such as seller subsidies, maintenance costs, and commissions, should be deferred to the period in which related holding period revenue is recorded if the cost is (a) incremental (only arising due to the holding period transaction), (b) directly associated with the revenue generating transaction, and (c) not in excess of the incremental revenue. Incremental costs from rental and other holding period operations in excess of incremental revenue should be charged to expense as incurred. Conversely, incremental holding period revenues in excess of incremental costs should be accounted for as a reduction of inventory costs.

Incidental rental activities outside the holding period should be accounted for as rental operations in accordance with FASB ASC 840-20, *Leases—Operating Leases*, (formerly SFAS No. 13, including the depreciation of rented units. FASB ASC 978 does not provide guidance for non-rental incidental operations that occur outside the holding period.

Sales by Homebuilders

Homebuilders have many of the characteristics of construction contractors, but they differ from construction contractors in that they often build on their own land. Their operations typically consist of the following activities:

- a. Building homes under a contract with the customer either:
 - (1) On lots owned by the customer.
 - (2) On lots owned by the homebuilder.
- b. Building on a speculative basis, i.e., without a contract.

Homebuilders often buy developed lots in several housing developments. Customers have the option of selecting one of those lots or furnishing their own lot. Similarly, the homebuilder usually has several basic plans, and the customers have the option of using one of the plans, either unmodified or modified, or supplying their own plans.

When homebuilders build on their own lots, title typically does not pass until closing. The contract with the customer may not distinguish between the lot sale and the construction elements of the contract. Down payment requirements often vary based on factors such as the following:

- If a homebuilder uses a basic plan without modification, a small down payment may be required because the homebuilder believes there is little to lose if the house converts to speculative (for example, if the buyer defaults).
- If the homebuilder's plans are modified or the buyer supplies the plans, a larger down payment often is required to ensure the buyer's commitment.

Contracts with customers often have contingencies such as obtaining suitable financing or selling a present home. Under those arrangements, the homebuilder will often include a clause requiring the contingency to be cured before the midpoint of construction so that, if not cured, the house may be converted to speculative.

Income Recognition. How income is recognized depends on whether the homebuilder owns the lot or builds on the buyer's lot.

- If the homebuilder builds on the buyer's lot under contract, the authors believe the homebuilder is acting as a construction contractor and FASB ASC 605-35, *Revenue Recognition—Construction-Type and Production-Type Contracts*, (formerly ARB No. 45, *Long-Term Construction-Type Contracts*, and SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* applies to the accounting for the contract. (Building on the buyer's lot without a contract would be rare for homebuilders.) *PPC's Guide to Construction Contractors* provides detailed guidance on applying the construction contractor literature.
- If the homebuilder owns the lot, the authoritative literature relating to real estate transactions in FASB ASC 360-20 (formerly SFAS Nos. 66) and FASB ASC 970 (formerly SFAS No. 67) applies both to building under contract and to speculative building.

As previously noted, when homebuilders build on their own lots, title normally does not pass until closing. According to FASB ASC 970-360-55 (formerly EITF Issue No. 86-7, "Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts") no gain should be recognized on those transactions until the title passes. Until then, the deposit method should be used for the construction activity and the land.

Net Profits Interests (Equity Kickers)

Occasionally, when property is sold, the seller may receive additional payments based on profits or cash flows (commonly called an "equity kicker"). For example, if the seller of an apartment building keeps a 20% equity kicker, the seller would receive 20% of the operating profits from the property and 20% of the gain, if any, when the buyer sells the property.

Effect on Real Estate Sales. According to FASB ASC 360-20-40-64 (formerly SFAS No. 66, paragraph 43), the presence of an equity kicker, by itself, does not preclude gain recognition under the full accrual method. However, in many cases, equity kickers are given to the seller as consideration for either—

- Providing seller financing on terms more favorable than those of independent financial institutions. In those situations, the buyer's investment tests often are not met.
- Assuming additional risks or having continuing involvement with the property (such as continuing to support operations of the property or pay for additional improvements or amenities).

Consequently, transactions involving equity kickers often have other elements that preclude the use of the full accrual method. Thus, all the aspects of the transaction should be considered before determining whether the conditions for using the full accrual method are met.

Recognizing Net Profits Income. Regardless of the method used to recognize gain on the sale, the seller can recognize the income from the equity kicker when it is earned. To illustrate, if a seller of land for development as lots is to receive 10% of the profits from sale of the lots, the seller should recognize income under the equity kicker as lots are sold.

FASB ASC 360-20-40-64 does not conflict with the acquisition, development, and construction arrangements guidance in FASB ASC 310-10, *Receivables—Overall*, (formerly in Exhibit I of AcSEC Practice Bulletin No. 1, *ADC Arrangements*, and EITF Issue No. 86-21, "Application of the AICPA Notice to Practitioners Regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property"), which to third parties that provide financing for the acquisition, development, and construction of real estate. FASB ASC 310-10 does not apply to a seller of real estate that provides financing for the buyer; FASB ASC 360-20-40-64 applies to that situation.

Sales of Options on Real Estate

For the sale of options by option holders, FASB ASC 360-20-40-45 (formerly paragraph 32 of SFAS No. 66) states that the accounting method to be used is either (a) the full accrual method, if the buyer's investments are adequate or (b) cost recovery method, if the buyer's investments are not adequate. In applying the initial and continuing investment tests, the sales value is the total of the exercise price of the option and the sales price of the option. To illustrate, if an option to acquire raw land guarantees a price of \$200,000, and the holder of the option sells it for \$75,000, the sales value for purposes of applying the initial and continuing investment tests is \$275,000, which is the sum of the option price of \$75,000 and the exercise price of \$200,000. Assuming development is expected to commence within two years after the sale, an initial investment of \$55,000 (which is 20% of \$275,000) would be required, and the level annual payments needed would be calculated based on the excess of \$275,000 over the actual cash down payment. Under the cost recovery method, income would be recognized for the excess of nonrefundable cash received over the option holder's basis in the option.

SELF-STUDY QUIZ

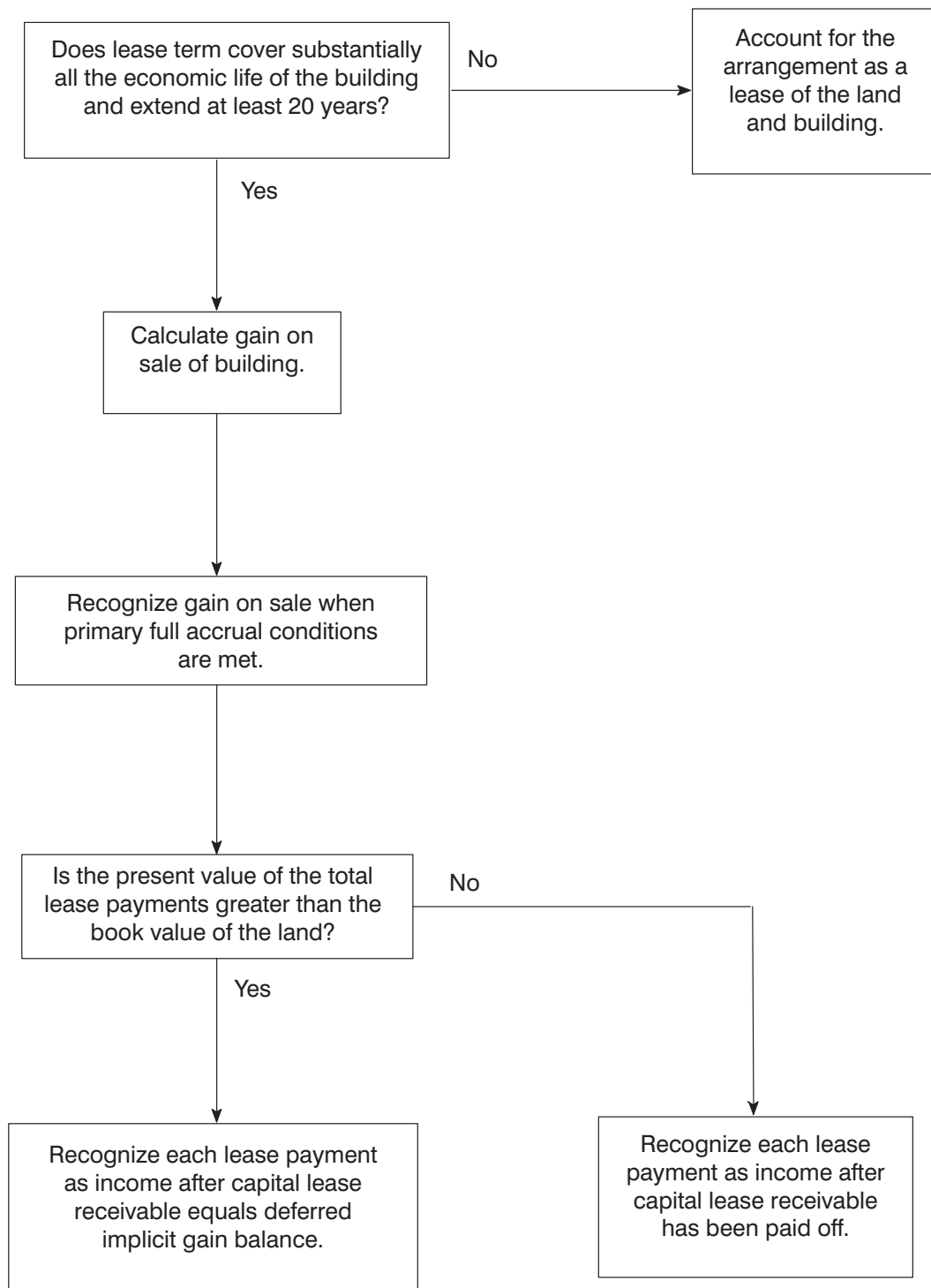
Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. The right-to-use (RTU) time-share transactions which traditionally have been treated as a sale, must now be treated as which of the following?
- a. Leasing arrangement.
 - b. Sales leaseback transaction.
 - c. Operating lease.
30. George and Nancy are attempting to purchase real estate. Due to a poor credit rating, they were unable to qualify for a loan from the community bank. The seller was very motivated and offered to finance the purchase at prime plus two. The extra interest income the seller will potentially enjoy is referred to as which of the following?
- a. Equity kicker.
 - b. Usury interest rate.
 - c. Boot.
 - d. Equity.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. The right-to-use (RTU) time-share transactions which traditionally have been treated as a sale, must now be treated as which of the following? **(Page 78)**
- a. Leasing arrangement. [This answer is incorrect. If the transaction is primarily a lease of the land and other part of the property, the transactions is considered a leasing arrangement.]
 - b. Sales leaseback transaction. [This answer is incorrect. Sale-leaseback transactions occur when an owner sells property and then leases all or part of it back from the new owner.]
 - c. **Operating lease. [This answer is correct. RTU time-share transactions, which have been traditionally treated as a sale, now must be treated as an operating lease with the revenue recognition deferred over the term of the contract.]**
30. George and Nancy are attempting to purchase real estate. Due to a poor credit rating, they were unable to qualify for a loan from the community bank. The seller was very motivated and offered to finance the purchase at prime plus two. The extra interest income the seller will potentially enjoy is referred to as which of the following? **(Page 79)**
- a. **Equity kicker. [This answer is correct. Whenever a seller receives additional payments or cash flows the cash flows are referred to as an equity kicker.]**
 - b. Usury interest rate. [This answer is incorrect. A usury rate generally is much higher than prime plus two.]
 - c. Boot. [This answer is incorrect. Boot is recognized in an exchange action.]
 - d. Equity. [This answer is incorrect. Equity is a term applied to ownership of property. In this instance, the seller may in fact be retaining equity in the property, however, another answer choice is better.]

Exhibit 2-5**Accounting for Sale of Building and Lease of Underlying Land
(Seller Leases Land to Buyer)**

* * *

Using Sale or Lease Accounting. If the buyer leases the land from a third party, the transaction is accounted for as a lease and a separate sale of improvements, and gain on the sale is recognized the same as for other real estate sales. However, if the seller sells improvements and leases the underlying land to the buyer of the improvements, the transactions are interdependent and accounted for either as a sale or as a lease, depending on the length of the lease term. According to FASB ASC 360-20-40-56 through 40-59 (formerly paragraphs 38–39 of SFAS No. 66), the arrangement should be accounted for as a sale if the lease (a) covers substantially all of the economic life of the building (or other improvements) (for example, 75%) and (b) is for at least 20 years. Otherwise, the arrangement is accounted for as a lease of both the land and building.

Calculating the Gain on Sale of Improvements When the Seller Is Also the Lessor. If the arrangement is accounted for as a sale, the gain on the sale of the improvements is determined as follows:

$$\begin{array}{rcl}
 & \text{Sales value of the building (or other improvements)} & \\
 + & \text{Present value of the land lease payments; however, the} & \\
 & \text{present value cannot exceed the book value of the land} & \\
 - & \underline{\text{Total book value of both the land and improvements}} & \\
 = & \underline{\underline{\text{Gain on the sale of improvements}}} &
 \end{array}$$

The present value of the land lease payments should be calculated based on the contractual lease payments over a period equal to either of the following:

- The primary debt (that is, first mortgage loan) of the building or other improvements.
- If no such debt exists, the customary loan term for a first mortgage loan on similar buildings.

The interest rate to be used should be an appropriate market rate on (a) first mortgage loans, if the lease is not subordinated to any third-party liens or (b) a second (or lesser) lien if the lease is subordinated.

The land lease affects the gain calculation in the previous paragraph in the following ways:

- a. The gain on sale of improvements is reduced by the excess of the book value of the land over the present value of the land lease payments over the primary debt term (or over customary terms if there is no debt).
- b. The gain on sale of improvements does not include any implicit gain on the land lease resulting from either of the following:
 - (1) Additional rents to be received after the primary debt is paid off (that is, at the end of the period used in the present value calculation).
 - (2) The excess of the present value of the total land lease payments over the book value of the land.

Recognizing the Gain on Sale of Improvements. The gain on sale of improvements is recognized in full if the full accrual conditions in FASB ASC 360-20 are met. The journal entry to record the sale is as follows:

Cash	
Receivable from buyer	
Real estate [book value of property sold]	
Gain on sale of real estate	
Deferred gain	

Obviously, the journal entry for a given transaction might differ slightly depending on the circumstances (for example, whether the seller provides financing). The receivable from the buyer includes notes from the buyer and the present value of lease payments reflected in sales value. The paragraphs beginning at FASB ASC 360-20-55-23 (formerly SFAS No. 66, Appendix C) include additional examples.

The guidance in the previous paragraphs on selecting the right accounting method for a real estate sale also applies to sales of improvements regardless of whether the seller or a third-party is the lessor. However, the following should be noted:

- a. If the seller of the improvements is also the lessor of the land, the present value of the land lease payments affects the calculation of the gain on the sale of the improvements. Thus, if the seller leases the land to the buyer, the "gain on sale" is the gain calculated in the previous paragraph. However, if a third party leases the land to the buyer, the gain is the same as for other real estate sales. In other words, sales value does not include the present value of the lease payments for purposes of calculating gain when the lessor is not the seller of the improvements.
- b. Regardless of whether the lessor is the seller or a third party, "sales value" includes the present value of the land lease payments over the term of the primary debt for purposes of evaluating the adequacy of the buyer's initial investment. Consequently, the buyer's initial investment must be determined based on both the sales value of the improvements and the present value of the land lease payments. However, the buyer's investment includes any lease payments made by the buyer on the land lease on or before the date of sale (for example, the first lease payment or first and last lease payments made at closing) because such payments represent additional proceeds paid in cash that are part of sales value. (See Exhibit 2-2.)
- c. The alternate initial investment requirement that applies when there is a recent permanent loan on the property should reflect the present value of the land lease payments. Accordingly, the buyer's initial investment in those situations must be at least equal to the *greater* of the following:

(1) The value determined using the table at Exhibit 2-3.

(2) The *lesser* of:

(a) 25% of sales value.

(b)

$$\text{Sales value} - \left[1.15 \times \left(\begin{array}{c} \text{amount of the} \\ \text{recent permanent} \\ \text{loan or} \\ \text{commitment} \end{array} + \begin{array}{c} \text{present value of} \\ \text{land lease payments} \\ \text{during the} \\ \text{primary debt term} \end{array} \right) \right]$$

Accounting for the Implicit Gain on the Land Lease. Sale/land lease transactions may have implicit gains on the land lease because of (a) additional rents to be received after the primary debt is paid off or (b) profit on the lease (that is, the excess of the present value of the total land lease payments over the book value of the land). The implicit gain is calculated as follows:

$$\begin{aligned} & \text{Present value of land lease payments over the full lease term} \\ & - \text{Lower of (a) the present value of land lease payments} \\ & \quad \text{over the primary debt term or (b) book value of the land} \\ & = \underline{\underline{\text{Implicit gain on land lease}}} \end{aligned}$$

Implicit gains on land leases are recognized separately from gains on sales of improvements. According to FASB ASC 360-20-40-57 through 40-59 (formerly paragraph 39 of SFAS No. 66), the implicit gain on the land lease should not be recognized until either (a) the land is sold or (b) the rent in excess of the seller's book value in the land is accrued under the lease. Losses on land leases (that is, the excess of the book value of the land over the present value of the land lease payments) are offset against gains on sales of improvements.

FASB ASC 360-20 does not explain *how* to recognize the implicit gain or how to account for the land lease receivable when there is implicit gain. In a typical capital lease transaction, the capital lease receivable is recorded

at the present value of the lease payments over the full lease term. Under that approach, a deferred gain account would be established for the difference between the present value of the lease payments over the full lease term and the book value of the land. However, such an approach requires deferral of a portion of each interest payment and is unnecessarily complex. It is believed that the following approach produces the same effect on the financial statements, but is less complex:

- a. *If the present value of the lease payments is less than the book value of the land*, record the receivable at the present value of the lease payments over the primary debt term and amortize the receivable over that term as payments are received. After the receivable is fully amortized, recognize each lease payment as income when it is received. (Since the excess of the book value of the land over the present value of the lease payments is offset against the gain on sale of improvements, the remaining book value of the land is considered to be recovered when the lease receivable is fully amortized.)
- b. *If the present value of the lease payments exceeds the book value of the land*, record the receivable at the present value of the lease payments over the primary debt term and record a deferred gain for the difference between the present value of the lease payments and the book value of the land. Amortize the receivable over the primary debt term until the principal balance of the receivable is equal to the deferred gain balance (that is, until the net receivable is zero). Recognize each subsequent lease payment as income when it is received.

Note that implicit gain is recorded in a separate account only when the present value of the lease payments exceeds the book value of the land. In the other situations, the implicit gain relates solely to lease payments to be received after the primary debt is repaid. Accordingly, the implicit gain is reflected by recording the capital lease receivable at the present value of the lease payments over the primary debt term instead of the full lease term.

If the underlying land is sold before the land lease expires, it is believed that the lease receivable less any deferred gain should be accounted for as the book value of the property sold in determining the gain or loss on sale of the land, and the typical SFAS No. 66 conditions should be applied to the sale.

EXAMINATION FOR CPE CREDIT**Lesson 2 (ARETG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. Which of the following statements is most accurate?
- a. FASB ASC 360-20 (formerly SFAS No. 66) specifies how to distinguish between an extended and a limited period when the accounting method to be used depends on the length of the guarantee.
 - b. FASB ASC 360-20 (formerly SFAS No. 66) specifies the use of the profit-sharing arrangement if the seller guarantees a return of the buyer's investment.
 - c. FASB ASC 360-20 (formerly SFAS No. 66) does not provide any guidance regarding changing accounting methods.
 - d. Do not select this answer choice.
20. FASB ASC 360-20 (formerly SFAS No. 66) states that a receivable is considered significant if it exceeds what percent of the maximum first mortgage loan that could be obtained from an independent financial institution?
- a. 10%.
 - b. 15%.
 - c. 20%.
 - d. 25%.
21. According to FASB ASC 360-20 (formerly SFAS No. 66), if a seller has a support management obligation for an extended period, the transaction should be accounted for using which of the following accounting methods?
- a. Installment.
 - b. Profit-sharing arrangement.
 - c. Percentage-of-completion.
 - d. Cost recovery.
22. There is a difference in the accounting methods for a guarantee to support operations for a limited period and a guarantee of a return on the buyer's investment for a limited period. Which of the following accounting methods should be used if the guarantee is for support of operations?
- a. Performance-of-services.
 - b. Financing.
 - c. Reduced profit.
 - d. Do not select this answer choice.
23. Which of the following accounting methods should be used if no support period is stated in the contract?
- a. Installment.

- b. Profit sharing.
 - c. Financing.
 - d. Performance-of-services.
24. In regards to the relationship between the seller and the buyer, if the seller exercises significant influence over the financial and operating policies of the buyer, which of the following methods of accounting should be used to account for the investment?
- a. Equity.
 - b. Reduced profit.
 - c. Deposit.
 - d. Installment.
25. Winnie, a realtor, sells a 40% interest in land that has a book value of \$500,000 to a developer. The land is to be developed as residential lots and sold to homebuilders. All decisions regarding the development and sale of the land will be made jointly between Winnie and the developer. The selling price is \$250,000. If the other gain recognition conditions are met, Winnie would recognize gain on the sale to the outside interests of \$50,000 [$\$250,000 - (\$500,000 \times 40\%)$]. This is an example of which of the following relations between the buyer and the seller?
- a. The seller is independent of the buyer, but still owns interest in the property.
 - b. The seller has a noncontrolling ownership interest in the buyer.
 - c. The seller controls the buyer.
 - d. The seller has sold the property as an undivided interest without joint control.
26. Which of the following methods of accounting should be used if a lien superiority condition is **not** met?
- a. Deposit.
 - b. Installment.
 - c. Cost recovery.
 - d. Percentage-of-completion.
27. According to the Standards, a timeshare note that is modified in a manner that results in collection of less than _____ of the original note constitutes uncollectibility.
- a. 50%.
 - b. 75%.
 - c. 85%.
 - d. 100%.

28. The following entry would record the sale of the note and change from the ____ method to the ____ method?

Cash	\$ 454,500	
Deferred gain	180,000	
Loss on sale of note	21,500	
Note receivable		\$ 450,000
Liability for loss		21,500
Gain		180,000
Fee income		4,500

- a. Installment, full accrual.
 - b. Reduced profit, deposit.
 - c. Cost recovery, installment.
 - d. Percentage-of-completion, full accrual.
29. Losses on sales of real estate should be recognized when which of the following occurs?
- a. On the date that a firm sales agreement is reached.
 - b. When the initial investment requirement is met.
 - c. On the date of sale.
 - d. On the date the receivables originated.
30. Which of the following methods of accounting should be used when time-share units are sold separately and construction is past the preliminary stage, but not enough units have been sold to ensure that the entire project will not be converted into rental property?
- a. Deposit.
 - b. Cost recovery.
 - c. Reduced profit.
 - d. Percentage-of-completion.

