cutting through complexity

Building a Bridge from Statement 66: Real Estate Sales Under the New Revenue Standard

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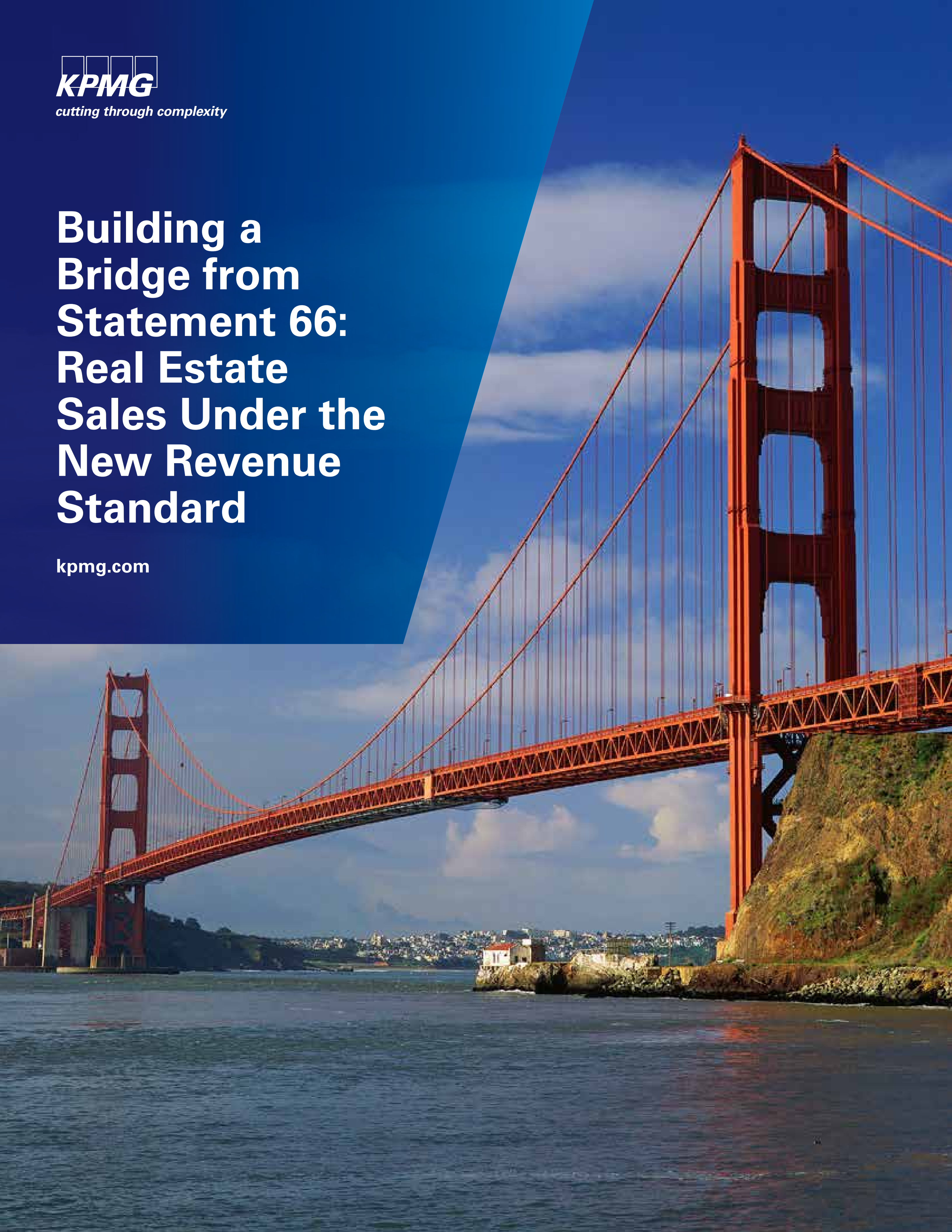


In May 2014, the IASB and the FASB published their new joint standard on revenue recognition. This replaces, among other things, most of the guidance on profit recognition for real estate sales that currently exists under U.S. GAAP. The 2017 effective date may seem a long way off (and the Boards are expected to announce their decision about deferring the effective date in the early part of the second quarter of 2015), but already many real estate companies are analyzing the implications and are finding that they are impacted in some way. The impacts to individual real estate companies vary widely depending on the nature of their business and how they contract with their customers and buyers.

In September 2014, we published Issues In-Depth: *Revenue from Contracts with Customers*.[1] That publication illustrates the main points of the new standard and includes examples, explains our emerging thinking on key interpretative issues and compares current IFRS and U.S. GAAP requirements. This publication is designed to provide supplemental technical guidance on key issues when applying the new revenue model to sales of real estate, focusing on the implications to U.S. GAAP reporting entities. This publication addresses some of the common questions about the new standard's effects on sales of real estate and we hope it will provide a starting point to advance the dialogue on these and other issues.

The guidance is organized in the form of questions with interpretive responses and illustrative examples. The citations refer to paragraphs from the FASB's Accounting Standards Codification (the Codification) added by Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*. We also cite paragraphs from existing Codification sections, most frequently ASC Subtopic 360-20, *Property, Plant, and Equipment-Real Estate Sales*, which includes most of the guidance that originally was issued in Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, and other related guidance.

Unless otherwise indicated explicitly or by comparison, the terms "customer" and "buyer" are used interchangeably in this publication to refer to the purchaser in a transaction involving the sale of real estate. This is because the guidance in this publication addresses both the requirements of ASC Topic 606 on revenue recognition from sales to customers, and the requirements of ASC Subtopic 610-20 on recognition of gains and losses from the derecognition of nonfinancial assets in transactions with parties other than customers.