GLOSSARY

Accrued interest: If a transfer of receivables are treated as a sale under SFAS No. 140, the transferor should treat any subsequent accrued interest receivables (AIRs), including late payment fees or other finance charges, that are billed and uncollected (or accrued but unbilled) as a retained beneficial interest

Amortization schedule method: An amortization schedule, updated each year, is maintained in a manner similar to a depreciation schedule. Each year the new provision for the current year is added and the earned discounts are taken into income.

Antispeculation clause: Antispeculation clauses typically either (a) require the buyer to develop the property (usually land) in a specific way or within a certain period or (b) prohibit the buyer from using the property for some specified purpose. If the buyer fails to comply with such clauses, the seller has the right to repurchase the property.

Binding contract: There is a contract that binds both parties.

Closing requirements: All of the conditions needed to close the sale (such as title policy, surveys, inspections, permits) have been met.

Contract sales price: The sales price specified in the sales contract. The contract sales price typically consists of cash, assumption of existing debt, notes payable to the seller, or some combination of the three.

Cost recovery method: This method also recognizes a sale and corresponding loan and may apply when dispositions do not qualify under the full accrual or installment methods. No profit or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan or a change to another accounting method is appropriate.

Deferral of revenue: The deferral of revenue is accomplished by deferring a portion of the net sales (gross sales less estimated cancellations and discounts). The deferral is based on the ratio of estimated cost to complete lots already sold, to the estimated total cost of lots sold.

Deposit method: The deposit method is used in situations where a sale of the real estate has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as other real estate.

Equity kicker: Occasionally, when property is sold, the seller may receive additional payments based on profits or cash flows commonly called an equity kicker.

Exchange of consideration: All consideration (such as cash, notes, and deeds) has been exchanged.

Financing arrangement: There are two primary ways to account for a transaction as a financing arrangement. The first is simply to use the deposit method. In effect, that treatment is used when the seller is obligated to support the operations of an unprofitable property for an extended period. The second approach may be used when the seller is required to repurchase the property at a price higher than the sales value.

Full-accrual method: Under this method, the disposition is recorded as a sale. Any resulting profit is recognized in full and the seller-financed asset is reported as a loan. The following conditions must be met in order to utilize this method.

- A sale has been consummated,
- The receivable is not subject to future subordination,
- The usual risks and rewards of ownership have been transferred, and
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.

Individual contract method: Schedules are maintained by individual contract.

Installment method: This method recognizes a sale and corresponding loan. Profits are recorded as the bank receives payments. Interest income is recognized on an accrual basis.

Inventory method: The estimated unamortized discount is computed at each reporting date. (Some companies make the computation periodically—at least annually—and estimate the interim amounts.)

Management contract: The seller agrees to manage the property under a noncancelable, long-term management contract, and the terms of the contract impose obligations on the seller beyond those of a typical property manager

Reduced-profit method: This method is appropriate in those situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements of the full accrual method. Like the installment method, any profit is recognized as payments are received. However, profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement. This method is seldom used in practice since sales with adequate down payments are generally not structured with inadequate loan amortization requirements.

Partial ownership: The seller retains a partial ownership interest in the property, and the seller will be required to support operations to an extent greater than its proportionate interest.

Partial sales: Partial sales are those in which the seller keeps an ownership interest in the property or has an ownership interest in the buyer.

Percentage-of-completion method: This method recognizes profit on a long-term construction contract as it is earned gradually during the construction period.

Reload transaction. SOP 04-2 defines a reload transaction as a time-sharing transaction where the buyer purchases a second time-share interval from the same seller but does not relinquish the right to the first time-share interval.

Right of refusal: A right of first refusal based on a bona fide offer from a third party.

Selling costs: Selling costs are the costs incurred in marketing and selling lots from retail land projects.

Significant receivable: The seller holds a significant receivable from the buyer, and collection of the receivable depends on the operations of the property

Superior lien: The seller's lien on the property must be superior to all other liens on the property, with certain exceptions.

Upgrade transaction: In an upgrade transaction, the buyer relinquishes the right to a currently held time-share interval and obtains a higher-priced time-share interval from the same seller.

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COMPANION TO PPC'S GUIDE TO REAL ESTATE**COURSE 2****Retail Land Sales (ARETG092)****OVERVIEW**

COURSE DESCRIPTION:	This interactive self-study course discusses the requirements of SFAS Nos. 66 & 67 as they relate to retail land sales as well as issues accountants may face when applying the statements. Lesson 1 describes the various accounting methods and requirements for retail land sales. Lesson 2 explains how to choose and apply the accounting methods as well as the direct selling costs and inventories specific to retail land sales.
PUBLICATION/REVISION DATE:	September 2009
RECOMMENDED FOR:	Users of <i>PPC's Guide to Real Estate</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting real estate transactions
CPE CREDIT:	5 QAS Hours, 5 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmarked by September 30, 2010
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES:**Lesson 1—Various Accounting Methods and Requirements for Retail Land Sales**

Completion of this lesson will enable you to:

- Explain the requirements of SFAS Nos. 66 and 67 as they relate to retail land sales.
- Identify the different methods of accounting for retail land transactions.
- Describe the requirements that must be met before a retail land sale contract can be recorded as a sale.
- Identify requirements for the retail land sales accounting methods: full accrual, percentage-of-completion, and installment method.

Lesson 2—Choosing and Applying the Accounting Methods, Direct Selling Costs, and Inventories

Completion of this lesson will enable you to:

- Summarize the characteristics of the accounting methods applicable to retail land sales and the implications of changing accounting methods.
- Describe the cost of retail lot sales using the selling costs unique to retail land projects.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

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Lesson 1: Various Accounting Methods and Requirements for Retail Land Sales

INTRODUCTION

This lesson discusses the requirements of SFAS Nos. 66 and 67 as they relate to retail land sales as well as issues accountants may face in applying the statements. It discusses one of the more difficult decisions in accounting for retail land sales—determining whether a land project is a retail land project. This lesson also introduces the four accounting methods for retail land sale contracts, and discusses the requirements that must be met before a retail land sale contract can be recorded as a sale. The end of this lesson discusses how to choose among the four accounting methods.

Learning Objectives:

Completion of this lesson will enable you to:

- Explain the requirements of SFAS Nos. 66 and 67 as they relate to retail land sales.
- Identify the different methods of accounting for retail land transactions.
- Describe the requirements that must be met before a retail land sale contract can be recorded as a sale.
- Identify requirements for the retail land sales accounting methods: full accrual, percentage-of-completion, and installment method.

RETAIL LAND SALES DEFINED

Retail land sales are generally characterized by volume sales of residential lots that are subdivisions of large tracts of land. Using concentrated marketing efforts, the developer usually provides the buyer with financing terms that require a lower down payment than banks and other financial institutions would require. Typically, the terms are such that financial institutions will not purchase the buyer's note without a substantial discount. In addition, the developer is often required by law to provide a refund period (sometimes referred to as a "cooling off period") during which the buyer can rescind the sale and receive a refund of all payments made under the contract. Development costs of retail land projects are accounted for under SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FASB ASC 970-340), and sales are accounted for under SFAS No. 66, *Accounting for Sales of Real Estate* (FASB ASC 976). There are, however, differences in how those statements are applied to retail land projects, and this chapter addresses those differences.

The first problem in accounting for retail land sales is determining whether a land project is actually a retail land project. Authoritative literature does not provide specific guidance on identifying retail land projects. Instead, it discusses the general characteristics of retail land sales and provides examples of real estate sales transactions that are not retail land sales.

Characteristics of Retail Land Projects

Concentrated Marketing. Retail land projects typically involve the purchase of large tracts of unimproved land that are subsequently improved, subdivided into residential lots, and marketed to retail customers using concentrated marketing techniques, such as mail, telephone, Internet, email, and brokers, as well as site visitations. Often, the marketing covers wide areas or geographic regions. Lots are normally used by the buyers as sites for primary or secondary homes or as places for motor homes or other recreational vehicles.

Favorable Financing. Lots can generally be purchased with relatively small down payments (i.e., down payments that are below the amount that would be required by a financial institution), and developers will often finance balances over reasonably long periods of time (5 to 10 years) at below market interest rates (i.e., interest rates that are below the rate that would be charged by a financial institution). The receivables are normally land sale contracts. While developers selling under land sale contracts may perform credit checks on buyers, they usually do not, and they usually have no recourse for nonpayment other than repossession of the lot. Typically, land sale contracts provide for a refund period of up to 30 days. (Some states have laws regulating the refund period.) If the

contract is canceled within the refund period, all payments are refunded. Once the refund period is passed, however, buyers who default (as defined in the contract) often lose the lots and all payments made. A land sale contract (sometimes referred to as a land contract) is an installment contract for the sale of land. The seller retains legal title until amounts due under the contract are paid in full.

Improvements. In most projects, the lots are improved or the developer is committed to add improvements such as roads, utilities, and site preparation. Many projects also include other improvements (amenities) such as golf courses, club houses, tennis courts, lakes, recreation centers, boat houses and docks, and other recreational facilities. Although rare, lots may also be sold without improvements or a commitment by the developer to complete improvements. Such sales may, however, indicate that the lots are being sold to investors rather than retail customers.

Land Sales That Are Not Retail Land Sales

SFAS No. 66 (FASB ASC 976-10-15-4) provides specific examples of transactions that should not be accounted for as retail land sales, including the following:

- Sales of lots, to builders.
- Sales of homes, buildings, and land parcels to builders and others.
- Sales of time-sharing interests.
- Sales of options to purchase real estate.

Bulk Sales. Bulk sales of residential lots are sometimes referred to as wholesale sales, and they are often made to homebuilders, other developers, or investors. Homebuilders usually purchase lots in order to build homes on a speculative basis or to sell the lots in conjunction with the construction of homes under contracts. Other developers, particularly small developers, may purchase tracts of lots to develop, which allows them to avoid investing large sums of money in large projects. Also, developers may sell tracts of lots to other developers as a way of financing project improvements. Investors buy lots to hold on a speculative basis.

The terms of those sales will usually distinguish them from the typical retail land sale. For example, the terms may be cash or, if the developer provides financing, the financing terms will normally be similar to terms that would be provided by financial institutions.

When Should Retail Land Sales Accounting Methods Be Applied?

Based on the preceding guidance, it is believed that retail land sales accounting is generally appropriate when a land project has all of the following characteristics:

- A parcel of land is subdivided into a large number of individual residential lots.
- Sales efforts include mass marketing directly to retail customers.
- Lots are sold individually, as opposed to bulk sales.
- Sales are to retail customers, as opposed to homebuilders, developers, or investors.
- Financing terms are provided that are more favorable than would be provided by a financial institution (such as, low down payments and/or below market interest rates).

It is important to note that the decision of whether a land development project is a retail land project (and, thus, is subject to retail land sales accounting methods) relates to the project, not individual transactions. Consequently, the preceding characteristics should be considered based on the pervasive characteristics of the project. Limited exceptions to each characteristic will be present in almost any retail land project. Also, if one part of a land project is being marketed in such a way that it has the characteristics of a retail land sales project, but another part is not, consideration should be given to accounting for the project as two separate projects.

When Should Retail Land Sales Accounting Methods Not Be Applied?

Generally, the real estate sales transactions earlier in this lesson and land projects that possess all of the following characteristics should be accounted for sales of real estate other than retail land sales—not as retail land projects:

- Land is sold with all, or substantially all, improvements in place and can be used immediately for construction.
- The developer provides the buyer with a deed and receives either full payment in cash or a down payment of not less than 10% with a note receivable that is legally enforceable against the buyer's general credit and is secured by a first mortgage on the land.
- The loan to collateral ratio is low enough and the buyer's credit (based on a credit investigation) is such that a local financial institution would finance the purchase at a rate comparable to the note's stated rate, and, consequently, the note is marketable at a financial institution without substantial discount and without recourse to the seller.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following statements regarding retail land financing is most accurate?
 - a. Although not required, developers usually provide buyers with refund periods.
 - b. A financial institution will purchase a buyer's note from a developer at a competitive price.
 - c. Above-market financing rates are one characteristic of a retail land sales contract.
 - d. Developers selling land under land sale contracts have only repossession of the lot as recourse action for nonpayment.
2. Which of the following statements regarding retail land sales is most accurate?
 - a. Retail land sales usually consist of a small number of lots subdivided into residential lots.
 - b. In most instances, the developer makes improvements to the lots.
 - c. Financing generally is at a higher rate than would be required by a financial institution.
3. Which of the following is considered a characteristic of when retail land sales accounting methods should be applied?
 - a. Lots are individually sold.
 - b. Land is sold with most of the improvements in place.
 - c. The developer provides the buyer with a deed and receives a down payment of not less than 20%.
 - d. Sales are directed toward investors.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following statements regarding retail land financing is most accurate? **(Page 97)**
 - a. Although not required, developers usually provide buyers with refund periods. [This answer is incorrect. A developer is often required by law to provide a refund period during which the buyer can rescind the sale and receive a refund of all payments made under the contract. Development costs of retail land projects are accounted for under SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FASB ASC 970-340), and sales are accounted for under SFAS No. 66, *Accounting for Sales of Real Estate* (FASB ASC 976).]
 - b. A financial institution will purchase a buyer's note from a developer at a competitive price. [This answer is incorrect. The terms of the developer's contract are such that financial institutions will not purchase the buyer's note without a substantial discount.]
 - c. Above-market financing rates are one characteristic of a retail land sales contract. [This answer is incorrect. Financing terms are provided in retail sales contract are more favorable than would be provided by a financial institution (such as, low down payments and/or below market interest rates).]
 - d. **Developers selling land under land sale contracts have only repossession of the lot as recourse action for nonpayment. [This answer is correct. Developers usually do not perform credit checks on buyers and have no other recourse for nonpayment other than repossession of the lot.]**
2. Which of the following statements regarding retail land sales is most accurate? **(Page 98)**
 - a. Retail land sales usually consist of a small number of lots subdivided into residential lots. [This answer is incorrect. Retail land projects usually involve substantial tracts of land. The AICPA accounting guide states that project sales consisting of a small number of lots should not be accounted for as retail sales.]
 - b. **In most instances, the developer makes improvements to the lots. [This answer is correct. Retail land property rarely is sold without improvements made by the developer. In most cases, the developer is obligated to add roads and utilities. Without such improvements, the sales may indicate that the lots are being sold to investors rather than retail customers.]**
 - c. Financing generally is at a higher rate than would be required by a financial institution. [This answer is incorrect. Developers usually require smaller down payments and are able to finance at rate below that of a financial institution because there is less risk.]
3. Which of the following is considered a characteristic of when retail land sales accounting methods should be applied? **(Page 98)**
 - a. **Lots are individually sold. [This answer is correct. A parcel of land that is subdivided into a large number of individual residential lots is one characteristic of when retail land sales accounting methods should be applied.]**
 - b. Land is sold with most of the improvements in place. [This answer is incorrect. Land that is sold with all, or substantially all, improvements in place and can be used immediately for construction is not considered and characteristic of when retail land sales accounting methods should be applied.]
 - c. The developer provides the buyer with a deed and receives a down payment of not less than 20%. [This answer is incorrect. When the developer provides the buyer with a deed and receives either full payment in cash or a down payment of not less than 10% with a note receivable that is legally enforceable against the buyer's general credit and is secured by a first mortgage on the land is a characteristic of when retail land sales accounting methods should not be applied.]
 - d. Sales are directed toward investors. [This answer is incorrect. One characteristic of when retail land sales accounting methods should be applied is when sales are to retail customers, not homebuilders, developers, or investors.]

ACCOUNTING METHODS

SFAS No. 66 (FASB ASC 976-605-25-2; 976-605-25-4 through 25-9) provides for four different methods of accounting for retail land sale transactions. Those methods include the following:

- Deposit method.
- Full accrual method.
- Percentage-of-completion method.
- Installment method.

By Contract or by Project

The deposit method is the only method used on a contract-by-contract basis. That is, each contract must be reviewed to determine if the deposit method must be used, and that determination is usually straightforward. If all of the conditions in the recognition of retail land sale contracts as sales section (later in this lesson) are not met, the sale is not recorded and the deposit method must be used for that contract until all of the conditions are met. When the conditions in that section are met, the sale is recorded and either the full accrual, percentage-of-completion, or installment method is used. The choice between those three methods is made on a project-by-project basis. Choosing a method is discussed in lesson 2 of this course.

One Method per Project

The same method of recognizing profits must be used for all recorded sales within a project. In other words, once a retail land sale has been recognized, all profit on retail land sales from the project must be recognized using either the full accrual, percentage-of-completion, or the installment method. If a company has more than one project in progress, it must make a separate determination as to the correct accounting method for each project. Due to the fact that accounting for retail land sales is done on a project-wide basis rather than on an individual transaction basis, the term "profit" is used in this course rather than "gain."

Summary of the Different Methods

When the deposit method is used, all payments (including interest) received from the buyer are recorded as deposits (i.e., a liability) by the developer. Each of the three other methods are profit recognition methods and are intended to fit specific situations. The methods differ primarily in the manner and timing of profit recognition. A brief summary of each method follows:

- Under the full accrual method, the entire profit on the sale is recognized when the sale is recorded.
- Under the percentage-of-completion method, profit is recognized when the sale is recorded, but only to the extent the promised improvements are complete (measured as costs incurred ÷ estimated total costs). The remaining revenue and the related improvement costs are recognized as the costs are incurred.
- Under the installment method, profit is recognized when the sale is recorded, but only to the extent the sales price has been collected (measured as sales price collected ÷ total sales price). The remaining profit is then recognized as principal payments are received from the buyer.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Which of the following methods of accounting is **not** used for retail land sales?
 - a. Installment.
 - b. Partial accrual.
 - c. Full accrual.
 - d. Percentage-of-completion.

5. Which of the following accounting methods is used on a contract-by-contract basis for retail land sale transactions?
 - a. Installment.
 - b. Deposit.
 - c. Cost recovery.
 - d. Percentage-of-completion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Which of the following methods of accounting is **not** used for retail land sales? **(Page 103)**
 - a. Installment. [This answer is incorrect. The installment method of accounting is used when there are uncertainties about specific assets of the retail land sales project.]
 - b. Partial accrual. [This answer is correct. The partial accrual method of accounting is not a known method of accounting for real estate sales.]**
 - c. Full accrual. [This answer is incorrect. The full accrual method of accounting is used for both retail land sales and sales of real estate other than retail land sales.]
 - d. Percentage-of-completion. [This answer is incorrect. When certain conditions are met, the percentage-of-completion method can be used for retail land sales.]
5. Which of the following accounting methods is used on a contract-by-contract basis for retail land sale transactions? **(Page 103)**
 - a. Installment. [This answer is incorrect. The choice to use the installment method of accounting is decided on a project-by-project basis.]
 - b. Deposit. [This answer is correct. The deposit method is the only method used per contract. Each contract must be examined to determine if all conditions are present to use the deposit method.]**
 - c. Cost recovery. [This answer is incorrect. The cost recovery method is not a method of accounting used for retail land sale transactions.]
 - d. Percentage-of-completion. [This answer is incorrect. The percentage-of-completion accounting method is also used on a project-by-project basis.]

RECOGNITION OF RETAIL LAND SALE CONTRACTS AS SALES

The characteristics of a typical retail land sale contract, such as small down payments, unenforceable contracts, and customer refunds, bring into question whether an exchange has taken place and whether the sales price can be valued with reasonable certainty. For that reason, SFAS No. 66 (FASB ASC 976-605-25-6 through 25-9) establishes conditions that must be met before a sale can be recognized. Until the sale is recognized, that transaction must be accounted for using the deposit method.

Conditions That Must Be Met to Record Sales

Prior to recording a retail land sale contract as a sale, SFAS No. 66 [FASB ASC 976-605-25-1; 976-605-25-6(a) and 25-6(b); 976-605-25-9] requires all of the following conditions to be met:

- The developer must have clearly demonstrated its ability to (a) provide funding for all planned improvements and off-site facilities promised in the contract and (b) meet all other promises it has made.
- The refund period must have expired.
- The buyer must have made the required down payment and each contractually required payment (including interest) due during the refund period.
- The payments (including interest) must equal or exceed 10% of the contract sales price.

The preceding conditions are illustrated in Exhibit 1-1. The following paragraphs discuss each of those conditions.

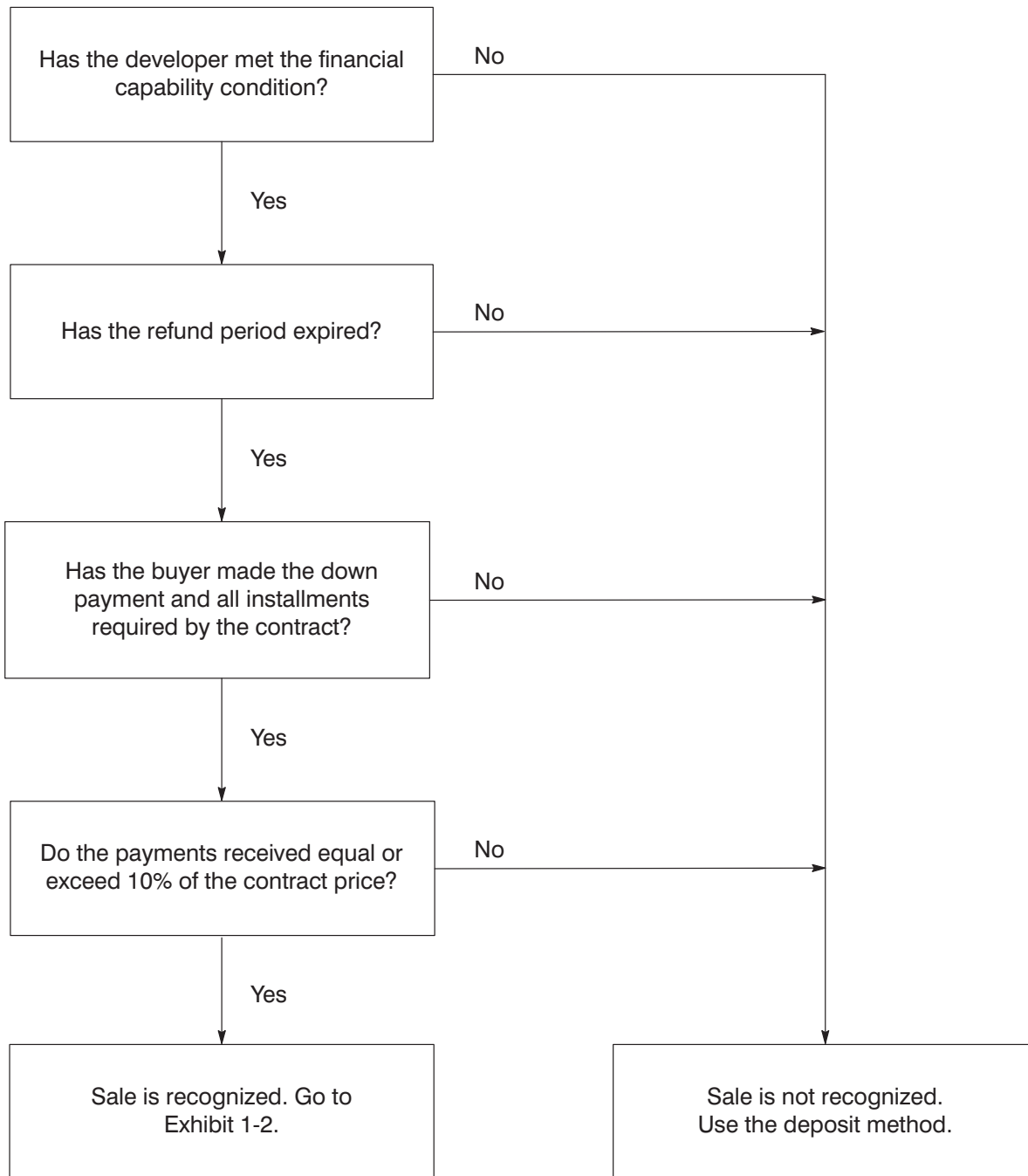
Ability to Fund Promised Improvements

In order to recognize a sales contract as a sale, Paragraph 47 of SFAS No. 66 (FASB ASC 976-605-25-1; 976-605-25-9) states that the developer must clearly demonstrate its ability to fund all promised improvements, including land improvements and any off-site facilities promised in the contract. In addition, the developer must clearly demonstrate its ability to meet all commitments it has made. Generally, that “financial capability” test is met if the developer can fund all anticipated costs from one or more of the following sources:

- Loans or loan commitments in place.
- Bonding in place.
- Available assets (particularly available liquid assets).
- Borrowing capacity.
- Cash flow from operations.

Although not specifically discussed generally, the “financial capability” test requires consideration of two additional factors typically addressed in relation to using the percentage-of-completion method. Those are as follows:

- Is the developer able to reasonably estimate the cost of future improvements?
- Has the project been determined to be practical?

Exhibit 1-1**Recording a Retail Land Sales Contract**

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Obviously, a determination cannot be made as to whether the developer is financially capable of funding all improvements unless the cost of those improvements can be reasonably estimated. Also, many of the considerations relating to whether the project is practical (e.g., legal or environmental restrictions and zoning considerations) affect both the cost of planned improvements and the developer's ability to complete the improvements. The following section discusses in further detail the consideration of those factors in relation to using the percentage-of-completion method. When considering those factors in relation to the "financial capability" test, judgment

must be applied. For example, cost estimates made early in the project are normally not as accurate as they will be after the project progresses. If the developer's financial strength is such that it can clearly meet all commitments, cost estimates need not be as precise as would be necessary if there were questions about the developer's financial strength.

Refund Period

Land contracts usually provide for a refund period of up to 30 days. (Some states have laws regulating the refund period.) SFAS No. 66 [FASB ASC 976-605-25-6(a)] requires the refund period to be the longer of the period—

- Required by local law.
- Established by the developer's policy.
- Specified in the contract.

Once the refund period has expired, buyers who default (as defined in the contract) often lose the lots and all payments made. If the contract is canceled within the refund period, all payments are refunded.

Buyer's Payments

The buyer must have made the down payment required by the sale contract and each contractually required payment (including interest) due during the refund period. The payments, including the down payment and principal and interest payments, must equal or exceed 10% of the contract sales price. However, a company could establish more restrictive conditions. Accordingly, in order to meet the receivable collectibility test without having to consider collectibility experience, or for other reasons, some companies, as a matter of policy, require down payments of 20% or more of the contract sales price. When that is the case, the 10% test discussed here will already have been met.

Returned Checks. A problem that sometimes occurs is that down payment checks are returned for insufficient funds. When a sale is recorded and the check subsequently is returned, the recording of the sale should be reversed. Some companies hold the sales journal open at the end of the reporting period to allow the checks time to clear. Those that do not clear are not recognized as sales.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Certain conditions must be met for retail land sale contracts to be recorded as sales. Which of the following is one of the four conditions that must be met in order to record sales?
 - a. All required improvements have been completed.
 - b. All payments have been received from the buyer.
 - c. A down payment must be made.
 - d. The project is determined to be practical.
7. When recording a retail land sale contract and the developer has met the financial capability condition, which of the following questions must be asked before moving to the next step in recognizing the sale transaction?
 - a. Has the refund period expired?
 - b. Do the payments received equal or exceed 10% of the contract?
 - c. Has the buyer made the down payment?
8. Which of the following conditions precede using the deposit method when the refund period has **not** expired?
 - a. The developer has met the financial capability condition.
 - b. The payment received equal or exceed 10% of the contract.
 - c. The buyer has not made the down payment required by the contract.
9. Which of the following tests is met if a developer can fund anticipated costs from sources such as borrowing capacity, cash flow from operations, and available assets?
 - a. Receivable collectability test.
 - b. 90% collectability test.
 - c. Financial capability test.
10. Which of the following statements regarding funding promised improvements is most accurate?
 - a. A developer must clearly demonstrate its ability to fund all off-site facilities.
 - b. Under the installment method, profit is recognized when the sale is recorded, but only to the extent the promised improvements are complete.
 - c. Sales of lots without improvement usually are an indication that the lots are being sold to retail customers.

11. Tom Green, a relatively new staff accountant for Highland Development Company, is thinking about a current land development project and is attempting to apply Paragraph 47 of SFAS No. 66 (FASB ASC 976-605-25-1; 976-605-29-9) to the project. Which of the following statements most accurately reflects the relationship between the cost of improvements made during development and the method for accounting for those improvements?
- a. Cost improvements must be reasonably estimated when deciding if a developer is financially capable of funding the improvements.
 - b. The full accrual method of accounting can only be used once ALL project improvements are initiated.
 - c. Once the improvements are close to completion, the developers will usually change to the installment method.
 - d. If the deferred revenue is not material, the deposit method of accounting must be used.
12. By which period must the buyer make the down payment required by the sale contract and each contractually required payment?
- a. Reporting period.
 - b. Collection period.
 - c. Refund.
13. The AICPA has indicated which of the following tests to be used by companies that require more restrictive conditions regarding the down payment and other contractually required payments?
- a. Receivable collectibility.
 - b. Nonsubordination.
 - c. Financial capability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Certain conditions must be met for retail land sale contracts to be recorded as sales. Which of the following is one of the four conditions that must be met in order to record sales? **(Page 107)**
 - a. All required improvements have been completed. [This answer is incorrect. This is a condition that must be met to use the full accrual method of accounting.]
 - b. All payments have been received from the buyer. [This answer is incorrect. Once all payments have been received from the buyer, the deposit method of accounting can be used and the developer accounts for the transaction as if no sale has occurred.]
 - c. **A down payment must be made. [This answer is correct. One of the four conditions that must be met to record sales is the buyer must have made the required down payment and each contractually required payment due during the refund period.]**
 - d. The project is determined to be practical. [This answer is incorrect. When using the percentage-of-completion method, the project must be considered practical.]
7. When recording a retail land sale contract and the developer has met the financial capability condition, which of the following questions must be asked before moving to the next step in recognizing the sale transaction? **(Page 107)**
 - a. **Has the refund period expired? [This answer is correct. This is an important question to ask because once the refund period is passed, buyers who default often lose the lots and all payments made.]**
 - b. Do the payments received equal or exceed 10% of the contract? [This answer is incorrect. The computation of payments to contract price is not the next step in the determination of when to record a retail land sales contract. Once the buyer has made the down payment and all installments required by the contract, then the determination is made as to whether the payments equal or exceed 10% of the contract.]
 - c. Has the buyer made the down payment? [This answer is incorrect. If the refund period has not expired then the determination as to if the buyer has made the down payment and all installments required by the contract must be made.]
8. Which of the following conditions precede using the deposit method when the refund period has **not** expired? **(Page 107)**
 - a. **The developer has met the financial capability condition. [This answer is correct. If the developer has met the financial capability condition and the refund period has not expired, the sale is not recognized and the deposit method must be used.]**
 - b. The payment received equal or exceed 10% of the contract. [This answer is incorrect. In order for this condition to be met and the deposit method to be used, the developer has to meet the financial capability condition, the refund period has to have expired, the buyer has made the down payment, and the payments received do not equal or exceed 10% of the contract price.]
 - c. The buyer has not made the down payment required by the contract. [This answer is incorrect. If the developer has met the financial capability condition, the refund period has not expired, the sale is not recognized if the buyer has not made the down payment.]

9. Which of the following tests is met if a developer can fund anticipated costs from sources such as borrowing capacity, cash flow from operations, and available assets? **(Page 107)**
- a. Receivable collectability test. [This answer is incorrect. In order to meet the receivable collectability test without having to consider collectability experience, or for other reasons, some companies, as a matter of policy, require down payments of 20% or more of the contract sales price.]
 - b. 90% collectability test. [This answer is incorrect. The 90% collectability test is based on contracts receivable recorded since the inception of the current project except those canceled within six months after being recorded.]
 - c. **Financial capability test. [This answer is correct. The financial capability test is met if a developer can fund anticipated costs from sources such as borrowing capacity, cash flow from operations, and available assets. Other sources include loan commitments in place, and bonding in place.]**
10. Which of the following statements regarding funding promised improvements is most accurate? **(Page 107)**
- a. **A developer must clearly demonstrate its ability to fund all off-site facilities. [This answer is correct. According to Paragraph 47 of SFAS No. 66, to recognize a sales contract as a sale the developer must clearly demonstrate its ability to fund all promised improvements, including land improvements and any off-site facilities promised in the contract.]**
 - b. Under the installment method, profit is recognized when the sale is recorded, but only to the extent the promised improvements are complete. [This answer is incorrect. Under the percentage-of-completion method, profit is recognized when the sale is recorded, but only to the extent the promised improvements are complete. The remaining revenue and the related improvement costs are recognized as the costs are incurred.]
 - c. Sales of lots without improvement usually are an indication that the lots are being sold to retail customers. [This answer is incorrect. Although rare, lots may also be sold without improvements or a commitment by the developer to complete improvements. Such sales may, however, indicate that the lots are being sold to investors rather than retail customers.]
11. Tom Green, a relatively new staff accountant for Highland Development Company, is thinking about a current land development project and is attempting to apply Paragraph 47 of SFAS No. 66 (FASB ASC 976-605-25-1; 976-605-29-9) to the project. Which of the following statements most accurately reflects the relationship between the cost of improvements made during development and the method for accounting for those improvements? **(Page 108)**
- a. **Cost improvements must be reasonably estimated when deciding if a developer is financially capable of funding the improvements. [This answer is correct. The reasonableness of the estimated cost to fund all improvements must be made by considering factors such as legal or environmental restrictions and zoning considerations. A determination cannot be made as if the developer is financially capable of funding all improvements unless the cost can be reasonably estimated.]**
 - b. The full accrual method of accounting can only be used once ALL project improvements are initiated. [This answer is incorrect. The full accrual method of accounting can be used, once all improvements are complete.]
 - c. Once the improvements are close to completion, the developers will usually change to the installment method. [This answer is incorrect. When improvements are close to completion, developers will normally be choosing between the full accrual and percentage-of-completion methods.]
 - d. If the deferred revenue is not material, the deposit method of accounting must be used. [This answer is incorrect. If the deferred revenue is not material, the full accrual method can be used.]

12. By which period must the buyer make the down payment required by the sale contract and each contractually required payment? **(Page 109)**
- a. Reporting period. [This answer is incorrect. The reporting period is used by some companies by holding the sales journal open at the end of the reporting period to allow the checks time to clear.]
 - b. Collection period. [This answer is incorrect. No guidance is provided in the authoritative literature as to how long a collection period should be or how many lots should be included to provide reliable evidence of collectibility.]
 - c. **Refund period. [This answer is correct. The required down payment must be made during the refund period. In addition to the down payment, other payments include the principal and interest payments and all must equal or exceed 10% of the contract sales price.]**
13. The AICPA has indicated which of the following tests to be used by companies that require more restrictive conditions regarding the down payment and other contractually required payments? **(Page 116)**
- a. **Receivable collectibility. [This answer is correct. The receivable collectibility tests can be administered by companies that wish to establish more restrictive conditions when collecting the down payment. To meet the receivable collectibility test without having to consider collectibility experience, or for other reasons, some companies, as a matter of policy, require down payments of 20% or more of the contract sales price. When that is the case, the 10% test discussed here will already have been met.]**
 - b. Nonsubordination. [This answer is incorrect. If conditions are not met for the project as a whole, the project fails the nonsubordination test. This test is not interrelated to the timing of a buyer's down payment.]
 - c. Financial capability. [This answer is incorrect. The financial capability test is met if the developer can fund all anticipated costs from cash flow operations. This is just one of several sources that is required to meet this test.]

CHOOSING THE ACCOUNTING METHOD

General

Profit on retail land sales in a retail land project must be recognized using either the full accrual, percentage-of-completion, or installment method. The developer of a retail land project is not free to choose among those three methods. That is, the methods do not represent equal alternatives. Instead, when certain conditions are met or not met, a specific method should be used. This lesson discusses the criteria for each accounting method. The guidance in this lesson is summarized in the flowchart at Exhibit 1-2.

One Method per Project

The same profit recognition method must be used for all recorded sales within a project. Companies who have more than one project in progress must make a separate determination as to the correct accounting method for each project.

Nonsubordination of the Receivables

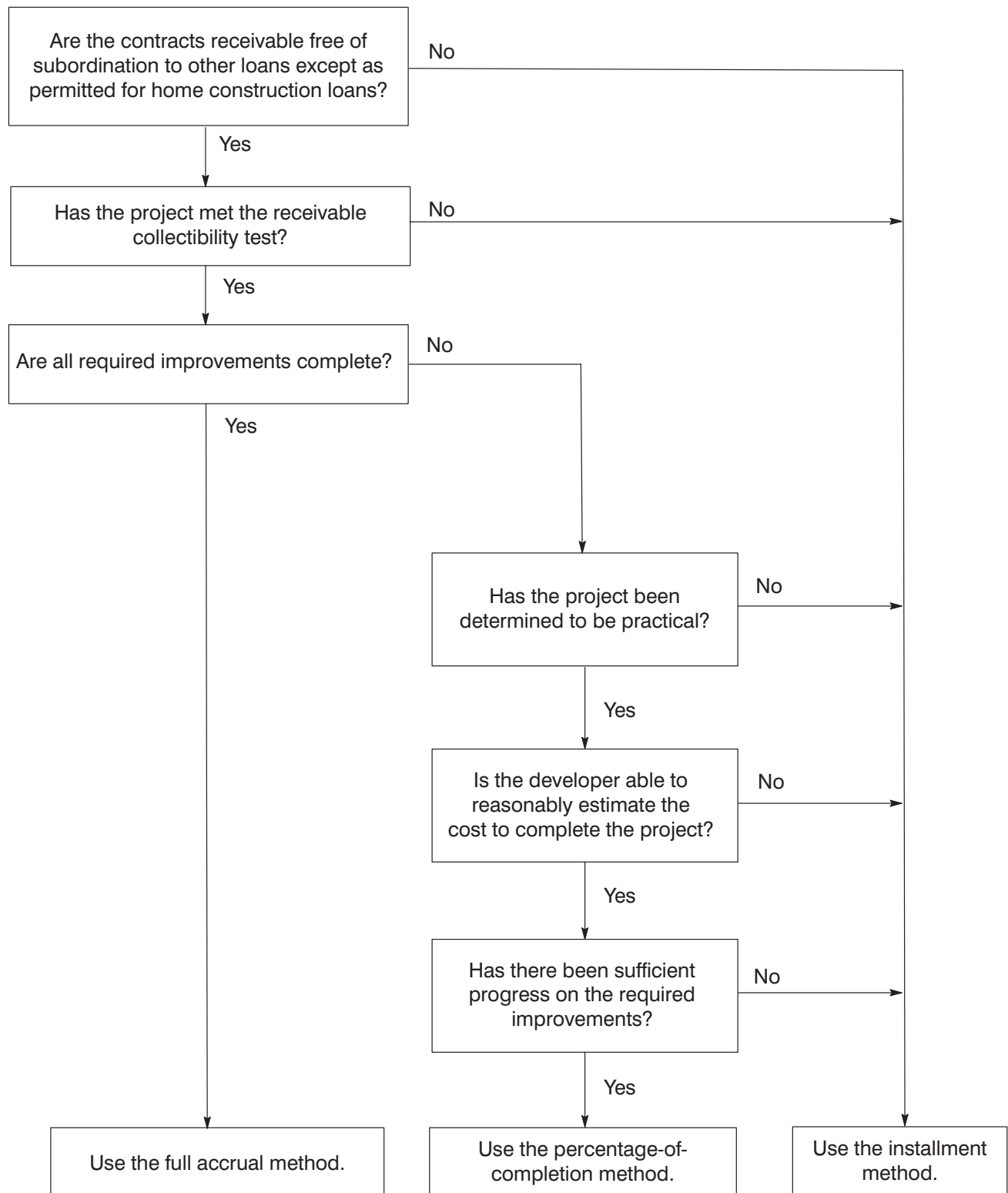
Paragraphs 45 and 46 of SFAS No. 66; 976-605-25-8 state that, to use the full accrual or the percentage-of-completion method, contracts receivable cannot be subordinate to new loans on the property. The one exception is that a receivable can be subordinate to a home construction loan obtained by the buyer. That exception is allowed, however, only if the collection experience on those "subordinated" receivables is the same or better than the collection experience on receivables that are not subordinated.

Compliance with the nonsubordination requirement, like all of the criteria discussed in this lesson, must be determined for the project as a whole. However, the conditions must be met for the entire project. Consequently, based on that standard, the project fails the nonsubordination test if even one of the project's receivables fails the nonsubordination test. Generally, a retail land project will have a standard contract that does not allow such a subordination (except as permitted as explained in the preceding paragraph). Occasionally, however, a lot may be sold under a modified sales contract that subordinates the receivable in a manner not contemplated. When that occurs, the project has technically not met the nonsubordination requirement. In those cases, it is believed that materiality should be considered. Generally, it is believed the project can be considered to have complied with the nonsubordination requirement if a significant percentage, such as 90% or more, of the project's receivables meet the nonsubordination test. That 90% rule-of-thumb is based on the 90% requirement specified by SFAS No. 66 [FASB ASC 976-605-25-6(c)] for assessing the collectibility of receivables.

Collectibility of Receivables

Another condition for use of the full accrual method or the percentage-of-completion method is that receivables must be considered to be collectible. That condition is met if a down payment of at least 20% is collected. If that is not done, the collectibility requirement is met if collection experience indicates that 90% or more of the contracts from the current project not canceled within six months following the date the sales contract is recorded will be collected in full. The 90% condition is assessed based on collection experience data from:

- Prior projects.
- The current project.

Exhibit 1-2**Accounting Methods for Retail Land Sales**

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Project Improvements

In most retail land projects, the lots are improved or the developer is committed to add improvements after the sale. It is rare for lots sold to be sold without improvements. Paragraph 45 of SFAS No. 66 (FASB ASC 976-605-25-6) indicates that, for the full accrual method to be used, all such improvements must be complete. As a practical matter, improvements need not be absolutely complete in order to use the full accrual method. Paragraph 73 of SFAS No. 66 (FASB ASC 976-605-30-1) indicates that revenue should be deferred when the estimated remaining cost of improvements are *significant* in relation to the estimated total cost. When improvements are close to completion, developers will normally be choosing between the full accrual and percentage-of-completion methods. Consequently, if the amount of revenue that would be deferred under the percentage-of-completion method is material to the financial statements, the percentage-of-completion method should be used. If the deferred revenue is not material, the full accrual method can be used.

If the contracts are free of subordination to other loans and meet the receivable collectibility test, but all required improvements are not complete, either the percentage-of-completion method or installment method must be used. The percentage-of-completion method is used if the following three conditions are met:

- Development is practical.
- The cost of the remaining improvements can be reasonably estimated.
- There has been sufficient progress on the required improvements.

If any of those conditions are not met, the installment method must be used.

Development Is Practical. Paragraph 46 of SFAS No. 66 (FASB ASC 976-605-25-8) indicates that development can be considered practical when—

- a. It is reasonable to expect that the land can be developed for the indicated purposes.
- b. It is expected that no legal restrictions (such as environmental problems or required permits) will restrict development.
- c. Improvements, such as access roads, water supply, sewage treatment or removal, are feasible within a reasonable time.

The practicality of the project should be assessed when determining if the developer is financially capable. Typically, in the early stages of a project (even before improvements are commenced), it is determined that the development is practical and contracts (after they meet the remaining conditions for sales recognition) are recorded as sales. As the project progresses, the nature and cost of the improvements become more defined, and plans for improvements may even be added that were not promised during earlier stages of the project. If the installment method is being used, a condition for changing to the percentage-of-completion method is that the development, as presently planned, is practical. If the project is already using the percentage-of-completion method, a redetermination that the development is practical need not be made.

Cost to Complete. Another condition for using the percentage-of-completion method is that the developer must be able to reasonably estimate the cost to complete the project, which is simply the total cost of the project less the costs incurred to date.

For the estimated total project cost to be acceptable for use with the percentage-of-completion method, Paragraph 75 of SFAS No. 66 (FASB ASC 976-605-30-3) states that the costs must—

- a. Be based on costs (such as, labor rates and the cost of material) generally expected in the construction industry locally.
- b. Include the unrecoverable costs of all planned off-site improvements, utilities, and amenities (such as, improvements). Planned improvements should include those—
 - (1) For which the developer is contractually obligated by sale contracts.

- (2) For which the developer is obligated by law.
- (3) That the developer has promised in selling documents (such as sales brochures).
- (4) That the developer plans to provide, even if not included in (1), (2), or (3).

When estimating unrecoverable costs, SFAS No. 66 (FASB ASC 976-605-30-3) requires the estimated recovery amounts to be discounted to their present values as of the date the net unrecoverable costs are recognized.