This publication is intended for use by preparers and other interested parties with a working knowledge of the existing real estate sales literature and an understanding of the new model. These interpretations have been developed using the existing literature and our understanding to date on its application. As every day brings new questions and new insights, particularly as the FASB/IASB Transition Resource Group for Revenue Recognition (TRG) continues its work, we expect to update and supplement this with future publications as our understanding of the new requirements and practice evolves.

[1] Issues In-Depth: Revenue from Contracts with Customers, available on KPMG's Financial Reporting Network at www.kpmg-institutes.com

Index of Questions and Answers

SCOPE

Question 0.1: When are sales of real estate and in substance real estate (including financial assets that are in substance real estate) in the scope of Topic 606, *Revenue from Contracts with Customers,* versus Subtopic 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*?

Background:
Determining whether the buyer of real estate is a "customer" is important as it affects whether the seller reports revenue and cost of sales or gain/loss on sale and may, in some circumstances, affect the amount and timing of revenue/profit recognition (see additional discussion in **Question 0.2**).

Sales to Customers
Customer sales are accounted for under Topic 606 and the seller recognizes revenue and cost of sales on the statement where net income is reported (i.e., income statement), regardless of whether the sale takes the form of a:

a. direct sale of real estate or in substance real estate (i.e., real estate with non-real estate components like the ski resort example described in paragraph 360-20-15-2),

b. sale of a financial asset (e.g., an ownership interest in an entity) that is in substance real estate (e.g., an entity that holds only land), or

c. sale of a financial asset comprising an interest in an entity that holds an operating real estate asset that is a business (as defined under Topic 805).

Under Topic 606, when a contract exists and the performance obligation is satisfied, the seller derecognizes the real estate (or in substance real estate) and recognizes as revenue the *transaction price*. Otherwise, the entity continues to report the real estate in its financial statements, depreciate it (if it is not held for sale under paragraphs 360-10-45-9 and 45-10) and test it for impairment under Section 360-10-35.

Sales to Noncustomers
Noncustomer sales (including any of the forms of sales described in (a) through (c) above) are accounted for under Subtopic 610-20 (unless they are not considered sales of nonfinancial assets, or in substance nonfinancial assets, see additional discussion in **Question 0.2**) and the seller recognizes gain or loss on the sale on the statement where net income is reported.

Subtopic 610-20 (in addressing real estate sales to noncustomers) incorporates many of the revenue recognition principles of Topic 606 (that addresses sales to customers)[2]. Specifically, paragraphs 610-20-32-1 and 40-1 require a seller of a nonfinancial asset (or an in substance nonfinancial asset) to a noncustomer to apply Subtopic 606-10's guidance on:

a. the existence of a contract (paragraphs 606-10-25-1 through 25-8),

b. determining the transaction price (paragraphs 606-10-32-2 through 32-27 and 32-42 through 32-45) including estimating variable consideration, constraining that consideration, evaluating whether there is a significant financing component, noncash consideration and consideration payable to the customer, and

c. when an entity satisfies a performance obligation by transferring control of an asset (paragraph 606-10-25-30).

Under Subtopic 610-20, when a contract exists and the performance obligation is satisfied, the seller derecognizes the real estate (or in substance real estate) and recognizes as a gain or loss the difference between the *transaction price* and the carrying amount of the real estate. Otherwise, like Topic 606, the entity continues to report the real estate in its financial statements, depreciate it (if it is not held for sale) and test it for impairment.

Answer 0.1: Paragraph 360-10-40-3A states Subtopic 610-20 applies to sales of nonfinancial assets (which would include property, plant and equipment) unless the entity sells or transfers the nonfinancial asset to a customer. Customer transactions are accounted for under Topic 606. A customer is defined in the Master Glossary as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." Accordingly, an entity needs to determine if the real estate being sold or transferred is an "output" of its ordinary activities.

An example of an entity that likely is selling real estate as an "output" of its ordinary activities could be a developer predominantly in the business of selling retail land or residential units. An example of when an entity likely is not selling an "output" of its ordinary activities could be a real estate investment trust (REIT) that is involved primarily in leasing real estate. While some REITs often sell properties as part of their overall investment strategy, the "output" of their normal activities is typically identified as the service they provide to their tenants as lessors. This conclusion is consistent with how these entities are operated for U.S. federal income tax purposes. Under U.S. tax law, while a REIT's income generally is tax-free (assuming all the REIT qualification criteria are met), sales of property held primarily for sale to customers in the ordinary course of business are prohibited transactions and would be taxable. Accordingly, in order to preserve the maximum tax advantage to the REIT and its investors, REITs generally do not sell property to customers in the ordinary course of business.

[2] While Subtopic 610-20 does not specifically incorporate Topic 606's guidance on identifying performance obligations (Step 2) and allocating transaction price (Step 4), we believe those principles often may be applicable by analogy to multi-element noncustomer real estate sales (as discussed in more detail throughout the remainder of this document).

Question 0.2: When is a real estate sale considered a sale of an in substance nonfinancial asset (sales to noncustomers accounted for under Subtopic 610-20) versus a sale of a business (sales to noncustomers accounted for under Subtopic 810-10)?

Background:

In some cases, a noncustomer sale involving real estate-related assets (or a group/subsidiary holding real estate assets) may be the sale of a business but not the sale of an in substance nonfinancial asset subject to Subtopic 610-20. In those situations, Subtopic 810-10 generally applies (or other GAAP, like Topic 860, *Transfers and Servicing*, may apply if the group of assets is neither an in substance nonfinancial asset nor a business). This distinction is important as it may affect the amount and timing of profit recognition.