The reasonableness of the estimated cost to complete the project is assessed at the date the developer is considering the use of the percentage-of-completion method, and the cost estimates are based on the developer's plans at that date. Development plans often change as the project progresses (for example, the developer decides to add an additional amenity), and cost estimates should reflect the developer's current plans. For example, assume that cost estimates at the beginning of a project were considered to be reasonable and it was determined that the developer was financially capable. All other conditions for sales recognition were met, but all conditions for using the percentage-of-completion method were not met (for example, there was not sufficient progress on improvements). Consequently, the developer adopted the installment method. If the developer is now considering a switch from the installment method to the percentage-of-completion method, the developer must be able to reasonably estimate the cost of the uncompleted improvements as presently planned.

Progress on Project Improvements. The last condition for using the percentage-of-completion method is that project improvements must have progressed beyond the preliminary stage, and evidence must indicate that the improvements will be completed according to plan. Paragraph 46 of SFAS No. 66 (FASB ASC 976-605-25-8) indicates that the following are suitable evidence that the improvements have progressed beyond the preliminary stage.

- Work has begun or funds have been expended on the actual improvements relating to the lots sold.
- In the absence of actual work on the improvements, there are engineering plans and work commitments (such as, construction contracts) relating to the lots sold.
- In the absence of efforts directly related to lots sold (such as site preparation and roads), completed access roads and/or amenities (such as a golf course or a park) exist.

SFAS No. 66 (FASB ASC 976-605-25-8) also requires that there be no indication of significant delaying factors such as problems obtaining permits, contractors, personnel, or equipment.

If evidence exists that the project is beyond the preliminary stage and the developer is financially able to complete the project, it can generally be assumed that the project will be completed according to plan. Usually, the best evidence of that is when the developer has invested enough funds to make it too costly to not complete the project.

The selection of an accounting method is not just a one-time decision. Ordinarily, a project will first use either the installment or percentage-of-completion method. As the project progresses and additional criteria are met, the accounting method will change until, ultimately, the full accrual method can be used. Consequently, the decision of which accounting method to use must be reassessed periodically. Neither authoritative literature does not indicate how often the determination should be made. However, SFAS No. 66 (FASB ASC 976-605-25-10) does indicate that, as the conditions are met, the method of accounting must change.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. Which of the following statements regarding accounting methods for project is most accurate?
 - a. The same profit recognition method must be used for all recorded sales within a project.
 - b. Companies that have more than one project in progress must use the same accounting method for all projects.
 - c. The developer is free to choose among various methods.
15. Paragraphs 45 and 46 of SFAS No. 66; 976-605-25-8 state that to use the full accrual or the percentage-of-completion method, contracts receivable cannot be subordinate to new loans on the property. The one exception is that a receivable can be subordinate to which of the following loans obtained by the buyer?
 - a. Acquisition.
 - b. Home construction.
16. Which of the following methods of accounting is most commonly used when the seller is obligated to build additional facilities as a condition of the sale?
 - a. Deposit.
 - b. Percentage-of-completion.
17. Which of the following is key when assessing if a development is practical?
 - a. The amount of contracts.
 - b. Developer is financially capable.
 - c. Similarity of land, environment, and clientele.
 - d. The developer is committed to add improvements after the sale.
18. If a developer uses their collection experience from a current project, what should be their primary consideration?
 - a. If a reasonable number of sales can provided enough evidence assuring that 90% of contracts will be collected.
 - b. If at least 50% of the contracts have been in place for at least 30 days constituting evidence of collectability.
 - c. If the lots are to be used for construction of primary residences.
 - d. If the economic conditions are similar to previous projects.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. Which of the following statements regarding accounting methods for project is most accurate? **(Page 116)**
- a. **The same profit recognition method must be used for all recorded sales within a project. [This answer is correct. The same method of recognizing profits must be used for all recorded sales within a project. In other words, once a retail land sale has been recognized, all profit on retail land sales from the project must be recognized.]**
 - b. Companies that have more than one project in progress must use the same accounting method for all projects. [This answer is incorrect. Companies that have more than one project in progress must make a separate determination as to the correct accounting method for each project.]
 - c. The developer is free to choose among various methods. [This answer is incorrect. The developer of a retail land project cannot choose among the three methods of accounting because the different methods do not represent equal alternatives.]
15. Paragraphs 45 and 46 of SFAS No. 66; 976-605-25-8 state that to use the full accrual or the percentage-of-completion method, contracts receivable cannot be subordinate to new loans on the property. The one exception is that a receivable can be subordinate to which of the following loans obtained by the buyer? **(Page 116)**
- a. Acquisition. [This answer is incorrect. An acquisition loan is a loan for purchasing raw, or yet to be developed, land. However, this type of loan would not be used in this situation.]
 - b. **Home construction. [This answer is correct. The one exception is that a receivable can be subordinate to a home construction loan obtained by the buyer. That exception is allowed, however, only if the collection experience on those subordinated receivables is the same or better than the collection experience on receivables that are not subordinated.]**
16. Which of the following methods of accounting is most commonly used when the seller is obligated to build additional facilities as a condition of the sale? **(Page 151)**
- a. Deposit. [This answer is incorrect. Under the deposit method, the seller is not obligated to develop the property. However, the seller does have the option to buy the property.]
 - b. **Percentage-of-completion. [This answer is correct. The percentage-of-completion method is commonly used when the seller is obligated to develop the property or build additional facilities as a condition of the sale.]**
17. Which of the following is key when assessing if a development is practical? **(Page 118)**
- a. The amount of contracts. [This answer is incorrect. Authoritative literature provides no guidance as to exactly how many contracts and what dollar amount constitute sufficient evidence of a financially practical development.]
 - b. **Developer is financially capable. [This answer is correct. The practicality of the project should be assessed when determining if the developer is financially capable. Typically, in the early stages of a project (even before improvements are commenced), it is determined that the development is practical and contracts (after they meet the remaining conditions for sales recognition) are recorded as sales.]**
 - c. Similarity of land, environment, and clientele. [This answer is incorrect. Determining whether projects are on the same type of land and in the same environment is important when deciding where to build.]

- d. The developer is committed to add improvements after the sale. [This answer is incorrect. It is rare for lots sold to be sold without improvements. Adding improvements is not key when assessing if a development is practical.]
18. If a developer uses their collection experience from a current project, what should be their primary consideration? **(Page 118)**
- a. **If a reasonable number of sales can provided enough evidence assuring that 90% of contracts will be collected. [This answer is correct. If the collectability of receivables condition cannot be met by either of the 20% down payment or collection experience from prior projects, collection experience for the current project should be considered. The primary consideration usually is whether an adequate number of sales have had a sufficiently long collection period to provide sufficient evidence that 90% of contracts will be collected.]**
- b. If at least 50% of the contracts have been in place for at least 30 days constituting evidence of collectability. [This answer is incorrect. Authoritative literature provides no guidance as to exactly how many contracts and what period of time constitute sufficient evidence of collectability.]
- c. If the lots are to be used for construction of primary residences. [This answer is incorrect. The similarity of clientele generally relates to the demographics of the project's target market. Although this is considered a key factor in collecting experience form prior projects, it is not a primary consideration used in collecting experience from a current project.]
- d. If the economic conditions are similar to previous projects. [This answer is incorrect. Although not specifically mentioned in authoritative literature, best practices indicate that one of the most important factors in using collections from prior projects is the similarity of economic conditions. This is not a primary factor when using collection experience from a current project.]

COLLECTIBILITY OF RECEIVABLES

One condition for use of the full accrual or the percentage-of-completion method is that receivables must be considered collectible. That condition is met if either of the following occurs:

- A down payment of at least 20% is collected.
- Collection experience indicates that at least 90% of the contracts from the current project not canceled within six months from the date the sale is recorded will be collected in full.

20% Down Payments

The more that buyers have at risk, the less likely they are to default on their sales contracts. For that reason, a down payment of at least 20% of the contract price is acceptable evidence of collectibility. Authoritative literature is explicit in referring to down payments. Consequently, only the down payment specified to in the contract should be considered. Payments received later (such as monthly payments) should not be considered. Cumulative payments are considered only in relation to the 10% test. Companies that require a 20% down payment will already have met that 10% test.

90% Collectibility Test

Similarity to the Allowance for Cancellations. Determining whether 90% of the contracts will be collected requires significant judgment. In some ways, the process is the same as determining an allowance for cancellations. That is, both require a decision as to whether contracts are expected to be collected or canceled. The primary difference, however, is that the 90% collectibility test is based on contracts receivable recorded since the inception of the current project *except those canceled within six months after being recorded*. The allowance for cancellations, however, is generally based on a cancellation rate including *all* contracts receivable recorded since inception of the project. Also, the allowance for cancellations must be considered each time financial statements are prepared, while consideration of the 90% collectibility test is unnecessary once the full accrual or percentage-of-completion method is adopted.

Contracts or Dollars? A literal reading of Paragraph 45 of SFAS No. 66 (FASB ASC 976-605-25-6) would indicate that the 90% collectibility test should be based on the number of contracts rather than the dollar amount of contracts. Because there is usually very little variation in lot prices within a retail land project, either approach will ordinarily provide the same results.

Collection Experience. The 90% collectibility test must be based on collection experience from either prior projects (if they are sufficiently similar to the current project) or the current project (if the developer has no sufficiently similar prior projects). The remainder of this lesson discusses the following specific issues in determining collection experience:

- Use of collection experience from prior projects.
- Use of collection experience from the current project.
- Use of industry averages.
- Calculating the collection percentage.

Collection Experience from Prior Projects

If developers are able to use their collection experience from prior projects, they will usually be able to convert to the full accrual or percentage-of-completion method sooner than if collection experience from the current project is used. Use of the collection experience from prior projects is permissible when the prior projects had—

- a. Predominately the same type of land, environment, clientele, contract terms, and sales methods (such as telephone, broker, and on-site) as the current project.

- b. Sufficiently long collection periods and enough lots to provide reliable evidence as to the percentage of current sales of the new project that will be collected in full.

Similarity of Land, Environment, and Clientele. Determining whether projects are on the same type of land and in the same environment is a matter of judgment. It is believed that use of the lots is a key factor. For example, a project consisting mostly of lots to be used for construction of primary residences may not be the same as a project consisting mostly of lots to be used for retirement or vacation homes. But the project could generally be considered the same as another project consisting mostly of lots of comparable value to be used for construction of primary residences. Similarity of environment also relates to the type of land being developed. For example, conversion of flood-prone land to residential lots involves unique concerns, and such a project may not be sufficiently similar to other land projects. Similarity of clientele generally relates to the demographics of the project's target market.

Similarity of Contracts. There are two types of contracts that are normally used in retail land projects. The most common type is a land sale contract. The other type is a purchase money mortgage. Generally, projects using mostly land sale contracts will be sufficiently similar to one another, and projects using mostly purchase money mortgages will be sufficiently similar to one another. However, projects using mostly land sale contracts may not be sufficiently similar to projects using mostly purchase money mortgages.

Similarity of Sales Methods. Since different sales methods are usually designed to reach different types of clientele, the different methods often produce sales that will have different collection experiences. When different sales methods are used to a significant degree, historical collection data should be separated by sales method. For example, if 60% of all sales are through brokers and 40% are on-site, separate data will often be necessary. However, if virtually all (such as, 90%) sales are through one method, separate data may not be necessary. The decision of whether separate data is necessary is a matter of judgment based on the specific circumstances of each project. The primary consideration is whether the collection experience can be expected to be similar. If it can, separate data is not needed.

Similarity of Economic Conditions. Although not specifically mentioned in authoritative literature, it is believed that one of the most important factors in using collections from prior projects is the similarity of economic conditions. That is, the real estate market during the period of collections on the prior project should be similar to the market expected during the period of collections on the current project. For example, if the region has entered a recession since the prior project was completed, the prior project may not be sufficiently similar to the current project to provide reliable evidence about collectibility.

Collection Period. No guidance is provided in authoritative literature as to how long a collection period should be or how many lots should be included to provide reliable evidence of collectibility. That conclusion requires judgment and should be based on factors such as the planned use of the lots (e.g., contracts on primary residential lots are more likely to be collectible), contract terms (e.g., the higher the down payment, the more likely the contract will be collected), the sales methods used, and the state of the economy. When those factors indicate that buyers are more likely to meet their obligations, fewer lots and a shorter collection period can be used. Conversely, if those factors indicate collectibility problems, more lots and a longer collection period should be used. It is believed that, in many cases, collection experience covering a minimum of 100 contract sales and 50% of the normal average contract payout period will be sufficient. For example, if ten years is the average length of the sales contracts in the prior project, the collection period should extend at least through the end of the fifth year of the project. The 100 lot—50% guideline assumes a relatively constant number of annual sales.

Collection Experience from Current Project

If the collectibility of receivables condition cannot be met by either of the first two methods (i.e., 20% down payment or collection experience from prior projects), collection experience for the current project should be considered. The primary consideration usually is whether an adequate number of sales have had a sufficiently long collection period to provide sufficient evidence that 90% of contracts will be collected.

How Many Contracts and for How Long? Authoritative literature provides no guidance as to exactly how many contracts and what period of time constitute sufficient evidence of collectibility. Note that the ability to satisfy the collectibility condition is the most difficult and vital to overcoming the uncertainties involving contract sales. It is

therefore not surprising that the guidance for retail land sales, effectively precludes new companies and companies without prior experience in retail land sales from using the full accrual or percentage-of-completion method.

Industry Averages

SFAS No. 66 (FASB ASC 976-605-25-6) specifically states that the collection experience must be that of the current project or the developer's prior project(s).

Calculating the Collection Percentage

Authoritative literature also does not discuss what type of collection experience data is necessary. However, in order to determine the collection percentage (that is, the percentage of contracts that (a) are not canceled six months after the sales were recognized and (b) are expected to be collected in full) the following information is needed:

- a. Project sales for the collection period.
- b. Cancellations of the sales contracts in a., segregated between—
 - (1) Contracts canceled within six months of the date the sales were recognized (referred to as six-month cancellations).
 - (2) Contracts canceled or expected to be canceled after six months (referred to as subsequent cancellations).

The collection percentage would be calculated as follows:

$$\frac{\text{Project sales} - \text{six-month cancellations} - \text{subsequent cancellations}}{\text{Project sales} - \text{six-month cancellations}}$$

Sources of Data. Collection percentages can be calculated based on representative samples. Project sales information generally can be obtained from financial statements or cumulative sales data maintained by most projects. Many projects also maintain cancellation data consisting of contract sales amounts, dates sales were recognized, and the cancellation dates. By reviewing that information, the six-month cancellation amount can be accumulated. A problem that almost always occurs, however, is that the cancellation date is the date of the actual cancellation rather than the date the contract actually became uncollectible. Consequently, consideration must also be given to contracts that are not expected to be collected but have not yet been canceled.

Which Contracts Have Canceled? The unpaid balance of a contract should be considered uncollectible (that is, canceled) when any of the following has occurred:

- a. A cancellation is formally received from the buyer. (Some projects use cancellation forms that may be completed by the buyer evidencing a "formal" cancellation.)
- b. The contract exceeds the delinquency periods specified in SFAS No. 66 (FASB ASC 976-310-35-1) as follows:

When the Percent of the Total Contract Price Collected Is

Less than 25%
25% but less than 50%
50% or over

And the Delinquency Period Is at Least

90 days (3 months)
120 days (4 months)
150 days (5 months)

- c. It otherwise is evident that the buyer is unwilling to continue payments, even though no cancellation notice has been signed. Such contracts will usually be identified when considering the delinquency periods in item b. However, there may be instances in which they are not (e.g., payments may be current, but the developer may have received a letter stating that no further payments will be made).

While SFAS No. 66 (FASB ASC 976-605) does not indicate that this guidance should be used for calculating the collection percentage, best practices indicate that the guidance can be used.

SFAS No. 66 (FASB ASC 976-310-35-2) states that the delinquency period in the preceding table can be extended if either of the following conditions exists:

- Recent collection experience has been better.
- The buyer has accepted, or is willing to accept, personal liability for the debt and the buyer's ability to make the payments can be determined. In other words, the debt can be enforced against the buyer and a credit check has been or can be made to determine the buyer's ability to pay. [While SFAS No. 66 (FASB ASC 976-310-35-2) refers to "is willing to accept," the authors believe it would be rare for this event to have not occurred if the delinquency periods are extended.]

To illustrate, assume the following facts:

- A company has begun selling lots from its second project. Down payments of 10% are required, so collectibility must be established by using the 90% collectibility test.
- The company's first project, which is sufficiently comparable to the current project, was completed and sold out (or substantially sold out) one year ago. Data on the first project includes:

Sales	\$ 15,000,000
Six-month cancellations	4,000,000
Subsequent cancellations	2,000,000

- A review of the subsequent cancellations was made to determine those that were in-substance six-month cancellations. In-substance six-month cancellations totaling \$500,000 were found. Since those contracts are treated as having been canceled within six months, they are excluded from subsequent cancellations and added to six-month cancellations when calculating the collection percentage.
- A review of the current receivable aging list revealed additional in-substance subsequent cancellations, totaling \$100,000. No additional in-substance six-month cancellations were found.

The collection percentage would be 85%, computed as follows:

Sales	\$ 15,000,000
Six-month cancellations	(4,000,000)
In-substance six-month cancellations	<u>(500,000)</u>
	<u>\$ 10,500,000</u>
$\frac{\$10,500,000 - (\$2,000,000 - \$500,000 + \$100,000)}{\$10,500,000} = 85\%$	

Since the collection percentage is only 85%, the 90% collectibility requirement for using the full accrual or percent-age-of-completion method of accounting is not met.

Another way to organize the data to more explicitly adhere to the collection percentage formula above is as follows:

<u>First Project Data</u>	<u>Original Data</u>	<u>+</u>	<u>Review of Subsequent Cancellations</u>	<u>+</u>	<u>Review of Current Receivables</u>	<u>=</u>	<u>Revised Data</u>
Sales	\$ 15,000,000						\$ 15,000,000
Six-month cancellations	4,000,000	\$	500,000				4,500,000
Subsequent cancellations	2,000,000		(500,000)	\$	100,000		1,600,000

Using the revised data from the first project, the collection percentage is computed as follows:

$$\frac{\$15,000,000 - \$4,500,000 - \$1,600,000}{\$15,000,000 - \$4,500,000} = 85\%$$

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following is **not** a condition that is necessary when using the percentage-of-completion method of accounting?
 - a. Practicality of the project.
 - b. Cost to complete the project.
 - c. Project improvement progression.
 - d. Similarity of sales methods.
20. Receivables must be considered collectible is a condition that must be met for use of which of the following two accounting methods?
 - a. Full accrual and installment.
 - b. Percentage-of-completion and full accrual.
 - c. Deposit and installment.
21. A land sale contract is only one type of contract that is normally used in retail land projects. Which of the following is the other type of contract?
 - a. Purchase money mortgage.
 - b. Time-share.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following is **not** a condition that is necessary when using the percentage-of-completion method of accounting? **(Page 125)**
- a. Practicality of the project. [This answer is incorrect. The first condition necessary to use the percentage-of-completion method is the project must be practical.]
 - b. Cost to complete the project. [This answer is incorrect. The cost of the remaining improvements being reasonably estimated is the second condition necessary to use the percentage-of-completion method of accounting.]
 - c. Project improvement progression. [This answer is incorrect. The last condition for using the percentage-of-completion method of accounting is the progress on project improvements.]
 - d. **Similarity of sales methods. [This answer is correct. Since different sales methods are usually designed to reach different types of clientele, the different methods often produce sales that will have different collection experiences. This is not a condition for using the percentage-of-completion method.]**
20. Receivables must be considered collectible is a condition that must be met for use of which of the following two accounting methods? **(Page 124)**
- a. Full accrual and installment. [This answer is incorrect. Under the full accrual method of accounting, receivables must be considered collectible; however, the basis for using the installment method is that a sale has occurred, but there are uncertainties about the collectibility of the receivable.]
 - b. **Percentage-of-completion and full accrual. [This answer is correct. One condition for the use of the full accrual or percentage-of-completion method of accounting is that receivables must be considered collectible. According to FASB ASC 976-605-25-6, that condition is met if a down payment of at least 20% is collected, or collection experience indicates that at least 90% of the contracts from the current project not cancelled within six months from the date the sale is recorded will be collected in full.]**
 - c. Deposit and installment. [This answer is incorrect. Under the deposit method, if the conditions for recording a sale are subsequently met, the sale and the receivable should be recorded, and the basis for using the installment method is that a sale has occurred, but there are uncertainties about the collectibility of the receivable.]
21. A land sale contract is only one type of contract that is normally used in retail land projects. Which of the following is the other type of contract? **(Page 125)**
- a. **Purchase money mortgage. [This answer is correct. A purchase money mortgage is a mortgage given by the purchaser of real property to the seller as part of the consideration in the sales transaction.]**
 - b. Time-share. [This answer is incorrect. A time-share contract normally is used in sales of real estate other than retail land sales.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (ARETG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. The refund period for land sale contract usually is up to _____ days.
 - a. 30.
 - b. 60.
 - c. 90.
 - d. 120.

2. Match the following characteristics with the real estate category.

1. Sales of options to purchase real estate	i. Retail land sales
2. Sales of lots to builders	ii. Real estate sales other than retail land sales
3. Lots used by buyers as sites for primary homes	
4. Marketing directly to retail customers	

- a. 1., 2., and i.
 - b. 1., 2., and ii.
 - c. 1., 3., and i.
 - d. 2., 4., and ii.

3. Which of the following statements regarding bulk sales is most accurate?
 - a. Bulk sales most often are made to consumers.
 - b. Developers have the option of selling tracts of lots to other developers as a way of financing improvements.
 - c. Bulk sales are often referred to as commercial sales.
 - d. Homebuilders usually purchase bulk sales to sell the lots individually.

4. Which of the following is one method of accounting used for retail land sales?
 - a. Reduced profit.
 - b. Percentage-of-completion.
 - c. Cost recovery.
 - d. Leasing arrangement.

5. Once a retail land sale has been recognized, all profit on retail land sales from the project must be recognized using which of the following?
- a. Installment method of accounting.
 - b. Deposit method of accounting.
 - c. Profit sharing arrangement method of accounting.
 - d. Depreciation method of accounting.
6. SFAS No. 66 (FASB ASC 976-605-25-2) has established conditions that must be met before a retail land sale can be recognized. Until a sale is recognized, which of the following accounting methods should be used to account for the transaction?
- a. Deposit.
 - b. Installment.
 - c. Percentage-of-completion.
 - d. Full accrual.
7. Profit is recognized under the percentage-of-completion method in which of the following ways?
- a. $\text{Sales price collected} \div \text{total sales price}$.
 - b. $\text{Costs incurred} \div \text{estimated total costs}$.
 - c. $\text{Total sales price} \div \text{costs incurred}$.
 - d. $\text{Estimated total costs} \div \text{total sales price}$.
8. Profit is recognized under the installment method in which of the following ways?
- a. $\text{Sales price collected} \div \text{total sales price}$.
 - b. $\text{Costs incurred} \div \text{estimated total costs}$.
 - c. $\text{Total sales price} \div \text{costs incurred}$.
 - d. $\text{Estimated total costs} \div \text{total sales price}$.
9. Certain conditions must be met in order to record retail land sale contracts as sales. One of those conditions is that the payments, including interest, must equal or exceed which of the following percentage of the contract price?
- a. 10%.
 - b. 15%.
 - c. 20%.
 - d. 25%.