Profit Recognition under Subtopic 610-20

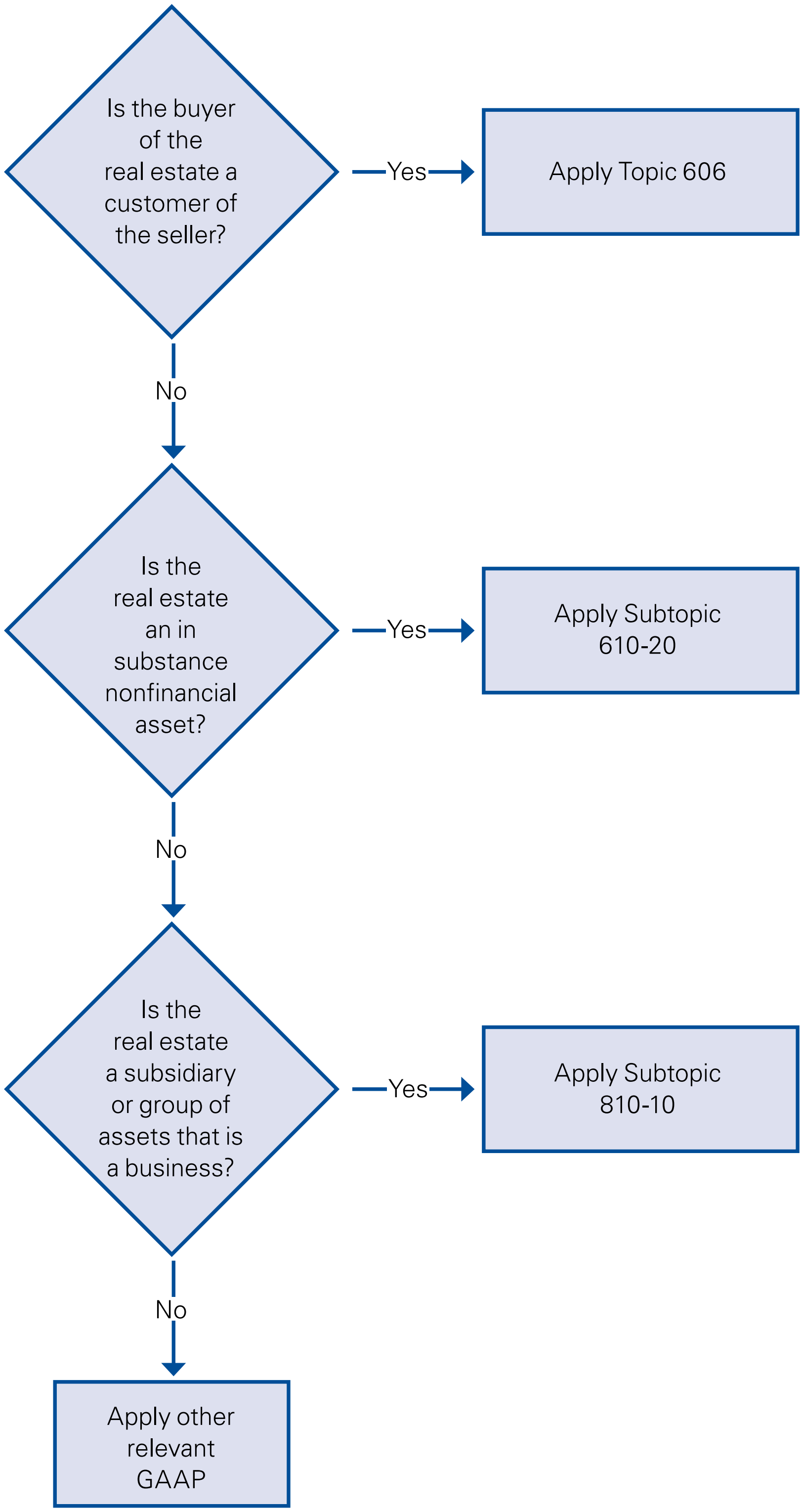
Under Subtopic 610-20, when a contract exists and the performance obligation is satisfied, the seller derecognizes the real estate (or in substance real estate) and recognizes as a gain or loss the difference between the transaction price and the carrying amount of the real estate (otherwise the entity continues to report the real estate in its financial statements as discussed in **Question 0.1**).

Profit Recognition under Subtopic 810-10

Under Subtopic 810-10, when the seller/parent no longer has a controlling financial interest, it deconsolidates/derecognizes the subsidiary/group of assets and recognizes as a gain or loss the difference between the fair value of the consideration received (including the fair value of any noncontrolling interest retained post-sale) and the carrying amount of the subsidiary's assets and liabilities (as well as the carrying amount of any noncontrolling interest existing just before the sale). Alternatively, under Subtopic 810-10, when the seller/parent's ownership decreases (but it retains a controlling financial interest post-transaction), it recognizes an adjustment to equity equal to the difference between the fair value of the consideration received and the amount by which the noncontrolling interest is adjusted (i.e., there is no gain or loss recognized in consolidated net income or comprehensive income).

Answer 0.2: Paragraphs 810-10-40-3A and 810-10-45-21A exclude the transfer of in substance nonfinancial assets from Subtopic 810-10's deconsolidation and decreases in ownership guidance. Similarly, paragraphs 360-10-40-3A and 40-3B (applicable to property, plant and equipment) state that derecognition of an in substance nonfinancial asset should be accounted for under Topic 606 (if the sale is to a customer) or Subtopic 610-20 (if the sale is to a noncustomer). That guidance also says that derecognition of a subsidiary or group of assets is accounted for under Subtopic 810-10 only if that subsidiary is (a) not an in substance nonfinancial asset, and (b) not sold to a customer. Therefore, the guidance on sales of an in substance nonfinancial asset takes precedence over the deconsolidation/derecognition guidance for sales of a business.