10. When applying the financial capability test, SFAS [FASB ASC 976-605-25-1; 976-605-25-6(a) and 25-6(b); 976-605-25-9] requires that two additional factors are considered in relation to using the percentage-of-completions method. Those factors include which of the following?
- a. Is the developer able to reasonably estimate the cost of future improvements, and is the project practical.
 - b. The seller's obligation to develop the property as a condition of the sale and the adequacy of buyer's down payment.
 - c. If the buyer's investments are adequate, and if all risks and rewards have been transferred.
 - d. The entire sales value has been received without seller financing and if the seller's receivables are significant.
11. SFAS No. 66 [FASB ASC 976-605-25-6(a)] requires the refund period to be the longer of the period of all of the following **except**:
- a. Completion of improvements.
 - b. Required by local law.
 - c. Established by the developer's policy.
 - d. Specified in the contract.
12. To avoid considering the collectibility experience, a receivable is considered collectible if a down payment of at least _____ is collected.
- a. 10%.
 - b. 20%.
 - c. 25%.
 - d. 30%.
13. Which of the following accounting methods should developers use when improvements are close to completion and the amount of revenue that would be deferred is material to the financial statements?
- a. Deposit.
 - b. Full accrual.
 - c. Installment.
 - d. Percentage-of-completion.
14. Under the percentage-of-completion method of accounting, all of the following indicates that development of retail land sales is considered practical **except**:
- a. The buyer has accepted, or is willing to accept, personal liability for the debt and the buyer's ability to make the payments can be determined.
 - b. It is reasonable to expect that the land can be developed for the indicated purposes.
 - c. It is expected that no legal restrictions (such as environmental problems or required permits) will restrict development.
 - d. Improvements, such as access roads, water supply, sewage treatment or removal, are feasible within a reasonable time.

15. Which of the following is the last condition that must be met before a developer can use the percentage-of-completion method?
- a. Evidence exists that all improvements will be completed according to plan.
 - b. Determining if the project is practical.
 - c. The collectibility test has been met.
 - d. The cost to complete the project has been reasonably estimated.
16. Which of the following is the last condition that must be met before a developer can use the full accrual method of accounting?
- a. Is the project practical?
 - b. All required improvements are complete.
 - c. The cost to complete the project has been reasonably estimated.
 - d. The collectibility test has been met.
17. Which of the following is the first condition that must be met before using the full accrual method of accounting?
- a. Contract receivables must be free of subordination to other loans.
 - b. Is the project practical?
 - c. The cost to complete the project has been reasonably estimated.
 - d. The collectibility test has been met.
18. According to SFAS No. 66 (FASB ASC 976-30-3), when estimating unrecoverable costs, the estimated recovery amounts to be discounted to their present value as of which of the following dates?
- a. The date the developer is considering using the percentage-of-completion method.
 - b. The date the net unrecoverable costs are recognized.
 - c. The date the sales contract recorded will be collected in full.
 - d. The date the net recoverable costs are recognized.
19. The reasonableness of the estimated cost to complete the project is assessed at the date the developer is considering the use of which of the following accounting methods?
- a. Deposit.
 - b. Installment.
 - c. Full accrual.
 - d. Percentage-of-completion.
20. Which of the following statements regarding retail land sales down payments is most accurate?
- a. The 10% test will be met whenever a company requires a 20% down payment.
 - b. Down payments specified in the retail land sales contract and all down payments thereafter should be considered in evidence of collectibility.
 - c. Cumulative payments are considered in all tests of the retail land sales project.
 - d. A characteristic of a typical retail land sale contract are large down payments.

Lesson 2: Choosing and Applying the Accounting Methods, Direct Selling Costs, and Inventories

INTRODUCTION

Lesson 2 describes how to apply each of the four accounting methods, and discusses inventories, direct selling costs, and other topics unique to accounting for retail land sales.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the characteristics of the accounting methods applicable to retail land sales and the implications of changing accounting methods.
- Describe the cost of retail lot sales using the selling costs unique to retail land projects.

DEPOSIT METHOD

When Is the Deposit Method Used?

As discussed earlier in this course, SFAS No. 66 [FASB ASC 976-605-25-1; 976-605-25-6(a) and 25-6(b); 976-605-25-9] establishes four conditions that must be met before a retail land sale contract can be recognized as a sale. Until the sale can be recognized, the transaction must be accounted for using the deposit method.

Accounting for Deposits

When the deposit method is used, the developer accounts for the transaction as if no sale has occurred. Accordingly—

- No profit is recognized.
- The developer does not record a sale or a receivable from the buyer.
- The developer keeps the inventory (land and improvements) on its books. (No costs are transferred from inventory to cost of retail lot sales.)
- All payments received from the buyer (including interest) are recorded as deposits (that is, a liability) by the developer.

Initial Recording of Deposits

Example No. 1. To illustrate the recording of payments received under the deposit method, assume that the following retail land sale contracts have been entered into. Also, assume the refund periods have expired.

<u>Contract</u>	<u>Contract Amount</u>	<u>Down Payment</u>	
		<u>Amount</u>	<u>Percent</u>
No. 1	\$ 10,000	\$ 800	8 %
No. 2	12,000	1,000	8 %
No. 3	8,000	200	2 %
	<u>\$ 30,000</u>	<u>\$ 2,000</u>	

Because a 10% down payment has not been received on any of the contracts, all three contracts must be recorded using the deposit method. The journal entry to record the deposits would be as follows:

Cash	\$ 2,000	
Deposit liability		\$ 2,000

Example No. 2. Assume that the following retail land sale contracts were entered into during the month of June. Also assume a refund period of 30 days.

<u>Contract</u>	<u>Contract Amount</u>	<u>Down Payment</u>	
		<u>Amount</u>	<u>Percent</u>
No. 1	\$ 10,000	\$ 2,000	20 %
No. 2	12,000	1,000	8 %
No. 3	8,000	1,200	15 %
	<u>\$ 30,000</u>	<u>\$ 4,200</u>	

As of June 30th, the refund period has not expired, therefore none of the contracts can be recorded as a sale even though cumulative payments on two contracts exceed 10%. The journal entry to record the deposits would be as follows:

Cash	\$ 4,200	
Deposit liability		\$ 4,200

When a Contract Is Canceled

Down payments and other payments received on retail land sale contracts canceled *before* expiration of the refund period generally must be refunded. Payments received on retail land sale contracts canceled *after* expiration of the refund period (for example, because the buyer defaults) generally are not refunded. Authoritative literature does not provide guidance on what income accounts forfeited deposits should be credited to. It is believed an account such as "Forfeited deposit income" can be used. If the amount is material, it should be reported in the income statement as a separate line item or disclosed in the notes to financial statements. If the amount is not material, it may be included in miscellaneous income.

When a Sale Is Subsequently Recorded

As previously noted, all payments received prior to recording a sale are credited to a deposit liability. Those payments include down payments as well as all principal and interest payments. If the conditions for recording the sale are subsequently met, the sale and the receivable should be recorded, and all payments should then be transferred from the deposit account, as follows:

- Down payments and principal payments—transfer to the contracts receivable account.
- Interest payments—transfer to interest income.

To illustrate, assume a developer sold a lot under a land sale contract for \$50,000 and received a \$5,000 down payment. Since the developer had not obtained the financing necessary to complete the project, the sale was not recorded and the down payment was credited to a deposit liability. Subsequently, monthly payments totalling \$2,000 have been received, consisting of \$600 in principal and \$1,400 in interest. Also, financing has now been obtained, and all conditions necessary for using the full accrual method have been met. The journal entry to record the sale would be as follows:

Deposit liability	\$ 7,000	
Retail lot contracts receivable	44,400	
Retail lot sales		\$ 50,000
Interest income		1,400

Direct Selling Costs

When the contract is subsequently recorded as a sale or canceled, the deferred costs should then be expensed. Many companies, however, find that the direct selling costs applicable to unrecognized sales are not material and choose to simply expense them as incurred. The following example illustrates the accounting in situations in which direct selling costs related to unrecorded sales are material. Assume that a retail land project has the following activity:

Sale contracts entered into during the current year	\$ 400,000
Direct selling costs incurred during the current year	100,000

Deposit and contract information:

	<u>Deposit</u>	<u>Contract Amount</u>
Balance at end of preceding year	\$ 2,400	\$ 30,000
New contracts	87,000	400,000
Canceled or recognized as a sale	<u>(86,500)</u>	<u>(390,000)</u>
Balance at end of current year	<u>\$ 2,900</u>	<u>\$ 40,000</u>

The direct selling costs that relate to unrecognized sales can be calculated as follows:

Direct selling costs	\$ 100,000
Sale contracts	<u>× 400,000</u>
Ratio	25%
Contract balance	<u>× 40,000</u>
Deferred selling costs	<u>\$ 10,000</u>

The deferred selling costs asset account would be adjusted to the \$10,000 with an offsetting credit to selling expense.

The preceding example shows the computation of deferred selling costs based on a ratio of direct selling costs to sale contracts for a one-year period. It may also be appropriate in some circumstances to use a period greater or less than a one-year period.

Sales Commissions. Some accountants do not include sales commissions in direct selling costs in the computation illustrated earlier in this section. Instead, they defer all of the sales commissions for each contract recorded under the deposit method. As the sales are recognized, the commissions are expensed. Still other accountants believe that sales commissions should not be recognized at all until a sale is recorded. Consequently, those accountants do not record sales commissions payable until a sale is recognized. Any sales commissions paid are, of course, recorded as deferred selling costs.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. No profit is recognized under which of the following accounting methods?
- a. Deposit.
 - b. Full accrual.
 - c. Cost recovery.
 - d. Reduced profit.
23. Under which of the following methods of accounting does the developer maintain all inventories on the books?
- a. Deposit.
 - b. Installment.
 - c. Full accrual.
 - d. Percentage-of-completion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. No profit is recognized under which of the following accounting methods? **(Page 135)**
- a. **Deposit.** [This answer is correct. Under the deposit method the seller does not recognize any profits, does not record a note receivable, and continues to reflect the property and related debt in the seller's financial statements, recording the buyer's initial investment and subsequent payments as a deposit.]
 - b. Full accrual. [This answer is incorrect. The entire gain on the sale is recognized at the date of sale on the full accrual method.]
 - c. Cost recovery. [This answer is incorrect. Profits are recognized after costs are completely recovered.]
 - d. Reduced profit. [This answer is incorrect. Under the reduced profit method, revenue is recognized at closing based on the sales profit less discount, and the discounted portion is deferred and recognized at the end of the discount period.]
23. Under which of the following methods of accounting does the developer maintain all inventories on the books? **(Page 135)**
- a. **Deposit.** [This answer is correct. According to SFAS No. 66, the developer keeps the inventory (land and improvements) on its books. No costs are transferred from inventory to cost of retail sales.]
 - b. Installment. [This answer is incorrect. Under the installment method, the developer does not maintain inventories on the books, but must periodically evaluate inventory for impairment.]
 - c. Full accrual. [This answer is incorrect. Under the full accrual method, the developer does not maintain inventories on the books, but must also periodically evaluate inventory for impairment.]
 - d. Percentage-of-completion. [This answer is incorrect. Under the percentage-of-completion method, the developer does not maintain inventories on the books, but must also periodically evaluate inventory for impairment.]

FULL ACCRUAL METHOD

When Is the Full Accrual Method Used?

The full accrual method is used only when the following conditions are met:

- All of the conditions for recording sales have been met.
- Receivables are considered collectible.
- Receivables are not subordinated to any new loans on the property.
- All required improvements have been completed.

How Is Profit Recognized?

Under the full accrual method, all profit is recognized when the sale is recognized, as follows:

- a. Sales are recorded at the contract amount. For example, if sales totaling \$370,000 with down payments totaling \$37,000 (10% for each contract) were made during the period, and all conditions for recognizing the sales were met, the journal entry would be as follows:

Cash	\$	37,000	
Retail lot contracts receivable		333,000	
Retail lot sales			\$ 370,000

- b. A provision for cancellation of contracts receivable that are not expected to be collected is recorded based on historical collection data.
- c. The cost of retail lot sales, based on sales less the provision for cancellations, is transferred from the inventory accounts.
- d. A provision for discounts is recorded to reduce the contracts receivable to the present value of the required payments. At the end of each reporting period, earned discounts are recognized in income.
- e. Canceled contracts are charged in their entirety to the allowance for contract cancellations.
- f. The cost of certain tangible assets and costs incurred to obtain regulatory approvals are deferred and amortized to selling expense as lots are sold. Other selling costs are expensed as incurred.
- g. Interest income is recognized as earned using a level yield method.

Allowance for Cancellations

Paragraph 70 of SFAS No. 66 (FASB ASC 976-310-35-1) requires developers using the full accrual method to provide an allowance for cancellations of contracts receivable that are not expected to be collected. Because of the nature of retail land sales, it is not practical to evaluate the collectibility of each individual receivable. Instead, a provision for cancellations is determined by applying a historical cancellation percentage to project sales. For developers of retail land projects, it would be rare that such an allowance would be unnecessary. (If such an allowance is not needed, the project probably does not meet the definition of a retail land project.)

Historical Collection Data. In order to compute a historical cancellation percentage, historical collection data must be accumulated and evaluated. SFAS No. 66, paragraph 71 (FASB ASC 976-310-35-1), indicates that the collection data should come from a representative sample of previous contracts whose collection period covers an adequate period of time to provide reasonable evidence of collectibility. However, most retail land projects maintain cancellation data on a cumulative basis from inception of each project. Consequently, sampling is usually not required.

Collection Data Period. The historical collection data must be updated frequently in order to ensure that the most current information is being used. However, recent sales should be excluded because they would distort the cancellation percentage. For example, the fact that a sale made one month ago has not been canceled does not provide reliable evidence that the receivable will be collected. It is suggested that the historical data be based on sales from inception to a period ended 12 months prior to the current date (or to the end of the preceding fiscal year). Use of a period from inception to a period ended six months prior to the current date may also be used.

SFAS No. 66 (FASB ASC 976-310-35-1) requires that the collection data used to determine the allowance for cancellations cover an adequate period of time. However, since the receivable collectibility condition, which requires that an appropriate collection period be used, will have been met prior to use of the full accrual or percentage-of-completion method, it is usually safe to assume that the collection data is adequate for purposes of establishing the provision.

Best practices indicate that the discussion earlier in this lesson on collection experience from prior projects, collection experience from current projects, and industry averages generally also applies to collection data for purposes of determining a provision for cancellations. One difference, however, is that the six-month period does not apply. That is, the historical collection data discussed in the preceding paragraphs should not exclude contracts canceled within six months. Only recently issued contracts should be excluded.

Which Contracts Have Canceled? The unpaid balance of a contract should be considered canceled when any of the following have occurred:

- a. A cancellation is formally received from the buyer. (Some projects use cancellation forms that may be completed by the buyer evidencing a "formal" cancellation.)
- b. The contract exceeds the specified delinquency periods. SFAS No. 66 (FASB ASC 976-310-35-1) provides that a contract should be considered canceled (an in-substance cancellation) when payments are delinquent as follows:

<u>When the Percent of the Total Contract Price Collected Is</u>	<u>And the Delinquency Period Is at Least</u>
Less than 25%	90 days (3 months)
25% but less than 50%	120 days (4 months)
50% or over	150 days (5 months)

- c. It otherwise is evident that the buyer is unwilling to continue payments, even though no cancellation notice has been signed. Such contracts will usually be identified when considering the delinquency periods in item b. However, there may be instances in which they are not (for example, payments may be current, but the developer may have received a letter stating that no further payments will be made).

SFAS No. 66 (FASB ASC 976-310-35-2) states that the delinquency periods listed earlier in this section can be extended if either of the following conditions exist:

- Recent collection experience has been better.
- The buyer has accepted, or is willing to accept, personal liability for the debt and the buyer's ability to make the payments can be determined. In other words, the debt can be enforced against the buyer and a credit check has been or can be made to determine the buyer's ability to pay.

Calculating a Provision for Cancellations. To illustrate the calculation of a provision for cancellations, assume the following facts:

- A company is in the fifth year of its first project. The project qualifies for the full accrual method of accounting.
- Sales and cancellation data for the collection data period (that is, the period from inception of the project to 12 months ago) are as follows:

Sales	\$ 5,000,000
Cancellations (i.e., the unpaid balances of canceled contracts)	300,000

- A review of the contract cancellations over the past 12 months indicates that \$100,000 of the cancellations relate to sales included in the \$5,000,000.
- A review of the current contracts receivable aging list reveals one in-substance cancellation of \$10,000 relating to sales included in the \$5,000,000.
- Sales for the period from inception of the project to the current date total \$6,000,000.
- The provision for cancellations (not the current allowance for cancellations) previously provided from inception of the project to the current date totals \$400,000.

Computation of the current period's provision for cancellations would be as follows:

Cancellations:	
During the collection data period	\$ 300,000
Subsequent cancellations	100,000
In-substance cancellations	10,000
Total cancellations	<u>410,000</u>
Sales during the collection data period	÷ 5,000,000
Cancellation rate	8.2%
Sales from inception of project to current date	× 6,000,000
Provision for cancellations	<u>492,000</u>
Provision for cancellations from inception of project to end of preceding year	<u>(400,000)</u>
Provision for the current year	<u>\$ 92,000</u>

The journal entry to record the provision for cancellations (assuming no entry was previously made during the year) would be as follows:

Provision for cancellations	\$ 92,000	
Allowance for cancellations		\$ 92,000

Authoritative literature does not specify that the provision must be computed as described in the preceding paragraph. Paragraph 71 of SFAS No. 66 (FASB ASC 976-310-35-1) indicates only that a provision based on historical collection data is required. Also, an additional allowance may be necessary. Paragraph 70 of SFAS No. 66 (FASB ASC 976-310-35-1) states that the "allowance shall be provided for receivables that are not expected to be collected because of cancellation in subsequent periods." By applying a historical percentage to project-to-date sales, an allowance for future cancellations equal to the historical cancellation rate is provided. Consideration should also be given to whether the historical cancellation rate is a good indicator of future cancellations. If future cancellation rates are expected to be higher (for example, due to a downturn in the real estate market or a delay in project development), an additional allowance may be necessary.

Change in Cancellation Rate. Any change in the cancellation rate is accounted for as a change in an estimate under SFAS No. 154, *Accounting Changes and Error Corrections* (FASB ASC 250). (SFAS No. 154 supersedes APB Opinion No. 20 but carries forward the guidance from APB Opinion No. 20 for changes in accounting estimates.) For that reason, the current provision is determined by computing the provision on a project-to-date basis and reducing it by the provision previously charged against sales.

Recording Cancellations. When a contract receivable is canceled (that is, when the receivable is written off), the unpaid receivable balance is charged to the allowance for cancellations. Since the cost of retail land sales is computed based on gross sales less the provision for cancellations inventory is not relieved for the portion of contracts that are expected to cancel. Therefore, when contracts are canceled, no amount is added back to inventory. Also, because the provision for valuation discounts is computed based on gross sales less the provision for cancellations no charge is made to the unamortized valuation discount when a contract is canceled.

Valuation Discounts

One of the characteristics of a retail land project is that the developer often provides financing to buyers at below market interest rates. In other words, land sale contracts usually have stated interest rates that are below the rates financial institutions would charge to loan money under similar circumstances. Also, because of the relatively high risk involved in retail land sale contracts, the rates financial institutions would charge to make similar loans would be higher than the rates charged on more conventional loans. In essence, the retail land developer is achieving a market rate of return by increasing the stated sales price. That concept is recognized in Paragraph 1 of APB Opinion No. 21, *Interest on Receivables and Payables* (FASB ASC 835-30-5-2 and 5-3), as follows:

Business transactions often involve the exchange of cash or property, goods, or service for a note or similar instrument. . . . The use of an interest rate that varies from prevailing interest rates warrants evaluation of whether the face amount and the stated interest rate of a note or obligation provide reliable evidence for properly recording the exchange and subsequent related interest . . . Unless the note is recorded at its present value in this circumstance, the sales price and profit to a seller in the year of the transaction and the purchase price and cost to the buyer are misstated, and interest income and interest expense in subsequent periods are also misstated.

Paragraph 70 of SFAS No. 66 (FASB ASC 976-310-30-1) requires developers using the full accrual method to discount receivables to their present value using an appropriate interest rate (not less than the rate stated in the sales contract), and the Statement refers to Paragraphs 13 and 14 of APB Opinion No. 21 (FASB ASC 835-30-10-1; 835-30-25-13) as guidance for selecting an appropriate rate. Those paragraphs in part, state the following:

. . . The objective [in determining an appropriate discount rate] is to approximate the rate for a note that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase that bears the prevailing rate of interest to maturity.

. . . the choice of a rate may be influenced by . . . (a) an approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note; (b) the prime or higher rate for notes that are discounted with banks, giving due weight to the credit standing of the maker . . .

What Rate Should Be Used? Paragraph 70 of SFAS No. 66 (FASB ASC 976-310-30-1) states that “the objective is to value the net receivable at the amount at which it could be sold without recourse to the seller at the date of the sales contract.” That is, the objective is to carry the receivables (net of allowance for contract cancellations and unamortized valuation discounts) at an amount that could be realized in a volume sale of all contracts, without recourse to the developer at the date of the initial transactions. However, since there is no active public market, and since the contracts can generally not be sold without recourse, the rate must be based on other considerations. SFAS No. 66 (FASB ASC 976-310-30-1) refers to Paragraphs 13 and 14 of APB Opinion No. 21 (FASB ASC 835-30-10-1; 835-30-25-13) but provides no specific guidance on how to apply that guidance to retail land sales. Previous authoritative literature, however, suggested that the rate should be at least the minimum rate charged by local banks and retail establishments to finance the purchase of consumer goods such as appliances.

No special provision is necessary for future accounting and collection costs as the interest rate takes those costs into consideration. Also, the rate used to discount the receivable should not be less than the rate stated in the sales contract. Consequently, if the developer is charging market interest rates (or above), no valuation discount is necessary.

Computation of the Discount. Valuation discounts are computed by calculating the present value of the contracts receivable less the allowance for cancellations. Since the provision for cancellations as a percent of the gross sales can (and usually does) change from period to period, computation of the unamortized valuation discount can be made only after the provision for cancellations for the period has been determined. Some companies compute and amortize the discounts by contract while others make one computation for all sales during the period. The following example illustrates the second alternative. (More than one computation would be needed if either the stated or imputed rate changed significantly during the period.)

Computation of the initial discount and amortization of the discount can best be explained by an example. For purposes of this example, assume the following:

- Sale contracts totaling \$1,000,000 with stated interest rates of 6%, down payments of 10%, and annual payments (including interest) aggregating \$132,000 for nine years were made during the year.
- The provision for cancellations is determined to be 20% of gross sales less down payments, so net receivables total \$720,000 (gross sales of \$1,000,000 less down payments of \$100,000 and a cancellation provision of \$180,000). The annual payment necessary to amortize \$720,000 over nine years at 6% is \$106,000 ($\$132,000 \times 80\%$).
- An appropriate imputed interest rate is determined to be 12%. The present value of nine annual payments of \$106,000 discounted at 12% equals \$565,000.

The following schedule illustrates the calculation and amortization of the valuation discount (000s omitted):

<u>Year</u>	<u>Annual Payments</u>			<u>Contracts Receivable</u>		<u>Interest Income</u>		
	<u>Total</u>	<u>Principal</u>	<u>Interest at 6%</u>	<u>Face Amount</u>	<u>Present Value at 12%</u>	<u>Unamortized Discount</u>	<u>Discount Amortization</u>	<u>Total</u>
Inception				\$ 720	\$ 565	\$ 155		
1	\$ 106	\$ 63	\$ 43	657	527	130	\$ 25	\$ 68
2	106	66	40	591	484	107	23	63
3	106	70	36	521	436	85	22	58
4	106	75	31	446	382	64	21	52
5	106	79	27	367	321	46	18	45
6	106	84	22	283	255	28	18	40
7	106	89	17	194	179	15	13	30
8	106	94	12	100	95	5	10	22
9	106	100	6	—	—	—	5	11
	<u>\$ 954</u>	<u>\$ 720</u>	<u>\$ 234</u>				<u>\$ 155</u>	<u>\$ 389</u>

Discount Amortization. Discounts must be amortized to interest income over the life of the contracts in a manner that results in a level rate of return over the life of the loans, as illustrated in the preceding example. That method is sometimes referred to as the “interest” method or the “level-yield” method. Other methods may be used only if the results are not materially different from that method.

Discounts are generally amortized using one of the following methods:

- Amortization Schedule Method.* An amortization schedule, updated each year, is maintained in a manner similar to a depreciation schedule. Each year the new provision for the current year is added and the earned discounts are taken into income.
- Individual Contract Method.* Schedules are maintained by individual contract. The schedule is similar to the amortization schedule illustrated later in this lesson except each contract is listed.
- Inventory Method.* The estimated unamortized discount is computed at each reporting date. (Some companies make the computation periodically—at least annually—and estimate the interim amounts.)

Amortization Schedule Method. An abbreviated example of the amortization schedule method follows (000s omitted):

<u>Year of Sale</u>	<u>Discount</u>	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
20X1	\$ 100	\$ 8	\$ 16	\$ 15	\$ 14
20X2	150		12	24	23
20X3	200			16	32
20X4	150				12
	<u>\$ 600</u>	<u>\$ 8</u>	<u>\$ 28</u>	<u>\$ 55</u>	<u>\$ 81</u>

The journal entry to record the 20X2 amounts would be:

Provision for discounts	\$ 150,000	
Unamortized discounts		\$ 122,000
Interest income		28,000

Inventory Method. The following example illustrates a method of computing the unamortized discounts as of any date. The example assumes contracts receivable totaling \$1,044,000 at January 1, 20X1 mature over the next five years. The example further assumes that all of the contracts bear interest at 6%, are discounted at a 12% rate, and are due at the end of the sixth month of each fiscal year. (000s omitted)

<u>Maturity</u>	<u>Principal Maturity</u>	<u>Allowance for Cancellations</u>	<u>Net Receivables</u>	<u>Present Value</u>
20X1	\$ 117	\$ 17	\$ 100	\$ 97
20X2	176	26	150	138
20X3	211	31	180	157
20X4	282	42	240	198
20X5	258	38	220	172
	<u>\$ 1,044</u>	<u>\$ 154</u>	<u>\$ 890</u>	<u>\$ 762</u>

Assuming a current period provision for discounts of \$50,000 and an unamortized discount balance at the beginning of the period of \$92,000, the discount amortization for the current period would be as follows:

Unamortized discount at beginning of year	\$ 92,000
Provision for discounts	50,000
	<u>142,000</u>
Unamortized discount at end of the year (\$890,000 – \$762,000)	<u>128,000</u>
Discount amortization	<u>\$ 14,000</u>

The journal entry to record the current provision and earned discount would be:

Provision for discounts	\$ 50,000	
Unamortized discounts		\$ 36,000
Interest income		14,000

A disadvantage of the inventory method is that separate computations must be made for receivables with different stated interest rates or imputed rates. However, if those rates are the same (or are not materially different) for all contracts, the inventory method is simple and avoids compiling an amortization schedule each year. At first, obtaining the principal maturity information may appear to be a disadvantage; however, since the information is a required financial statement disclosure, it should be available.

Changes in Cancellation Rates. Changes in the cancellation rate are accounted for as changes in estimates and, according to SFAS No. 154 (FASB ASC 250), *Accounting Changes and Error Corrections*, the increase or decrease

in the allowance is reflected in the current period's provision. Since the provision for discounts is computed based on sales less the provision for cancellations, changes in the cancellation rates will also affect discounts. The increase or decrease in the discount is reflected in the current period's provision.

Contract Cancellations. The provision for discounts is computed based on sales less estimated cancellations and, accordingly, no charge is made to unamortized discounts when a contract is cancelled.

Inventory Impairment

Best practices indicate that impairment for a retail land project generally should be assessed for the project as a whole rather than individual lots. Because the full accrual method cannot be used unless the improvements to the lots have been completed, the project should be reported at the lower of its carrying amount or fair value less cost to sell.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. According to SFAS No. 66, Paragraph 70 (FASB ASC 976-310-35-1), allowances for cancellations of contracts receivable that are not expected to be collected must be provided by all developers using which of the following accounting methods?
- a. Deposit.
 - b. Full accrual.
 - c. Installment.
25. Which of the following statements regarding the collection of historical data is most accurate?
- a. The most recent sales should be used when accumulating historical data.
 - b. SFAS No. 66 (FASB ASC 976-310-35-1) specifically states that the collection data used to determine the allowance for cancellations cover at least 24 months of data.
 - c. The historical data can include contracts canceled within six months.
26. The estimated unamortized discount is computed at each reporting date under which of the following methods?
- a. Amortization schedule.
 - b. Individual contract.
 - c. Inventory.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. According to SFAS No. 66, Paragraph 70 (FASB ASC 976-310-35-1), allowances for cancellations of contracts receivable that are not expected to be collected must be provided by all developers using which of the following accounting methods? **(Page 141)**
- a. Deposit. [This answer is incorrect. Under the deposit method of accounting, no allowances are made for cancellations of contracts receivable. Any down payments or other payments received on retail land sale contracts canceled before expiration of the refund period generally must be refunded.]
 - b. Full accrual. [This answer is correct. Under the full accrual method a provision for cancellations is determined by applying a historical cancellation percentage to project sales.]**
 - c. Installment. [This answer is incorrect. Under the installment method of accounting, the receivable balance on all canceled contracts is charged to various other accounts.]
25. Which of the following statements regarding the collection of historical data is most accurate? **(Page 142)**
- a. The most recent sales should be used when accumulating historical data. [This answer is incorrect. Recent sales should be excluded because they can distort the cancellation percentage.]
 - b. SFAS No. 66 (FASB ASC 976-310-35-1) specifically states that the collection data used to determine the allowance for cancellations cover at least 24 months of data. [This answer is incorrect. According to SFAS No. 66 (FASB ASC 976-310-35-1), the allowance for calculations should cover an adequate time period. SFAS No. 66 does not state a specific time period.]
 - c. The historical data can include contracts canceled within six months. [This answer is correct. When using historical data to compute the historical percentage, the historical data should not exclude contracts canceled within six months.]**
26. The estimated unamortized discount is computed at each reporting date under which of the following methods? **(Page 145)**
- a. Amortization schedule. [This answer is incorrect. An amortization schedule is maintained in a manner similar to a depreciation schedule. Each year the new provision for the current year is added and the earned discounts are taken into income.]
 - b. Individual contract. [This answer is incorrect. The schedule is similar to the amortization schedule except each contract is listed.]
 - c. Inventory. [This answer is correct. The estimated unamortized discount is computed at each reporting date since this is a required financial disclosure under the inventory method. (Some companies make the computation periodically-at least annually-and estimate the interim amounts.)]**

PERCENTAGE-OF-COMPLETION METHOD

When Is the Percentage-of-completion Method Used?

The percentage-of-completion method can be used only when the following conditions have been met:

- All of the conditions for using the full accrual method are met except the project improvements are not complete.
- The project has been determined to be practical.
- The developer is able to reasonably estimate the cost to complete the project.
- Project improvements are beyond the preliminary stage and evidence exists that the improvements will be completed according to plan.

How Is Profit Recognized?

Accounting under the percentage-of-completion method differs from accounting under the full accrual method only in the area deferred revenue. Since use of the full accrual method is not permitted unless improvements are complete, there is no need to defer revenue. However, when the developer has not completed all improvements, the earnings process is not complete, and a portion of the revenue must be deferred.

As a practical matter, improvements need not be absolutely complete in order to use the full accrual method. SFAS No. 66 (FASB ASC 976-605-30-1) indicates that revenue should be deferred when the estimated remaining costs of improvements are *significant* in relation to the estimated total cost. When improvements are close to completion, developers will normally be choosing between the full accrual and percentage-of-completion methods. Consequently, if the amount of revenue that would be deferred under the percentage-of-completion method is material to the financial statements, the percentage-of-completion method should be used. If the deferred revenue is not material, the full accrual method can be used.

Deferred Revenue

The deferral of revenue is accomplished by deferring a portion of the net sales (gross sales less estimated cancellations and discounts). The deferral is based on the ratio of estimated cost to complete lots already sold, to the estimated total cost of lots sold [costs incurred to date (including direct selling costs) plus costs to complete]. The deferred revenue is recognized as the costs of completing the improvements related to lots sold are incurred. The formula for computing deferred revenue, from Appendix D of SFAS No. 66 (FASB ASC 976-605-55-4), is as follows:

$$\frac{\text{Estimated cost to complete}}{\text{Estimated cost to complete} + \text{costs incurred} + \text{direct selling costs}} \times \text{Net sales}$$

To illustrate the deferred revenue calculations, assume the following:

- All conditions for use of the percentage-of-completion method have been met and the relative sales value method is used to allocate cost to retail lot sales.
- Retail lot sales information is as follows (000s omitted):

	<u>Gross Sales</u>	<u>Provision for Cancellations</u>	<u>Sales Less Provision for Cancellations</u>	<u>Valuation Discounts</u>	<u>Net Sales</u>
To end of preceding year	\$ 630	\$ 115	\$ 515	\$ 105	\$ 410
Current year	<u>370</u>	<u>65</u>	<u>305</u>	<u>65</u>	<u>240</u>
To end of current year	<u>\$ 1,000</u>	<u>\$ 180</u>	820	<u>\$ 170</u>	<u>\$ 650</u>
Estimated remaining sales			<u>3,180</u>		
Estimated total project sales			<u>\$ 4,000</u>		

- Project cost information is as follows (000s omitted):

	<u>Land</u>	<u>Improvements</u>	<u>Total</u>
To end of preceding year	\$ 120	\$ 400	\$ 520
Current year	<u>—</u>	<u>200</u>	<u>200</u>
To end of current year	<u>120</u>	<u>600</u>	<u>720</u>
Estimated remaining	<u>—</u>	<u>600</u>	<u>600</u>
Estimated total project costs	<u>\$ 120</u>	<u>\$ 1,200</u>	<u>\$ 1,320</u>

- Direct selling cost information is as follows (000s omitted):

To end of preceding year	\$ 200
Current year	<u>100</u>
To end of current year	<u>\$ 300</u>

Cost of Retail Lot Sales from Inception of the Project. The cost of retail lot sales from inception of the project would be computed as follows (000s omitted):

	<u>From Inception of the Project to the End of the</u>	
	<u>Preceding Year</u>	<u>Current Year</u>
Sales, less provision for cancellations	\$ 515	\$ 820
Estimated total project sales	<u>÷ 4,000</u>	<u>÷ 4,000</u>
Percent of the project sold	<u>13 %</u>	<u>20 %</u>
Costs incurred applicable to lots sold:		
Land		
(13% × \$120)	\$ 16	
(20% × \$120)		\$ 24
Improvements		
(13% × \$400)	<u>52</u>	
(20% × \$600)		<u>120</u>
	<u>\$ 68</u>	<u>\$ 144</u>

The increase in the cumulative cost of retail lot sales would be \$76,000 (\$144,000 – \$68,000).

Computation of Deferred Revenue. The deferred revenue at the end of the preceding and the current years would be computed as follows (000s omitted):

	From Inception of the Project to the End of the	
	<u>Preceding Year</u>	<u>Current Year</u>
Costs incurred applicable to lots sold:		
$[13\% \times (\$1,200 - \$400)]$	<u>\$ 104</u>	
$[20\% \times (\$1,200 - \$600)]$		<u>\$ 120</u>
Land and improvement costs applicable to the lots sold	<u>\$ 68</u>	<u>\$ 144</u>
Direct selling costs	<u>\$ 200</u>	<u>\$ 300</u>
Net sales	<u>\$ 410</u>	<u>\$ 650</u>
Deferred revenue—future improvements		
$[\$104 \div (\$104 + \$68 + \$200) \times \$410]$	<u>\$ 115</u>	
$[\$120 \div (\$120 + \$144 + \$300) \times \$650]$		<u>\$ 138</u>

The increase in the deferred revenue balance for the current period would be \$23,000 (\$138,000 – \$115,000).

Earned Portion of Deferred Revenue from Sales in Prior Years. The amount recognized is referred to here as the earned portion. At the end of each reporting period, the earned portion of the deferred revenue from sales in prior years should be taken into income.

The following is a summary of the deferred revenue accounts illustrated in the preceding paragraphs (000s omitted):

	<u>Balance Sheet</u>	<u>Current Year Income Statement</u>	
	<u>Deferred Revenue</u>	<u>Deferred Revenue— Future Improvements</u>	<u>Improvement Revenue— Prior Sales</u>
End of preceding year	\$ (115)	N/A	N/A
Earned portion of revenue deferred in prior years	29	—	\$ (29)
Revenue deferred applicable to current year sales	<u>(52)</u>	<u>\$ 52</u>	<u>—</u>
	<u>\$ (138)</u>	<u>\$ 52</u>	<u>\$ (29)</u>

Revenue Deferred Applicable to Current Period Sales. While the \$52,000 in the preceding paragraph can be arrived at as shown there (i.e., the amount necessary to adjust the balance to \$138,000), the amount can also be computed as follows, using the formula from earlier in this lesson and current year net sales of \$240,000.

$$\$120,000 \div (\$120,000 + \$144,000 + \$300,000) \times \$240,000 = \$52,000$$

The journal entry to record the activity in the deferred revenue related accounts for the current year would be as follows:

Deferred revenue—future improvements	\$ 52,000	
Deferred revenue		\$ 23,000
Improvement revenue—prior sales		29,000

Changes in Cost Estimates. The estimated cost to complete the project should be reviewed at least annually. Changes to the cost estimates should be expected, especially in the earlier stages of the project, and should be accounted for as changes in estimates. No adjustment to previously recorded deferred revenue should be made. Costs and revenues are recalculated on a cumulative basis and adjusted accordingly. Also, as noted earlier, when estimating unrecoverable costs, SFAS No. 66 (FASB ASC 976-605-30-3) requires the estimated recovery amounts to be discounted to their present values as of the date the net unrecoverable costs are recognized.

Inventory Losses

If the cost to complete the lots sold exceeds the deferred revenue, the total expected loss should be charged to income during the current period. A discussion of how to compute and account for that loss is provided later in this lesson. Also, the need to recognize projected losses on lots sold may indicate that land and improvements still in inventory are impaired.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. The following illustration is an example of which accounting method?

Fiona is a developer who owns 200 acres of land with a book value of \$800,000. Schrack agrees to buy the land for \$2 million if Fiona adds roads and utilities costing \$700,000. Schrack pays Fiona a down payment of \$400,000, and gives Fiona a note for \$1.6 million, which requires interest payments during the construction period and payment of the principal at the end of construction. By the end of Year 2, Fiona has incurred developmental costs of \$400,000. The project is completed in Year 3, Schrack pays Fiona the remaining \$1.6 million.

- a. Percentage-of-completion.
- b. Cost recovery.
- c. Installment.
- d. Deposit.

28. Which of the following conditions is necessary to use the percentage-of-completion accounting method?

- a. The proposed project has been formally documented.
- b. The developer is able to reasonably estimate the cost to complete the project.
- c. The total amount of collections is highly uncertain.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. The following illustration is an example of which accounting method? **(Page 151)**

Fiona is a developer who owns 200 acres of land with a book value of \$800,000. Schrack agrees to buy the land for \$2 million if Fiona adds roads and utilities costing \$700,000. Schrack pays Fiona a down payment of \$400,000, and gives Fiona a note for \$1.6 million, which requires interest payments during the construction period and payment of the principal at the end of construction. By the end of Year 2, Fiona has incurred developmental costs of \$400,000. The project is completed in Year 3, Schrack pays Fiona the remaining \$1.6 million.

- a. **Percentage-of-completion. [This answer is correct. The percentage-of-completion method recognizes profit on a long-term construction contract as it is earned gradually during the construction period. In the above illustration, the remaining \$1.6 million is not paid until the project is completed in Year 3. A ratio of the percentage of completion is determined and applied to the expected gross profit on the contract to determine the gross profit and revenue to be recognized in the financial statements.]**
 - b. Cost recovery. [This answer is incorrect. When the cost-recovery method is used, no profit is recognized until all costs have been recovered.]
 - c. Installment. [This answer is incorrect. The installment method is used when the criteria for using the full accrual method or the percentage-of-completion method are not met.]
 - d. Deposit. [This answer is incorrect. In the above illustration, the sale has been completed and the sale can be recognized, which is not the case when using the deposit method.]
28. Which of the following conditions is necessary to use the percentage-of-completion accounting method? **(Page 151)**
- a. The proposed project has been formally documented. [This answer is incorrect. Documentation of the proposed project is not a necessary condition when using the percentage-of-completion method.]
 - b. **The developer is able to reasonably estimate the cost to complete the project. [This answer is correct. According to SFAS No. 66, the percentage-of-completion method should be used when reliable estimates of the degree of completion are possible.]**
 - c. The total amount of collections is highly uncertain. [This answer is incorrect. Generally, the cost recovery method is used only when the total amount of collections is highly uncertain.]

INSTALLMENT METHOD

When Is the Installment Method Used?

The installment method is used when—

- All of the conditions for recording sales have been met.
- The criteria for using the full accrual method or the percentage-of-completion method are not met.

The basis for using the installment method is that a sale has occurred, but there are uncertainties about—

- The collectibility of the receivable, and/or
- The developer's ability to complete the project.

How Is Profit Recognized?

Under the installment method, profit is recognized in proportion to the collection of the contract price. In other words, a profit percentage ($\text{profit} \div \text{sales}$) is calculated and applied to the principal payments received. While some companies calculate the cost of retail lot sales and deferred profit by individual contract, most do that on a portfolio basis for all transactions during a reporting period.

Accounting Procedures. The following accounting procedures are applied when the installment method is used for retail land sales:

- Sales are recorded at the contract amount. For example, if sales totaling \$370,000 with down payments totaling \$37,000 were made during the year, and all conditions for recognizing the sales were met, the journal entry would be as follows:

Cash	\$	37,000	
Retail lot contracts receivable		333,000	
Retail lot sales			\$ 370,000

- The cost of retail lot sales is transferred from the inventory accounts.
- A liability for future improvement costs is provided.
- Profit (sales less cost of retail lot sales and direct selling costs) is deferred and recognized in income as principal payments are received.
- Interest income is recorded at the contract rate as it is collected.
- Contract cancellations are recorded by writing off the related contracts receivable, liability for future improvements, and unamortized deferred profit. The net difference is recorded by restoring the inventory previously charged to cost of retail lot sales and charging the remainder to cancellation losses.
- Certain selling costs are deferred and charged to expense as sales are recognized, while all other selling expenses are expensed as incurred.
- An allowance for cancellation losses should be provided by a charge to selling expense when necessary.

Valuation Discounts. Paragraph 57 of SFAS No. 66 (FASB ASC 360-20-55-8) states that, under the installment method, it is not necessary to discount contracts receivable that have below market interest rates. Discounting yields a lower sales price and, therefore, a lower principal balance, a lower profit, and a lower profit percentage. As a result, the profit recognized in each period is lower than if the receivable had not been discounted. However, since interest income on the discounted contract is recognized using the market rate, more interest income is recognized

in each period when the receivable is discounted because the discount rate is higher than the stated rate. In the earlier years of the term of the contract when interest income is highest, interest income using the market rate is generally sufficiently higher than interest using the stated rate that the total of interest income and gain recognized is greater than if the receivable had not been discounted. In the later years, as interest income declines, the total is less than if the receivable had not been discounted.

To illustrate the installment method, assume the following:

- Due to the lack of data to conclude that the receivable collectibility condition has been met, the installment method is used to account for profit on retail lot sales.
- The relative sales value method is used to allocate cost of retail lot sales.
- Retail lot sales information is as follows (000s omitted):

Sales to end of preceding year	\$ 560
Current year sales	400
Sales to end of current year	<u>960</u>
Estimated remaining sales	<u>3,040</u>
Estimated total project sales	<u>\$ 4,000</u>

- Project cost information is as follows (000s omitted):

	<u>Land</u>	<u>Improvements</u>	<u>Total</u>
Costs incurred:			
To end of preceding year	\$ 120	\$ 400	\$ 520
Current year	<u>—</u>	<u>200</u>	<u>200</u>
To end of current year	<u>120</u>	<u>600</u>	<u>720</u>
Estimated remaining project costs	<u>—</u>	<u>600</u>	<u>600</u>
Estimated total project costs	<u>\$ 120</u>	<u>\$ 1,200</u>	<u>\$ 1,320</u>

- Direct selling cost information is as follows (000s omitted):

To end of preceding year	\$ 120
Current year	<u>100</u>
To end of current year	<u>\$ 300</u>

- Contracts receivable balances are as follows (000s omitted):

At end of preceding year	\$ 500
At end of current year	700
Receivable balances cancelled in current year	<u>34</u>

Cost of Retail Lot Sales and Liability for Future Improvements. Computation of the cost of retail lot sales under the installment method is unlike the computation under the full accrual and percentage-of-completion methods. The differences are as follows:

- Cost of retail lot sales under the full accrual and percentage-of-completion methods include only costs incurred (the full accrual method is used only if the project is complete). Under the installment method, the cost of retail lot sales includes both costs incurred and the estimated cost of future improvements that relate to the lots sold.
- Under the full accrual and percentage-of-completion methods, the cost of retail lot sales is provided on gross sales less the provision for cancellations. Under the installment method, the cost of retail lot sales is provided on gross sales (with no deduction for any provision for cancellations).