This flowchart depicts the decision sequence:



While "in substance nonfinancial asset" is not defined, the legacy guidance in paragraph 360-20-15-2 on identifying in substance real estate (including the requirement to consider the nature of the entire real estate component being sold) was retained (both in Subtopic 360-20 and paragraphs 978-10-15-7 through 15-12). While this guidance was retained to identify the scope of sale-leaseback transactions that remain subject to the guidance in Subtopic 360-20 and timeshare transactions within the scope of Topic 978, we believe this discussion of what constitutes in substance real estate remains relevant for concluding whether a sale of an asset with a real estate component to a noncustomer is in the scope of Subtopic 610-20 (for in substance nonfinancial assets) or Subtopic 810-10 (for businesses).

Under paragraph 360-20-15-2, land plus property improvements and integral equipment are collectively considered "in substance real estate," so sales of those assets to noncustomers are accounted for under Subtopic 610-20. As discussed above, this applies even if all (or part) of the operations of the property otherwise meet the definition of a business for which derecognition would normally be accounted for under Subtopic 810-10. Conclusions on whether an operating real estate property or an ownership interest in an entity with significant real estate assets is in substance real estate (sales to noncustomers accounted for under Subtopic 610-20) or a business (sales to noncustomers accounted for under Subtopic 810-10) is a matter of judgment and all facts and circumstances should be considered. We believe generally the sale of a single real estate property should be accounted for as the sale of a nonfinancial asset under Subtopic 610-20. Further, we believe if an entity has an ownership interest in an entity that holds a single real estate property or substantially all of a multi-asset entity's value comprises real estate assets, a sale of that ownership interest likely is a sale of an in substance nonfinancial asset and is subject to Subtopic 610-20 (see paragraph 610-20-15-2(b)).

Question 0.3: How is Topic 606 applied when an entity sells property improvements (or integral equipment) to a customer and leases the underlying land to the buyer of the improvements? Does the answer differ if the transaction is with a noncustomer?

Answer 0.3: When a contract contains elements covered by different Codification Topics, paragraph 606-10-15-4 states that if those other Topics specify how to separate and/or initially measure one or more parts of the contract, then the entity first applies those requirements. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity applies the separation/measurement guidance in Subtopic 606-10.

Paragraphs 840-10-15-17 through 15-19 require the seller/lessor to separate lease and non-lease components based on relative stand-alone selling price. This requirement is consistent with the guidance in paragraphs 606-10-15-4 and 32-28 through 32-41. Accordingly, the seller/lessor separates the transaction into the lease of the land and the sale of the improvements and accounts for each separately. Revenue is recognized on the sale of the property improvements (or integral equipment) when control transfers to the buyer (based on the requirements of Topic 606) and the lease of the land is accounted for under Topic 840. Topic 840 requires lessors to classify land leases as operating leases if there is no automatic transfer of title to the lessee by the end of the lease term.

Because Topic 840 generally addresses separation and measurement in transactions with lease and non-lease components regardless of whether the lessee is a customer, we believe the guidance above is applicable equally to similar transactions involving noncustomers (with the difference being presentation – gain/loss presentation for noncustomer transactions under Subtopic 610-20 versus revenue and cost of sales presentation for customer transactions on the sale of the property improvements or integral equipment).

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-56 through 40-59 and 55-33 through 55-43 address the sale of property improvements with an accompanying lease of the underlying land. That guidance requires the transaction to be accounted for on a combined basis as a lease of both the land and the improvements if the term of the land lease either (a) does not cover substantially all of the economic life of the improvements, or (b) is not for a substantial period (e.g., 20 years). Under Topic 606 and the related amendments to Topic 840, the seller will account for the sale of the improvements and the lease of the land separately.

Even in cases where the sale of the improvements and lease of the land currently are accounted for separately under Subtopic 360-20 (i.e., when the land lease does cover substantially all of the economic life of the improvements and extends for a "substantial period"), the profit recognized on the sale of the improvements is a function of the present value of the rental payments, the term of the primary indebtedness on the improvements (if any), the sales value of the improvements and the carrying amount of the improvements and the land. Under Topic 606 and the related amendments to Topic 840, profit on the sale of the improvements is more simply a function of the consideration allocated to the sale (based on the relative stand-alone selling prices of the two elements) and the carrying amount of the improvements.

Question 0.4: How is Topic 606 applied when a seller guarantees the return of the buyer's investment (or a return on that investment) for a limited or extended period in connection with the sale of real estate? Is the answer different if the transaction is with a noncustomer?

Answer 0.4: When a contract with a buyer contains elements addressed by different Topics, paragraph 606-10-15-4 states that if the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity first applies those separation and/or initial measurement requirements. Accordingly, the seller first determines whether Topic 460, Topic 815, or another Topic, applies to the guarantee (note that contracts accounted for under Topics 460 and 815 are scoped out of Topic 606 under paragraph 606-10-15-2). If the guarantee is within the scope of Topic 460 or Topic 815, the seller/guarantor initially recognizes and measures it at fair value under the initial measurement guidance in the applicable Topic. The remainder of the consideration would be allocated to the sale of the property.

Paragraph 460-10-15-4 lists the following types of guarantee contracts that are within the scope of Topic 460:

a. Contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party

b. . . . .

c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party

Paragraph 460-10-55-2(b) states that a market value guarantee on a nonfinancial asset owned by the guaranteed party is an example of the type of contract described in paragraph 460-10-15-4(a). Seller guarantees similar to market value guarantees (like the one described above) therefore generally are separated from the sale transaction and initially measured at fair value. The remainder of the contract consideration is then allocated to the sale of the real estate and is subject to Topic 606's guidance on determining the *transaction price*. Because the guarantee is accounted for separately, it does not affect the seller's ability to recognize revenue (gain/loss) under Topic 606 (Subtopic 610-20) when or as the seller transfers control of the real estate to the buyer. Guarantee-like arrangements not within the scope of Topic 460 or other Topics remain combined with the sale transaction accounted for under Topic 606 (or Subtopic 610-20) and may affect the amount and timing of revenue recognition on that sale as they may result in the transaction price being variable or may preclude control transfer (see **Question 5.6** for discussion of put options).