Based on the assumptions in the earlier paragraph, the cost of retail lot sales for the current year would be \$132,000 (\$317,000 – \$185,000), computed as follows (000s omitted):

	<u>From Inception of the Project to the End of the</u>	
	<u>Preceding Year</u>	<u>Current Year</u>
Sales	\$ 560	\$ 960
Estimated total project sales	<u>÷ 4,000</u>	<u>÷ 4,000</u>
Percent of the project sold	<u>14 %</u>	<u>24 %</u>
Costs incurred applicable to lots sold:		
Land		
(\$120 × 14%)	\$ 17	
(\$120 × 24%)		\$ 29
Improvements		
(\$400 × 14%)	56	
(\$600 × 24%)		144
Estimated cost of future improvements		
(\$800 × 14%)	<u>112</u>	
(\$600 × 24%)		<u>144</u>
	<u>\$ 185</u>	<u>\$ 317</u>

The current year journal entry to record the cost of retail lot sales would be as follows (000s omitted):

Cost of retail lot sales (\$317 – \$185)	\$ 132	
Land—accumulated cost of retail lot sales (\$29 – \$17)		\$ 12
Improvements—accumulated cost of retail lot sales (\$144 – \$56)		88
Liability for future improvements (\$144 – \$112)		32

This illustration results in an addition to the liability for future improvements. As the project improvements near completion, the entry would result in a reduction of the liability. When all improvements are complete, the liability will be zero. For example, assume that in the above illustration, the percentage of the project sold increased to 28% in the next year, and future improvements costing \$400,000 were completed. The journal entry would be (000s omitted):

Cost of retail lot sales [(28% – 24%) × \$1,320]	\$ 53	
Liability for future improvements [\$144 – (\$200 × 28%)]	88	
Land—accumulated cost of retail lot sales [(\$120 × 28%) – \$29]		\$ 5
Improvements—accumulated cost of retail lot sales		
[\$(1,000 × 28%) – \$144]		136

Deferred Profit. Computation of the deferred profit applicable to the current year sales can be computed using the profit percentage for the current year or the percentage from inception of the project to the end of the current year. Authoritative literature does not illustrate or explain the computation in sufficient detail to suggest a specific method.

Based on the assumptions earlier in this lesson, deferred profit would be computed as follows (000s omitted):

**From Inception of the Project
to the End of the**

	Preceding Year	Current Year
Sales	\$ 560	\$ 960
Cost of retail lot sales	(185)	(317)
Direct selling expenses	<u>(200)</u>	<u>(300)</u>
Profit	<u>\$ 175</u>	<u>\$ 343</u>
Profit percentage (\$175 ÷ \$560)	31%	
(\$343 ÷ \$960)		36%
Contracts receivable before current year cancellations	<u>× 500</u>	<u>× 734</u>
Deferred profit at the end of each year	<u>\$ 155</u>	<u>\$ 264</u>

The increase of \$109,000 (\$264,000 – \$155,000) in the deferred profit during the current year consists of the following components:

- \$169,000 of deferred profit on the sales recorded in the current period.
- \$60,000 of deferred profit recognized as income in the current period.

The following is a summary of the change in contracts receivable and an allocation of the change in deferred profit for the current year (except for current year cancellations) (000s omitted):

	Contracts Receivable	Deferred Profit
Balance at end of preceding year	\$ 500	\$ 155
Current year sales	400	169
Collections	<u>(166)</u>	<u>(60)</u>
Balance at end of current year (before current year cancellations)	<u>\$ 734</u>	<u>\$ 264</u>

The journal entry to record the activity in the deferred profit accounts follows:

Provision for deferred profit	\$ 169,000	
Deferred profit recognized		\$ 60,000
Unamortized deferred profit		109,000

Contract Cancellations

Under the installment method, when a contract is cancelled, the receivable balance is charged to various accounts as follows:

- *Inventory (Land and Improvements)*. The amount previously charged to cost of retail lot sales is restored.
- *Liability for Future Improvements*. The amount related to the cancelled contract is written off.
- *Unamortized Deferred Profit*. The amount related to the cancelled contract is written off.
- *Cancellation Loss*. The remaining balance (which represents deferred selling costs) is charged to cancellation losses.

When a contract accounted for under the full accrual (or percentage-of-completion) method is cancelled, the entire receivable balance is charged to the allowance for cancellations. The reasons for the difference in accounting for cancellations under the installment method are—

- Under the installment method, no provision for cancellations is provided.
- Under the full accrual and percentage-of-completion methods, the cost of retail lot sales and deferred revenue are provided on sales net of the provision for cancellations. In other words, since no amount is transferred from inventory to cost of retail lot sales for the expected cancellations, it is not necessary to restore an amount to inventory when a contract is cancelled. Under the installment method, cost of retail lot sales is provided on total sales, including those expected to cancel. Accordingly, when a contract is cancelled, the lot must be restored to inventory. The same rationale is true for deferred revenue and the liability for future improvements.

Allowance for Cancellation Losses

Generally, an allowance for cancellation losses is unnecessary when the installment method is used. That is because the installment method recognizes profit only when the receivables are collected. As long as the value of the property does not decline, losses are limited to the deferred selling costs. Although projects with significant delinquent contracts receivable should consider the need for an allowance, the contract cancellation losses will generally not be material.

However, if the total estimated cost of the lots sold to date (including selling costs and estimated liability for future improvements) exceeds projected sales, the fair value of any lots recovered as a result of cancellations may be less than their original cost (including direct selling costs). That may result in losses on cancellations in addition to the deferred selling costs. Consequently, projects with significant delinquent contracts receivable should consider the need for an allowance to cover those potential additional losses. Those conditions may also indicate that land and improvements still in inventory are impaired.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. If a sale does not meet all the conditions for full accrual method until sometime after the sale date, the sale must be accounted for using which of the following accounting methods?
- a. Reduced profit.
 - b. Installment.
 - c. Deposit method.
 - d. Percentage-of-completion.
30. Contract cancellations are recorded by writing off the related contracts receivable, liability for future improvements, and unamortized deferred profit under which of the following methods?
- a. Installment.
 - b. Full accrual.
 - c. Percentage-of-completion.
31. Which of the following statements regarding valuation discounts is most accurate?
- a. A retail land developer usually achieves a market rate of return by decreasing the stated sales price.
 - b. The interest income is higher, earlier in the contract term; and lower later in the contract term.
 - c. Contract receivables that have below-market interest rates must be discounted under the installment method.
 - d. A developer must make a valuation discount if he or she is charging market interest rates.
32. It is unnecessary to provide an allowance for cancellation losses when which of the following methods of accounting is used?
- a. Installment.
 - b. Deposit.
 - c. Full accrual.
 - d. Percentage-of-completion.
33. Under which of the following accounting methods does the cost of retail lot sales include both costs incurred and the estimated costs of future improvements that relate to lots sold?
- a. Installment.
 - b. Full accrual.
 - c. Percentage-of-completion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. If a sale does not meet all the conditions for full accrual method until sometime after the sale date, the sale must be accounted for using which of the following accounting methods? **(Page 157)**
- a. Reduced profit. [This answer is incorrect. SFAS No. 66 (FASB ASC 360-20) does not specifically address using the reduced profit method when conditions for using full accrual are not met.]
 - b. Installment. [This answer is correct. In the case where a real estate sale does not meet all the full accrual method conditions until after the sale, the sale is initially accounted for using the appropriate method. The appropriate method may be the installment method or the cost recovery method.]**
 - c. Deposit method. [This answer is incorrect. SFAS No. 66 (FASB ASC 360-20) does not specifically address using the deposit method of accounting when conditions for using full accrual are not met.]
 - d. Percentage-of-completion. [This answer is incorrect. The percentage-of-completion is not recognized as a method used when a sale does not meet all conditions for full accrual.]
30. Contract cancellations are recorded by writing off the related contracts receivable, liability for future improvements, and unamortized deferred profit under which of the following methods? **(Page 157)**
- a. Installment. [This answer is correct. Contract cancellations are recorded by writing off the related contracts receivable, liability for future improvements, and unamortized deferred profit. The net difference is recorded by restoring the inventory previously charged to cost of retail lot sales and charging the remainder to cancellation losses.]**
 - b. Full accrual. [This answer is incorrect. Under the full accrual method of accounting the entire receivable balance is charged to the allowance for cancellations.]
 - c. Percentage-of-completion. [This answer is incorrect. The entire receivable balance is charged to the allowance for cancellations.]
31. Which of the following statements regarding valuation discounts is most accurate? **(Page 157)**
- a. A retail land developer usually achieves a market rate of return by decreasing the stated sales price. [This answer is incorrect. Because of the relatively high risk involved in retail land sale contracts, the rates financial institutions would charge to make similar loans would be higher than the rates charged on more conventional loans. In essence, the retail land developer is achieving a market rate of return by increasing the stated sales price.]
 - b. The interest income is higher, earlier in the contract term; and lower later in the contract term. [This answer is correct. Since interest income on the discounted contract is recognized using the market rate, more interest income is recognized in each period when the receivable is discounted because the discount rate is higher than the stated rate. In the earlier years of the term of the contract when interest income is highest, interest income using the market rate is generally sufficiently higher than interest using the stated rate that the total of interest income and gain recognized is greater than if the receivable had not been discounted. In the later years, as interest income declines, the total is less than if the receivable had not been discounted.]**
 - c. Contract receivables that have below-market interest rates must be discounted under the installment method. [This answer is incorrect. Discounting yields a lower sales price and, therefore, a lower principal balance, a lower profit, and a lower profit percentage. Therefore, under the installment method, it is not necessary to discount contracts receivable that have below market interest rates.]

- d. A developer must make a valuation discount if he or she is charging market interest rates. [This answer is incorrect. The rate used to discount the receivable should not be less than the rate stated in the sales contract. Consequently, if the developer is charging market interest rates (or above), no valuation discount is necessary.]
32. It is unnecessary to provide an allowance for cancellation losses when which of the following methods of accounting is used? **(Page 161)**
- a. **Installment.** [This answer is correct. Under the installment method of accounting, profit is only recognized when the receivables are collected.]
 - b. Deposit. [This answer is incorrect. No profit is recognized under the deposit method.]
 - c. Full accrual. [This answer is incorrect. Under the full accrual method, all profit is recognized when the sale is recognized.]
 - d. Percentage-of-completion. [This answer is incorrect. The percentage-of-completion method recognizes only a portion of the profit each year.]
33. Under which of the following accounting methods does the cost of retail lot sales include both costs incurred and the estimated costs of future improvements that relate to lots sold? **(Page 158)**
- a. **Installment.** [This answer is correct. Under the installment accounting method, the cost of retail lot sales include both costs incurred and the estimated costs of future improvements that relate to lots sold. Also, the cost of retail lot sales is provided on gross sales.]
 - b. Full accrual. [This answer is incorrect. Only costs incurred are included under the full accrual method.]
 - c. Percentage-of-completion. [This answer is incorrect. Only costs incurred are included under the percentage-of-completion method of accounting. Also, the costs of retail lot sales are provided on gross sales less the provision for cancellations.]

INVENTORIES AND COST OF RETAIL LOT SALES

Retail land project inventories are simply the capitalized land and development costs of the project. This section discusses considerations unique to retail land inventories. Specifically, the following topics are discussed:

- Calculating the cost of retail lot sales under each profit recognition method (that is, full accrual, percentage-of-completion, or installment method).
- Calculating a provision for losses on retail lot sales when the percentage-of-completion method is used and the estimated cost to complete lots sold exceeds deferred revenue.
- Assessing retail land inventories for impairment.
- Accounting for amenities.

Calculating the Cost of Retail Lot Sales

Full Accrual Method. Inventories under the full accrual method consist of the cost of land and improvements pertaining to (a) lots for which a sale has not been recognized and (b) lots sold which are expected to cancel. In other words, the cost of retail lot sales is based on gross sales less the provision for cancellations.

To illustrate the calculation of the cost of retail lot sales when the full accrual method is used, assume the following:

- All conditions for use of the full accrual method have been met and the relative sales value method is used to allocate costs to retail lot sales.
- Sales information is as follows (000s omitted):

From inception of the project:	
Gross sales	\$ (1,000)
Provision for cancellations	(180)
Estimated sales for the remainder of the project	<u>3,180</u>
Estimated total project sales	<u>\$ 4,000</u>

- Project costs to date include (000s omitted):

Land	<u>\$ 120</u>
Improvements	<u>\$ 600</u>

- Total cost of retail lot sales from inception of the project to the end of the preceding year was as follows (000s omitted):

Land	<u>\$ 16</u>
Improvements	<u>\$ 104</u>

The cost of retail lot sales from inception of the project would be computed as follows (000s omitted):

Sales, less provision for cancellations (\$1,000 – \$180)	\$ 820
Estimated total project sales	÷ 4,000
Percent of the project sold	<u>20%</u>
Costs incurred to date applicable to lots sold:	
Land (\$120 × 20%)	\$ 24
Improvements (\$600 × 20%)	<u>120</u>
	<u>\$ 144</u>

The cost of retail lot sales for the current year would be \$24,000, computed as follows (000s omitted):

<u>Cost of retail lot sales</u>	<u>Land</u>	<u>Improvements</u>	<u>Total</u>
From inception of the project	\$ 24	\$ 120	\$ 144
To end of preceding year	<u>16</u>	<u>104</u>	<u>120</u>
Current year	<u>\$ 8</u>	<u>\$ 16</u>	<u>\$ 24</u>

The journal entry to record the cost of retail lot sales for the current year would be as follows:

Cost of retail lot sales	\$ 24,000	
Land—accumulated cost of retail lot sales		\$ 8,000
Improvements—accumulated cost of retail lot sales		16,000

Percentage-of-completion Method. When the percentage-of-completion method is used, the cost of retail lot sales is computed in the same manner as for the full accrual method. That is because, under the percentage-of-completion method, the cost of retail lot sales is based on the costs incurred to date. Revenue for the estimated remaining costs applicable to the lots sold is deferred. The deferred revenue and related costs are recognized as the costs are incurred.

Installment Method. Computation of the cost of retail lot sales under the installment method differs from the computation under the full accrual and percentage-of-completion methods, as follows:

- Cost of retail lot sales under the full accrual and percentage-of-completion methods includes only costs incurred (the full accrual method is used only if the project is complete). Under the installment method, the cost of retail lot sales includes both costs incurred and the estimated cost of future improvements related to the lots sold.
- Under the full accrual and percentage-of-completion methods, the cost of retail lot sales is provided on gross sales less the provision for cancellations. Under the installment method, the cost of retail lot sales is provided on gross sales (with no deduction for any provision for cancellations).

Provision for Losses on Retail Lot Sales

When a developer uses the percentage-of-completion method, revenue is deferred in proportion to costs to be incurred. The deferred revenue is based on the estimated cost to complete lots sold, and the cost estimate is reevaluated at least annually. Changes in the estimated costs are generally accounted for as changes in estimates. However, if a loss is indicated (that is, the revised cost to complete the lots sold exceeds the deferred revenue), the total expected loss should be charged to income during the current period. The need to recognize projected losses on lots sold may also indicate the need to provide for expected losses on land and improvements not yet sold.

The following example illustrates the calculation of a provision for losses on lots sold. Note that the estimate of costs to complete lots sold can be affected by a change in estimated total project sales as well as a change in total estimated project costs. The following example includes both. To illustrate, assume the following:

- All conditions for use of the percentage-of-completion method have been met and the relative sales value method is used to allocate cost to retail lot sales.
- Land sales information is as follows (000s omitted):

	Gross Sales	Provision for Cancellations	Sales Less Provision for Cancellations	Valuation Discounts	Net Sales
To end of preceding year	\$ 630	\$ 115	\$ 515	\$ 105	\$ 410
Current year	<u>370</u>	<u>65</u>	<u>305</u>	<u>65</u>	<u>240</u>
To end of current year	<u>\$ 1,000</u>	<u>\$ 180</u>	820	<u>\$ 170</u>	<u>\$ 650</u>
Estimated total project sales as of end of preceding year			<u>\$ 3,800</u>		
Revised estimated total sales at end of current year			<u>\$ 4,000</u>		

- Project cost information is as follows (000s omitted):

	Land	Improvements	Total
As of end of preceding year:			
Costs incurred	\$ 120	\$ 400	\$ 520
Estimated remaining costs	<u>—</u>	<u>800</u>	<u>800</u>
Estimated total project costs	<u>\$ 120</u>	<u>\$ 1,200</u>	<u>\$ 1,320</u>
As of end of current year:			
Costs incurred to end of preceding year	\$ 120	\$ 400	\$ 520
Cost incurred during current year	<u>—</u>	<u>400</u>	<u>400</u>
Costs incurred to end of current year	<u>120</u>	<u>800</u>	<u>920</u>
Estimated remaining costs	<u>—</u>	<u>1,000</u>	<u>1,000</u>
Estimated total project costs	<u>\$ 120</u>	<u>\$ 1,800</u>	<u>\$ 1,920</u>

- Direct selling cost information is as follows (000s omitted):

To end of preceding year	\$ 200
Current year	<u>100</u>
To end of current year	<u>\$ 300</u>

The cost of retail lot sales would be computed as follows (000s omitted):

	From Inception of the Project to the End of the	
	Preceding Year	Current Year
Sales, less estimated cancellations	\$ 515	\$ 820
Estimated total project sales	<u>÷ 3,800</u>	<u>÷ 4,000</u>
Percent of the project sold	<u>14 %</u>	<u>20 %</u>
Costs incurred to date applicable to lots sold:		

	From Inception of the Project to the End of the	
	<u>Preceding Year</u>	<u>Current Year</u>
Land		
$(\$120 \times 14\%)$	\$ 17	
$(\$120 \times 20\%)$		\$ 24
Improvements		
$(\$400 \times 14\%)$	<u>56</u>	
$(\$800 \times 20\%)$		<u>160</u>
	<u>\$ 73</u>	<u>\$ 184</u>

The deferred revenue at the end of the preceding and the current years would be as follows (000s omitted):

	From Inception of the Project to the End of the	
	<u>Preceding Year</u>	<u>Current Year</u>
Cost to complete the lots sold		
$(\$800 \times 14\%)$	<u>\$ 112</u>	
$(\$1,000 \times 20\%)$		<u>\$ 200</u>
Land and improvement costs incurred to date applicable to the lots sold	<u>\$ 73</u>	<u>\$ 184</u>
Direct selling costs	<u>\$ 200</u>	<u>\$ 300</u>
Net sales less discounts	<u>\$ 410</u>	<u>\$ 650</u>
Deferred revenue—future improvements		
$[\$112 \div (\$112 + \$73 + \$200) \times \$410]$	<u>\$ 119</u>	
$[\$200 \div (\$200 + \$184 + \$300) \times \$650]$		<u>\$ 190</u>

Because the estimated cost to complete the lots sold exceeds the deferred revenue—future improvements at the end of the current year by \$10,000 (\$200,000 – \$190,000), the loss should be provided for in the current period. The journal entry would be as follows:

Provision for losses on retail lots sold	\$ 10,000	
Liability for losses on retail lots sold		\$ 10,000

Inventory Impairment

It is believed that impairment for a retail land project generally should be considered for the project as a whole rather than individual lots. This is because most projects consist of homogeneous, integral parts. However, portions of the projects that are not homogeneous, integral parts should be evaluated separately. The following discussion assumes that the project can be evaluated as a whole.

If the improvements to the project are substantially complete, and the lots are ready for sale, the project should be reported at the lower of its carrying amount or fair value less cost to sell. If the improvements are not substantially complete, the SFAS No. 144 (FASB ASC 360-10-35) rules for property to be held and used apply. Accordingly, the property should be assessed for impairment when events or changes in circumstances indicate that the carrying amount of the project may not be recoverable. Examples of conditions that may indicate impairment include—

- Sales have been slower than expected.

- Significant cost overruns have been experienced.
- Under the percentage-of-completion method, costs to complete the lots exceed deferred revenue.
- Under the installment method, total estimated cost of lots sold to date (including selling costs and estimated liability for future improvements) exceeds projected sales.

In those situations, the total estimated future cash flows from the project should be compared to the current carrying amount of the project. If the project's carrying amount exceeds the total estimated future cash flows, it should be written down to its fair value.

SELLING COSTS

Selling costs are the costs incurred in marketing and selling lots from retail land projects. This section discusses considerations unique to retail land projects. Specifically, the following topics are discussed:

- Defining direct selling costs.
- Deferral of direct selling costs.
- Tangible assets and costs incurred to obtain regulatory approvals.

Defining Direct Selling Costs

A primary difference between a retail land project and other development projects is that the marketing effort is usually a dominant activity in a retail land project. Selling costs that are directly identifiable with a project and with obtaining sales contracts are considered direct selling costs. The following are examples of selling costs commonly incurred by retail land projects that may be considered direct selling costs:

- Gifts (such as, dinners, free weekends, or other incentives) given to prospective buyers attending promotional programs or making on-site visits.
- Salaries directly identifiable with a promotional program.
- Cost of facilities used exclusively for prospective buyers.

Deferral of Direct Selling Costs

If certain conditions are met, direct selling costs are deferred (i.e., recorded as a prepaid expense) and charged to expense when the related revenue is recognized. Similar procedures are followed for retail land sales. Direct selling costs are deferred as an asset as long as a sale contract is recorded as a deposit. However, under the percentage-of-completion and installment methods, direct selling costs are deferred indirectly. That is, they are expensed and are factored into the deferred revenue and deferred profit computation in a way that decreases the revenue and profit deferred. In other words, the deferred selling costs are offset against the deferred revenue or deferred profit rather than being treated as deferred assets.