While Subtopic 610-20 does not address separating noncustomer multi-element transactions, we believe an entity selling to a noncustomer applies the same guidance because Subtopic 610-20 refers to Topic 606's transaction price and control transfer principles (the two areas most likely to be affected by the existence of a guarantee in connection with a sale).

Comparison to Legacy U.S. GAAP

A guarantee of a buyer's return on/of investment in connection with a real estate sale, while generally meeting the definition of a guarantee in Topic 460, currently is accounted for in combination with the real estate sale under Subtopic 360-20 because it is scoped out of Topic 460 (see paragraphs 460-10-15-17(g) and 55-17(a)). Paragraph 360-20-40-41 requires a seller that guarantees the return of the buyer's investment (or a return on that investment) for an extended period to account for the transaction as a financing, leasing, or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the seller accounts for the transaction under the deposit method until operations of the property cover all operating expenses, debt service, and contractual payments. At that time, profit is recognized on the basis of performance of the required services.

Topic 606 changes this accounting because the existence of the guarantee does not, in and of itself, preclude the seller from recognizing a sale of the real estate; rather the guarantee is accounted for separately under Topic 460 (if it is within its scope). The existence of the guarantee does, however, result in a reduction of profit on the sale of the real estate under Topic 606 because the fair value of the guarantee reduces the contract consideration allocated to the sale of the real estate (which serves as the basis for determining the *transaction price* for the sale of the real estate). If the guarantee is not within the scope of Topic 460 or other Topics, then the transaction price is variable and the guidance on variable consideration, including the constraint (see paragraphs 606-10-32-11 through 32-13), applies for determining the amount of revenue or gain/loss.

Question 0.5: How is Topic 606 applied when a seller is required to initiate or support the operations of a property being sold to a customer (e.g., the seller agrees to support the operations of a property up to a breakeven level of cash flows for a period of time)? Is the answer different if the transaction is with a noncustomer?

Answer 0.5: If the seller's obligation to support the operations of the property is within the scope of Topic 460 (i.e., it has the characteristics of a guarantee as described in Section 460-10-15), the seller separates the support obligation and initially recognizes and measures it at fair value under Topic 460's initial measurement guidance (see paragraph 460-10-30-2). The remainder of the contract consideration is then allocated to the sale of the real estate and is subject to Topic 606's guidance on determining the *transaction price*.

In our experience, support obligations generally have the characteristics of a guarantee, as they are analogous to a guarantee of the collection of scheduled contractual cash flows from financial assets (paragraphs 460-10-15-4(a) and 460-10-55-2(e)) or a guarantee of the revenue of a business (paragraphs 460-10-15-4(a) and 460-10-55-2(d)). Accordingly, we believe most seller support obligations will be within the scope of Topic 460 and therefore will be separated from the sale transaction. When the support obligation is accounted for separately, it does not affect the seller's ability to recognize revenue under Topic 606 when or as the seller transfers control of the real estate to the buyer. Guarantee-like arrangements not within the scope of Topic 460 or other Topics remain combined with the sale transaction accounted for under Topic 606 and may affect the amount and timing of revenue recognition on that sale as they may result in the transaction price being variable or may preclude control transfer (see **Question 5.6** for discussion of put options).

While Subtopic 610-20 does not address separating noncustomer multi-element transactions, we believe an entity selling to a noncustomer applies the same guidance because Subtopic 610-20 refers to Topic 606's transaction price and control transfer principles (the two areas most likely to be affected by the existence of a guarantee in connection with a sale).

Comparison to Legacy U.S. GAAP

An agreement to initiate or support the operations of a property in connection with a sale of that property, while generally meeting the definition of a guarantee in Topic 460, currently is accounted for in combination with the real estate sale under Subtopic 360-20 and therefore is scoped out of Topic 460 (see paragraphs 460-10-15-17(g) and 55-17(b)). Paragraph 360-20-40-43 requires a seller to account for a sale transaction as a financing, leasing, or profit-sharing arrangement if it is required to initiate or support operations or continue to operate the property at its own risk (or may be presumed to have such a risk) for an extended period of time and provides conditions that, if present, presume support for an extended period of time. If support is required (or presumed to be required) for a limited time, paragraph 360-20-40-44 requires a seller to recognize profit on a proportional performance basis as the services are provided. Performance of those services is measured by the costs incurred and to be incurred over the period during which the services are performed (i.e., on a cost-to-cost basis). The seller begins to recognize profit when there is reasonable assurance that the future rent receipts will cover operating expenses and debt service including payments due to the seller under the terms of the transaction.

Topic 606 changes the accounting for these arrangements because the existence of the support obligation does not, in and of itself, preclude the seller from recognizing a sale of the real estate; rather the guarantee is accounted for separately under Topic 460 (if it is within its scope). The existence of the guarantee does, however, result in a reduction of profit on the sale of the real estate under Topic 606 because the fair value of the support obligation reduces the contract consideration allocated to the sale of the real estate (which serves as the basis for determining the *transaction price*). If the support obligation is not within the scope of Topic 460 or other Topics, then the transaction price is variable and the guidance on variable consideration, including the constraint, applies for determining the amount of revenue or gain/loss.

EXAMPLE 0.1: Property Sale with Support Obligation

Description of the Arrangement

ABC Corp. sells a newly-constructed property with a cost of $1,200,000 to DEF Corp. for $2,000,000 in cash. ABC guarantees the cash flows of the property will be sufficient to meet all the property's operating needs for the first three years after the sale date. The fair value of the guarantee at the sale date is $30,000 and there is no other variable consideration.

Evaluation

Because the support obligation is a guarantee within the scope of Topic 460, it is initially separated from the real estate sale and measured at fair value. Accordingly, $30,000 of the total $2,000,000 contract consideration is allocated to the guarantee and $1,970,000 ($2,000,000 contract consideration less the fair value of the guarantee of $30,000) is allocated to the sale of the property and represents the *transaction price*. A gain of $770,000 ($1,970,000 less $1,200,000 cost) is recognized on transfer of control of the property if the transaction is with a noncustomer. The guarantee continues to be accounted for separately under Topic 460 and therefore does not affect the gain on sale (i.e., the income statement effect of subsequent remeasurements of the guarantee would be recognized separately from the gain on sale).

Question 0.6: What is the unit of account under Topic 606 for sales of condominium *units* within a condominium *project* (or similar structure)?

Answer 0.6: Topic 606 generally specifies the unit of account is an individual contract with a customer. Further, paragraph 606-10-55-180 contemplates that individual contracts with customers to construct individual units in a multi-unit residential complex are accounted for separately. Paragraph 606-10-10-4 does, however, provide a practical expedient allowing an entity to apply the guidance to a portfolio of contracts (or performance obligations) with similar characteristics but only if the entity reasonably expects the effect on the financial statements to not differ materially from applying the guidance to the individual contracts. We believe it may be difficult for entities to demonstrate a reasonable expectation that the effect of using a project approach is materially the same as the effect of using an individual contract approach because (a) the control of the individual units likely will transfer at different points in time (see **Question 5.4** for additional discussion of the pattern of control transfer in unit sales), and (b) the transaction prices of (and the costs to fulfill) individual units within a project are likely to be different.

Comparison to Legacy U.S. GAAP

If individual units in condominium projects or time-sharing interests are being sold separately, paragraph 360-20-40-50 requires profit to be recognized using the percentage-of-completion method on the sale of individual units or interests if construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest, sufficient units have already been sold to assure that the entire property will not revert to rental property, sales prices are collectible, and aggregate sales proceeds and costs can be reasonably estimated.

Sellers/developers may have historically applied the percentage-of-completion method under paragraph 360-20-40-50 by measuring progress on a cost-to-cost basis relative to the project as a whole and applying that measure of progress to the estimated gross profit (revenue and expense) on an individual unit sold. The unit is considered "sold" for this purpose if the criteria in paragraph 360-20-40-50 are met (which is typically before closing has occurred).

Under Topic 606, sellers/developers generally are required to separately account for each contract with an individual customer unless the entity reasonably expects the effect on the financial statements of using a portfolio (or project) approach not to differ materially from applying the guidance to the individual contracts. See section *Step 5: Recognize Revenue* for discussion of the pattern of control transfer of real estate sales and **Question 5.4** specifically for discussion of unit sales.

STEP 1: IDENTIFY THE CONTRACT

Question 1.1: What consideration, if any, should be given to the buyer's initial and continuing investments when evaluating if a seller of real estate has a contract with a buyer?

Answer 1.1: Unlike Subtopic 360-20, there are no explicit initial or continuing investment requirements for the buyer under Topic 606. However, paragraph 606-10-25-1 requires the seller to evaluate, among other things, whether the parties are "committed to perform their respective obligations" and whether it is "probable [the seller] will collect the consideration to which it will be entitled" in exchange for property transferred to the buyer. Assessing collectibility involves evaluating the customer's ability and intention to pay. In evaluating whether collectibility is *probable*, the seller may need to consider factors such as:

- Payment Terms – Do the payment terms reflect inherent uncertainty about the buyer's intent on fulfilling its obligations? Payment terms that may suggest a significant uncertainty about the buyer's intent and ability to fulfill its obligations may include:
  - Small down payment relative to the overall contracted price;
  - Nonrecourse, seller-provided financing;
  - Customer-provided collateral or guarantees that are not highly liquid or have highly variable or unobservable fair value;
  - Continuing periodic payments that extend beyond a customary financing period for similar transactions (or beyond the estimated useful life of the property) or no periodic payments until maturity;
  - Guarantees provided by non-highly rated counterparties.
- Importance of the property to the buyer's operations – Does the buyer's business model and reasons for entering into the transaction raise doubt about the buyer's intent to follow through with its obligations? For example, a buyer may be more committed to perform if it is purchasing property necessary to operate a particular line of business versus making a speculative investment not part of its ordinary business activities.
- Prior Experience – Does the seller have prior experience with the buyer (or a similar class of buyer) for the same or similar transactions that calls into question the intent and ability of the buyer to perform? Or similarly, has the seller previously chosen not to enforce its contractual rights in similar contracts with the buyer (or buyer class) under similar circumstances?
- Whether the seller's receivable is subject to future subordination.

None of these factors should be viewed in isolation; instead, they should be evaluated collectively based on all relevant facts and circumstances. No single factor is determinative as to whether the customer is committed to perform or collectibility is probable. An entity that refers to the legacy initial and continuing investments guidance in Subtopic 360-20 as an indicator of whether collectibility is probable under Topic 606 should not consider these thresholds as safe-harbors or bright lines and all facts and circumstances should be considered.

If the paragraph 606-10-25-1 criteria are not met, the arrangement is not considered a *contract* and is accounted for under paragraphs 606-10-25-6 through 25-8. That guidance requires the seller to account for any cash collected as a deposit liability until:

a. the seller has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the promised consideration has been received and is nonrefundable,

b. the contract has been terminated and the consideration received is nonrefundable, or

c. the paragraph 606-10-25-1 criteria are subsequently met (in which case, revenue or gain is recognized by applying the guidance in Topic 606 or 610).