Tangible Assets and Costs Incurred to Obtain Regulatory Approvals

Costs of tangible assets and costs incurred to obtain regulatory approvals are deferred and amortized as lots are sold. In a retail land project, those costs are accounted for in the same way. That is, they are deferred and amortized to expense as lots are sold. When expensed, they are included in the direct selling costs amount used in calculating deferred revenue under the percentage-of-completion method or deferred profit under the installment method.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Which of the following statements regarding selling costs for retail land projects is most accurate?
- a. Direct selling costs cannot be deferred.
 - b. Selling costs that are directly identifiable with a project and with obtaining sales contracts are considered direct selling costs.
 - c. Gifts to prospective buyers are not considered selling costs.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Which of the following statements regarding selling costs for retail land projects is most accurate? **(Page 170)**
- a. Direct selling costs cannot be deferred. [This answer is incorrect. Sales commissions and other selling costs that are directly related to a specific sale should be deferred (that is, recorded as prepaid expenses) and charged to expense when the related revenue is recognized.]
 - b. **Selling costs that are directly identifiable with a project and with obtaining sales contracts are considered direct selling costs. [This answer is correct. A primary difference between a retail land project and other development projects is that the marketing effort is usually a dominant activity in a retail land project. Selling costs that are directly identifiable with a project and with obtaining sales contracts are considered direct selling costs.]**
 - c. Gifts to prospective buyers are not considered selling costs. [This answer is incorrect. Gifts (such as, dinners, free weekends, or other incentives) given to prospective buyers attending promotional programs or making on-site visits are all considered selling costs.]

CHANGING TO A DIFFERENT ACCOUNTING METHOD

The prior sections of this course discuss how to select and administer an accounting method for each retail land project. Exhibit 1-1 and Exhibit 1-2 illustrate the process of selecting an accounting method, and Exhibit 2-1 summarizes the major differences between the methods. The following paragraphs discuss the implications of changing to a different accounting method.

All retail land sales from a project must be accounted for using the installment, percentage-of-completion, or full accrual method. A project using the installment method must change to either the percentage-of-completion or the full accrual method when the conditions for use of either of those methods is met, and a project using the percentage-of-completion method must change to the full accrual method when the conditions for use of the full accrual method are met. Although paragraph 49 of SFAS No. 66 (FASB ASC 976-605-25-11) states that the "percentage-of-completion method of accounting may be adopted . . .," paragraph 44 (FASB ASC 976-605-25-10) states that the ". . . method of recognizing profit shall be changed when certain conditions are met for the entire project."

Changing from the Installment Method

When a project using the installment method meets all of the conditions for use of the full accrual or the percentage-of-completion method, the new method must be adopted for the entire project (current and prior sales). SFAS No. 66, Paragraph 49 (FASB ASC 976-605-25-11), indicates that the change is a change in an estimate. Under SFAS No. 154 (FASB ASC 250), *Accounting Changes and Error Corrections*, a change in an estimate is not recorded as an adjustment of prior financial statements. Instead, the dollar amount of the change is either recorded entirely in current income or current and future periods if the change affects both. The following steps are necessary to change from the installment method of accounting:

- a. Reversing the balance in the "Liability for future improvements" account.
- b. Reversing the balance in the "Deferred profit" account.
- c. Providing an allowance for cancellations for all remaining contracts receivable.
- d. Providing unamortized valuation discounts for all remaining contracts receivable.

If the change is to the percentage-of-completion method, the change would also include providing deferred revenue for all current year and prior sales.

The net (pretax) effect of the change will generally be a credit and should be included as a single line item in the revenue section of the income statement and described as follows:

Income resulting from change from the installment to the percentage-of-completion [full accrual] method of accounting for retail land sales.

SFAS No. 154, Paragraph 22 (FASB ASC 250-10-50-4), also requires disclosure in the year of change of the effect on income before extraordinary items and net income (that is, the after-tax effect). The effect of the change is the difference between net income computed using the installment method and net income using the new method. An example note disclosure is as follows:

During 20X2, the Company changed its method of recognizing profit on retail lot sales from the installment method to the percentage-of-completion [full accrual] method because the conditions for use of the percentage-of-completion [full accrual] method were met. The effect of this change was to increase income before extraordinary items and net income for 20X2 by \$XX,XXX.

Changing to the Full Accrual Method. Using the example earlier in this lesson to illustrate a change in accounting methods, assume that as of the end of the current year the company has adequate data to conclude that the receivable collectibility condition has been met *and* all required improvements have been completed at the previously estimated costs.

Exhibit 2-1**Retail Land Transaction Accounting Method Characteristics**

Characteristics	Accounting Method			
	Deposit	Installment	Percentage of Completion	Full Accrual
Transaction is considered a sale	No	Yes	Yes	Yes
Developer records payments received as revenue (profit)	No	Partial	Partial	Yes
Developer records payments received as a liability (deposits)	Yes	Partial	Partial	No
Developer records a sale and a receivable	No	Yes	Yes	Yes
Developer must establish an allowance for cancellations	No	No	Yes	Yes
Developer provides a provision for cancellations	No	No	Yes	Yes
Developer must establish a valuation discount	No	No	Yes	Yes
Costs of sales includes estimated future improvements	Not applicable	Yes	No	No
Costs of sales is provided on gross sales less the cancellation provision	Not applicable	No	Yes	Yes
Developer maintains inventory on books	Yes	No	No	No
Developer must periodically evaluate inventory for impairment	Yes	Yes	Yes	Yes
Developer defers direct selling costs	Yes	Indirectly	Indirectly	No

Reverse Liability for Future Improvements. The first step in changing from the installment method to the full accrual method (or the percentage-of-completion method) is to reverse the balance in the "Liability for future improvements" account. The estimated cost of future improvements at the end of the current year is \$138,000. The journal entry to reverse this liability is as follows (000s omitted):

Liability for future improvements (\$144 – \$6)	\$ 138
Income resulting from change from installment to the percentage-of-completion method of accounting for retail land sells	\$ 138

Reverse Installment Method Deferred Profit. The next step is to reverse the "Deferred profit" account. Using the information in the earlier paragraphs, the journal entry to reverse the deferred profit after current year cancellations would be (000s omitted):

Unamortized deferred profit (\$264 – \$12)	\$ 252	
Deferred profit recognized		\$ 252

Establish a Cancellation Allowance. Because of the change to the full accrual method (or the percentage-of-completion method), an allowance for cancellations and a valuation discount must be provided. To determine the cancellation rate and provision, the sales and cancellations to the end of the previous year will serve as the collection data period. Slightly modifying the computation method, a cancellation provision of \$40,000 is established as follows:

Cancellations:		
During the collection data period (assumed)	\$	22,000
Subsequent cancellations		34,000
Total cancellations to date		<u>56,000</u>
Sales to end of current year	÷	560,000
Cancellation rate		10%
Sales from inception of project to current date	×	960,000
Provision for cancellations		<u>96,000</u>
Total cancellations to date		<u>(56,000)</u>
Provision for the current year		40,000

The journal entry to record the cancellation allowance would be as follows:

Provision for cancellations	\$ 40,000	
Allowance for cancellations		\$ 40,000

Establish a Valuation Discount. Once the cancellation allowance is established, the valuation discount for the remaining contracts receivable can be calculated. For simplicity, it is assumed that the contracts mature evenly over the next eight years, bear interest at 5.7%, require average annual payments of \$105,000 due at the end of each year, and are discounted at an 11% rate. The valuation discount is calculated as follows:

Contracts receivable at end of year	\$	700,000
Cancellation Allowance		<u>(40,000)</u>
Net receivables		660,000
PV of net receivables		<u>(540,000)</u>
Unamortized valuation discount	\$	<u>120,000</u>

The journal entry to record the unamortized valuation discount would be as follows:

Provision for discounts	\$ 120,000	
Unamortized discounts		\$ 120,000

Calculation of Net Amount Credited to Income. The net (pretax) effect of the change will generally be a credit and should be included as a single line item in the revenue section of the income statement. This amount is calculated as follows:

Reversal of installment method liability for future improvements	\$	138,000
Reversal of installment method deferred profit		252,000
Less:		
Establishment of accrual method cancellation allowance		(40,000)
Establishment of accrual method valuation discount		<u>(120,000)</u>
Net amount credited to income	\$	<u>230,000</u>

The net (pretax) affect of the change should be described in the income statement as follows:

Income resulting from change from the installment to the full accrual method of accounting for retail land sales.

Changing to the Percentage-of-completion Method. The only difference between changing from the installment method to the percentage-of-completion method (as opposed to the full accrual method) is the inclusion of a deferred revenue provision. However, this statement is slightly deceiving because to determine the deferred revenue provision, the costs incurred to date and the estimated costs to complete the project must be calculated.

Changing from the installment method to the percentage-of-completion method requires the reversal of the installment method liability for future improvements, the reversal of the installment method deferred profit, and the establishment of a percentage-of-completion cancellation allowance and valuation discount. Accordingly, except for the establishment of a deferred revenue provision, the process is identical to the change from the installment method to the full accrual method of accounting illustrated.

Establish Percentage-of-completion Deferred Revenue. The change to the percentage-of-completion method also includes providing deferred revenue for all inception-to-date sales. The formula earlier in this lesson is used to calculate the deferred profit under the percentage-of-completion method. To use the formula, the following four pieces of data are needed:

- Costs incurred to date on lots sold
- Estimated costs to complete the lots sold
- Direct selling costs—\$300,000
- Net sales

The land and improvement costs applicable to lots sold is computed as follows (000s omitted):

Sales, less provisions for cancellations (\$960 – \$40)	\$ 920
Estimated total project sales	<u>÷ 4,000</u>
Percent of the project sold	<u>23 %</u>
Costs incurred applicable to lots sold:	
Land (23% × \$120)	\$ 28
Improvements (23% × \$600)	<u>138</u>
Costs incurred to date on lots sold	<u>\$ 166</u>

The estimated cost to complete the project is the total estimated remaining project costs less the improvement completion costs incurred to date. In other words, the estimated completion cost is simply the estimated costs to complete the improvements multiplied by the percentage of the project sold. For this example, the estimated costs to complete the project is computed as follows:

Estimated costs to complete the improvements	\$ 600,000
Percent of the project sold	<u>× 23 %</u>
Estimated cost to complete the project	<u>\$ 138,000</u>

Net sales equals gross sales less provisions for cancellations and discounts. Thus, net sales equal \$800,000 [\$960,000 (gross sales) – \$40,000 (cancellation provisions) – \$120,000 (discount provisions)]. Using the deferred revenue formula, a total of \$183,000 of deferred revenue is calculated as follows (000s omitted):

$$\frac{\$138 \text{ (estimated cost to complete)}}{\$138 \text{ (estimated cost to complete)} + \$166 \text{ (costs incurred)} + \$300 \text{ (direct selling costs)}} \times \$800 \text{ (net sales)}$$

The journal entry to reverse the deferred profit after current year cancellations would be (000s omitted):

Deferred revenue—future improvements	\$ 183	
Deferred revenue		\$ 183

The net (pretax) effect of the change will generally be a credit and should be included as a single line item in the revenue section of the income statement. This amount is calculated as follows:

Reversal of installment method liability for future improvements	\$ 138,000
Reversal of installment method deferred profit	252,000
Less:	
Establishment of percentage-of-completion method cancellation allowance	(40,000)
Establishment of percentage-of-completion method valuation discount	(120,000)
Establishment of percentage-of-completion method deferred revenue	<u>(183,000)</u>
Net amount credited to income	<u>\$ 47,000</u>

The net (pretax) affect of the change should be described in the income statement as follows:

Income resulting from change from the installment to the percentage-of-completion method of accounting for retail land sales.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following methods of accounting includes estimated future improvements in the costs of sales?
- a. Deposit.
 - b. Installment.
 - c. Percentage-of-completion.
 - d. Full accrual.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following methods of accounting includes estimated future improvements in the costs of sales?
(Page 173)
- a. Deposit. [This answer is incorrect. Under the deposit method of accounting, estimates of future improvements are not applicable.]
 - b. Installment. [This answer is correct. Under the installment method of accounting, a liability for future costs is provided, and the retail lot sale included the estimated cost of future improvements that relate to the lots sold.]**
 - c. Percentage-of-completion. [This answer is incorrect. Under the percentage-of-completion method of accounting, costs of sales do not include estimated future improvements.]
 - d. Full accrual. [This answer is incorrect. Under this method all improvements must be completed and all the conditions for recording sales have been met.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (ARETG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. When is a sale subsequently recorded?
- a. When the receivables are considered collectible.
 - b. When the sale is recognized.
 - c. When the conditions for recording the sale is met.
 - d. When the project is determined practical.
22. Which of the following methods of accounting should be used if the seller is required to support operations of the property for a limited period?
- a. Leasing.
 - b. Deposit.
 - c. Percentage-of-completion.
 - d. Financing.
23. Which of the following accounting methods is used when receivables are not subordinated to any new loans on the property?
- a. Percentage-of-completion.
 - b. Full accrual.
 - c. Installment.
 - d. Deposit.
24. The deferral of revenue is accomplished by deferring a portion of which of the following?
- a. Net sales.
 - b. Gross sales.
 - c. Unrecorded sales.
 - d. Retail lot sales.
25. How often should the estimated cost to complete a retail land sale project be reviewed?
- a. At least semi-annually.
 - b. At least annually.
 - c. At least every two years.

- d. At least every three years.
26. Under which of the following accounting methods is profit recognized in proportion to the collection of the contract price?
- a. Installment.
 - b. Deposit.
 - c. Percentage-of-completion.
 - d. Full accrual.
27. Under which of the following accounting methods is the cost of retail lot sales based on gross sales less the provision for cancellation?
- a. Full accrual.
 - b. Deposit.
 - c. Installment.
 - d. Do not select this answer choice.
28. Which of the following statements regarding how profit is recognized under the percentage-of-completion method is most accurate?
- a. Developers must use the percentage-of-completion method when improvements are close to completion.
 - b. The percentage-of-completion method must be used when the amount of revenue that normally would be deferred under the percentage-of completion method is material to the financial statements.
 - c. All improvements do not necessarily have to be complete to use the full accrual method.
 - d. Do not select this answer choice.
29. Under which of the following accounting methods is the cost of retail lot sales based on the costs incurred to date?
- a. Deposit.
 - b. Percentage-of-completion.
 - c. Installment.
 - d. Full accrual.
30. Which of the following methods of accounting includes both costs incurred and the estimated cost of future improvements related to the lots sold?
- a. Percentage-of-completion.
 - b. Full accrual.
 - c. Installment.
 - d. Deposit.

31. Under which of the following accounting methods are direct selling costs deferred as an asset?
- a. Installment.
 - b. Percentage-of-completion.
 - c. Full accrual.
 - d. Deposit.
32. A project using the installment method must change to which of the following two methods when the conditions for use of either of those methods are met?
- a. Percentage-of-completion, full accrual.
 - b. Full accrual, deposit.
 - c. Deposit, percentage-of completion.
 - d. Full accrual, cost recovery.
33. Which of the following methods should **not** be used when a developer records a sale and a receivable?
- a. Installment.
 - b. Deposit.
 - c. Percentage-of-completion.
 - d. Full accrual.
34. What is the difference between changing between the percentage-of-completion method and the installment method?
- a. Inclusion of a deferred revenue provision.
 - b. The costs incurred.
 - c. The developer maintains inventory on the books.
 - d. The developer defers direct selling costs.
35. Changing from the installment method to the percentage-of-completion method requires the reversal of which of the following account balances?
- a. Percentage-of-completion cancellation allowance.
 - b. Liability for future improvements.
 - c. Valuation discount.
 - d. Deferred revenue.

GLOSSARY

Accrued interest: If a transfer of receivables are treated as a sale under SFAS No. 140, the transferor should treat any subsequent accrued interest receivables (AIRs), including late payment fees or other finance charges, that are billed and uncollected (or accrued but unbilled) as a retained beneficial interest

Amortization schedule method: An amortization schedule, updated each year, is maintained in a manner similar to a depreciation schedule. Each year the new provision for the current year is added and the earned discounts are taken into income.

Antispeculation clause: Antispeculation clauses typically either (a) require the buyer to develop the property (usually land) in a specific way or within a certain period or (b) prohibit the buyer from using the property for some specified purpose. If the buyer fails to comply with such clauses, the seller has the right to repurchase the property.

Binding contract: There is a contract that binds both parties.

Closing requirements: All of the conditions needed to close the sale (such as title policy, surveys, inspections, permits) have been met.

Contract sales price: The sales price specified in the sales contract. The contract sales price typically consists of cash, assumption of existing debt, notes payable to the seller, or some combination of the three.

Cost recovery method: This method also recognizes a sale and corresponding loan and may apply when dispositions do not qualify under the full accrual or installment methods. No profit or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan or a change to another accounting method is appropriate.

Deferral of revenue: The deferral of revenue is accomplished by deferring a portion of the net sales (gross sales less estimated cancellations and discounts). The deferral is based on the ratio of estimated cost to complete lots already sold, to the estimated total cost of lots sold.

Deposit method: The deposit method is used in situations where a sale of the real estate has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as other real estate.

Equity kicker: Occasionally, when property is sold, the seller may receive additional payments based on profits or cash flows commonly called an equity kicker.

Exchange of consideration: All consideration (such as cash, notes, and deeds) has been exchanged.

Financing arrangement: There are two primary ways to account for a transaction as a financing arrangement. The first is simply to use the deposit method. In effect, that treatment is used when the seller is obligated to support the operations of an unprofitable property for an extended period. The second approach may be used when the seller is required to repurchase the property at a price higher than the sales value.

Full-accrual method: Under this method, the disposition is recorded as a sale. Any resulting profit is recognized in full and the seller-financed asset is reported as a loan. The following conditions must be met in order to utilize this method.

- A sale has been consummated,
- The receivable is not subject to future subordination,
- The usual risks and rewards of ownership have been transferred, and
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.

Individual contract method: Schedules are maintained by individual contract.

Installment method: This method recognizes a sale and corresponding loan. Profits are recorded as the bank receives payments. Interest income is recognized on an accrual basis.

Inventory method: The estimated unamortized discount is computed at each reporting date. (Some companies make the computation periodically-at least annually-and estimate the interim amounts.)

Management contract: The seller agrees to manage the property under a noncancelable, long-term management contract, and the terms of the contract impose obligations on the seller beyond those of a typical property manager

Partial ownership: The seller retains a partial ownership interest in the property, and the seller will be required to support operations to an extent greater than its proportionate interest.

Partial sales: Partial sales are those in which the seller keeps an ownership interest in the property or has an ownership interest in the buyer.

Percentage-of-completion method: This method recognizes profit on a long-term construction contract as it is earned gradually during the construction period.

Reduced-profit method: This method is appropriate in those situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements of the full accrual method. Like the installment method, any profit is recognized as payments are received. However, profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement. This method is seldom used in practice since sales with adequate down payments are generally not structured with inadequate loan amortization requirements.

Reload transaction: SOP 04-2 defines a reload transaction as a time-sharing transaction where the buyer purchases a second time-share interval from the same seller but does not relinquish the right to the first time-share interval.

Right of refusal: A right of first refusal based on a bona fide offer from a third party.

Selling costs: Selling costs are the costs incurred in marketing and selling lots from retail land projects.

Significant receivable: The seller holds a significant receivable from the buyer, and collection of the receivable depends on the operations of the property

Superior lien: The seller's lien on the property must be superior to all other liens on the property, with certain exceptions.

Upgrade transaction: In an upgrade transaction, the buyer relinquishes the right to a currently held time-share interval and obtains a higher-priced time-share interval from the same seller.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Real Estate—Course 1— Sales Other Than Retail Land Sales (ARETG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
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EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET
Companion to PPC's Guide to Real Estate—Course 1—
Sales Other Than Retail Land Sales (ARETG091)

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙ .

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. ○	○	○	○	9. ○	○	○	○	17. ○	○	○	○	24. ○	○	○	○
2. ○	○	○	○	10. ○	○	○	○	18. ○	○	○	○	25. ○	○	○	○
3. ○	○	○	○	11. ○	○	○	○	19. ○	○	○	○	26. ○	○	○	○
4. ○	○	○	○	12. ○	○	○	○	20. ○	○	○	○	27. ○	○	○	○
5. ○	○	○	○	13. ○	○	○	○	21. ○	○	○	○	28. ○	○	○	○
6. ○	○	○	○	14. ○	○	○	○	22. ○	○	○	○	29. ○	○	○	○
7. ○	○	○	○	15. ○	○	○	○	23. ○	○	○	○	30. ○	○	○	○
8. ○	○	○	○	16. ○	○	○	○								

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: September 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Real Estate—Course 1—
Sales Other Than Retail Land Sales (ARETG091)

Course Acronym: ARETG091

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☒.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
2. How would you rate the examination related to the course material?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
3. Does the examination consist of clear and unambiguous questions and statements?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
4. Were the stated learning objectives met?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
5. Were the course materials accurate and useful?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
7. Was the time allotted to the learning activity appropriate?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
8. If applicable, was the technological equipment appropriate?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
10. If applicable, how well did the audio/visuals contribute to the program?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Real Estate—Course 2— Retail Land Sales (ARETG092)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
ARETG092 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

	Page
CPE Examination Questions (Lesson 1)	131
CPE Examination Questions (Lesson 2)	181

EXAMINATION FOR CPE CREDIT ANSWER SHEET**Companion to PPC's Guide to Real Estate—Course 2—Retail Land Sales (ARETG092)****Price \$79**

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

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Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add \$24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ✓.

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. ○	○	○	○	10. ○	○	○	○	19. ○	○	○	○	28. ○	○	○	○
2. ○	○	○	○	11. ○	○	○	○	20. ○	○	○	○	29. ○	○	○	○
3. ○	○	○	○	12. ○	○	○	○	21. ○	○	○	○	30. ○	○	○	○
4. ○	○	○	○	13. ○	○	○	○	22. ○	○	○	○	31. ○	○	○	○
5. ○	○	○	○	14. ○	○	○	○	23. ○	○	○	○	32. ○	○	○	○
6. ○	○	○	○	15. ○	○	○	○	24. ○	○	○	○	33. ○	○	○	○
7. ○	○	○	○	16. ○	○	○	○	25. ○	○	○	○	34. ○	○	○	○
8. ○	○	○	○	17. ○	○	○	○	26. ○	○	○	○	35. ○	○	○	○
9. ○	○	○	○	18. ○	○	○	○	27. ○	○	○	○				

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Expiration Date: September 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Real Estate—Course 2—Retail Land Sales Course Acronym: ARETG092

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ○ ⊗ ⊙.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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(Please print legibly):

Additional Comments:

1. What did you find **most** helpful? _____
2. What did you find **least** helpful? _____
3. What other courses or subject areas would you like for us to offer? _____
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5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____