Paragraphs 606-10-55-95 through 55-98 illustrate the collectibility analysis in the context of a real estate sale whereby a real estate developer sells a building and provides long-term, nonrecourse financing for 95% of the sales price. The buyer expects to repay the loan primarily from income derived from its restaurant business (which is a business facing significant risks because of the high competition in the industry and the customer's limited experience) and lacks other income or assets that could be used to repay the loan. Because of the uncertainty associated with the buyer's ability and intention to pay, the seller concludes the paragraph 606-10-25-1 criteria are not met and therefore recognizes the nonrefundable deposit received from the buyer as a deposit liability, does not derecognize the asset and does not recognize a receivable for the remainder of the sales price. The seller continues to assess the contract to determine whether the paragraph 606-10-25-1 criteria are subsequently met or the other events in paragraph 606-10-25-7 have occurred.

The guidance on evaluating the existence of a contract (and the accounting if a contract does not exist) applies to both customer and noncustomer transactions. In addition, paragraph 360-10-40-3C states that if a *contract* for the transfer of a nonfinancial asset does not exist, the seller needs to continue to report the nonfinancial asset in its financial statements, depreciate it (if it is not held for sale under paragraphs 360-10-45-9 and 45-10) and evaluate it for impairment under the guidance in Section 360-10-35.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-5 requires, among other things, that a buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property in order to recognize profit by the full accrual method. Adequacy of the buyer's initial investment is measured both by its composition (see paragraphs 360-20-40-10 and 40-13) and its size compared with the sales value of the property (see paragraph 360-20-40-18). The buyer's continuing investment does not qualify under paragraph 360-20-40-19 unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than 20 years for land or the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. If the buyer's initial or continuing investment is not adequate, paragraph 360-20-40-31 requires the seller to apply the installment, cost recovery or deposit method to account for the sale, depending on the likelihood of recovering the cost of the property if the buyer defaults.

Topic 606 changes the accounting for those transactions where a contract exists (based on the qualitative considerations previously discussed), but would not otherwise meet the initial and continuing investment requirements of Subtopic 360-20. Under Topic 606, those contracts result in revenue recognition (or gain recognition in a noncustomer transaction) when or as control transfers to the buyer whereas under Subtopic 360-20, they result in application of the installment, cost recovery or deposit method. The results of applying Topic 606 may also differ from the current accounting under Subtopic 360-20 even when a contract does not exist because Topic 606 does not permit application of the installment or cost recovery methods; it requires accounting similar to the deposit method.

Question 1.2: What consideration, if any, should be given to the future subordination of a seller's receivable when evaluating if a seller of real estate has a contract with a buyer?

Answer 1.2: Like **Question 1.1** on the buyer's initial and continuing investments, there is no explicit guidance on future subordination of the seller's receivable in Topic 606. However, the seller is required to evaluate, among other things, whether the parties are "committed to perform their respective obligations" and whether it is "probable [the seller] will collect the consideration to which it will be entitled" in exchange for property transferred to the buyer. If those criteria are not met, the arrangement is not a *contract* and the seller applies the guidance in paragraphs 606-10-25-6 through 25-8 and 360-10-40-3C.

Evaluating whether the parties are committed to perform and collectibility is probable requires an analysis of all relevant facts and circumstances. Refer to **Question 1.1** for additional discussion of factors to consider. While the seller's receivable being subject to future subordination is one factor to consider, it is not itself determinative that the parties are not committed to perform or collectibility is not probable. If, after having considered all the factors, the seller concludes it does have a contract with the buyer (i.e., the buyer is committed to perform on its obligations and collectibility is probable), revenue (or gain in a noncustomer transaction) will be recognized in accordance with the recognition and measurement provisions of Topic 606 and any future uncollectibility arising as a result of the subordination of the receivable will be recognized based on the impairment guidance applicable to financial instruments in Section 310-10-35.

As discussed in **Question 1.1**, the guidance on evaluating the existence of a contract (and the accounting if a contract does not exist) applies to both customer and noncustomer transactions. In addition, paragraph 360-10-40-3C states that if a *contract* for the transfer of a nonfinancial asset does not exist, the seller continues to report the nonfinancial asset in its financial statements, depreciate it (if it is not held for sale under paragraphs 360-10-45-9 and 45-10) and evaluate it for impairment under the guidance in Section 360-10-35.

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-5 and 40-25 preclude a seller from recognizing profit on a real estate sale if the seller's receivable from the buyer is subject to future subordination, except if it is subordinate only to a first mortgage on the property existing at the time of sale or to a future loan (including an existing permanent loan commitment) provided the terms of the sale require that the proceeds of that loan will first be applied to the payment of the seller's receivable. If the seller's receivable is subject to future subordination, paragraph 360-20-40-36 requires that profit be recognized using the cost recovery method.

Topic 606 changes the accounting for those transactions where a contract exists (based on the qualitative considerations previously discussed) and the seller's receivable from the buyer is subject to future subordination. Under Topic 606, those contracts result in revenue recognition (or gain recognition in a noncustomer transaction) when or as control transfers to the buyer whereas under Subtopic 360-20, they result in application of the cost recovery method. The results of applying Topic 606 may also differ from the current accounting under Subtopic 360-20 even when a contract does not exist because Topic 606 does not permit application of the cost recovery method; it requires accounting similar to the deposit method.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS

Question 2.1: Is the sale of an undivided interest in the common areas on which future amenities may be built considered a separate performance obligation from the sale of a condominium unit or residential lot when the undivided interest is transferred in connection with the sale of the unit or lot?

Answer 2.1: Under paragraph 606-10-25-14, a seller accounts for a separate performance obligation if the good or service is distinct from other goods or services in the contract. Under paragraph 606-10-25-19(a) and (b), a good or service is distinct if:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct), and

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct in the context of the contract).

Paragraph 606-10-25-20 provides additional guidance on what makes a good or service capable of being distinct (criterion (a)). A good or service is capable of being distinct if it could be "used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits." In addition, "the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources." Paragraph 606-10-25-21 provides factors indicating a good or service is distinct in the context of the contract (criterion (b)), including that the entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract, the good or service does not significantly modify or customize another good or service promised in the contract, or the good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract.

Because an undivided interest in the common areas (with or without completed amenities) that is transferred in connection with the sale of a unit or lot generally (a) cannot generate independent economic benefits to the buyer (the undivided interest is not practically or legally separable from the fee interest in the unit or lot), and (b) the buyer is unable to purchase (or not purchase) the undivided interest without the unit or lot, we do not believe it is capable of being distinct (i.e., the undivided interest cannot generate economic benefits on its own or with other readily available resources) or distinct in the context of the contract (i.e., the undivided interest is highly dependent on and highly interrelated with the unit/lot because the customer cannot purchase the unit/lot without the undivided interest). Therefore the sale of the unit/lot and the accompanying undivided interest in the common area is a single performance obligation. We believe this conclusion is consistent with the discussion in paragraph 606-10-55-180 which states that depending on the nature of the construction, the developer's performance in the construction of common areas (and the initial construction, like the foundation and basic structure) may need to be reflected when measuring its progress toward complete satisfaction of a performance obligation to construct an individual unit within a multi-unit residential complex.

See additional discussion in **Question 5.4** on the timing of revenue recognition for sales of condominium units (and other similar structures).

Question 2.2: Does the sale of land together with an agreement to construct property improvements comprise multiple performance obligations? Is the analysis different if the buyer is not a customer?

Answer 2.2: It depends. As discussed in **Question 2.1**, a seller accounts for a separate performance obligation under paragraph 606-10-25-19 only if the goods or services are distinct from other goods or services in the contract. A good or service is distinct if:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct), and

b. The entity's promise to transfer the good or service to the customer is separable from other promises in the contract (that is, the good or service is distinct in the context of the contract).

In evaluating whether the transfer of the land and the construction contract are *capable of being distinct*, the seller/developer considers whether the land alone (and/or the property improvements that are the output of the construction contract) can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits for the customer (paragraph 606-10-25-20). For example, could the land alone be sold, developed by another party, or leased to others? Could the property improvements alone be sold (perhaps if the buyer leased the underlying land), used to generate other revenue, or leased to others? Does the seller/developer (or another similarly-situated party) separately sell land or construction services?

In evaluating whether the purchase of the land and the construction contract are *distinct in the context of the contract,* the seller/developer considers the guidance in paragraph 606-10-25-21. Indicators a good or service is *distinct in the context of the contract* include (but are not limited to):

a. The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.

While land seems to be an input to deliver any property-improvement output, the land with the property improvement may not be a "combined output" specified by the customer in the contract. The land transfer and property-improvement construction may be separate promises in the contract and not otherwise linked. For example, the stated contract consideration (not necessarily the *transaction price*) for the land sale may be independent of the consideration for the construction service, the timing for delivery of each promise may be different (e.g., title to the land transfers to the buyer before construction begins) and/or the dispute resolution and/or default provisions associated with the land sale, the construction contract, or both, may not affect the terms of the other promise.

b. The good or service does not significantly modify or customize another good or service promised in the contract.

Whether property improvements significantly modify or customize the land on which they are built may depend, in part, on the nature of the improvement and the characteristics of the land. For example, certain parcels of land may be expected to have largely the same value with or without the property improvements (e.g., one in a unique location and/or zoned for a particular use) or may not require significant site preparation (demolition, clearing, grading, excavation, etc.) so the construction of the improvements may not significantly modify or customize the land.

c. The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

Whether the land sale and construction contract are highly dependent or highly interrelated may, like indicator (a), depend on if (and how) the contract terms of each promise relate to each other. For example, if land and construction services are separately sold by the seller/developer, an entity may look to the consideration in the combined contract relative to the stand-alone selling prices of its components to determine whether it is economically feasible for the customer to purchase the land and construction services separately. If the combined terms suggest a deep discount to the aggregate of the stand-alone selling prices, it may suggest the customer could not decide to purchase one component separately without significantly affecting the others. In other words, if the buyer is compelled to purchase both the land and the construction services together from the seller because to purchase one without the other (and presumably purchase the second from another party) would be so economically disadvantageous, then the seller may conclude the sale of the land is highly dependent on, or highly interrelated, with the construction services. If the combined terms suggest a premium to the aggregate stand-alone selling prices, it also may suggest the components are highly dependent, or highly interrelated, because the customer is willing to pay a premium to obtain the land and the construction services from a single seller/developer.

Careful consideration of the contract in its totality is critical in evaluating the above indicators and, more broadly, whether a promise is distinct in the context of the contract. All facts and circumstances should be considered.

We believe the guidance on identifying performance obligations for a customer transaction also is applicable by analogy to noncustomer transactions even though Subtopic 610-20 does not specifically reference paragraphs 606-10-25-14 through 25-22.

See additional discussion in **Question 5.3** on the timing of revenue recognition for land sales with accompanying construction contracts.

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-61 through 40-64 address real estate sale contracts with future development required by the seller. If the future costs of development can be reasonably estimated at the time of sale, profit allocable to performance before the sale of the land and the sale of the land are recognized at the time of sale (assuming the other criteria for recognition of profit by the full accrual method are satisfied) and profit allocable to performance after the sale is recognized by the percentage-of-completion method as development and construction proceed. This results in the same rate of profit being attributed to each activity.

Under Topic 606, a seller/developer must first determine if the contract comprises one or two performance obligations (*Step 2*, as discussed in **Question 2.2**). After the performance obligations are identified and the overall *transaction price* is determined (*Step 3*), the seller/developer needs to allocate the *transaction price* to the performance obligations (*Step 4*) and then evaluate, for each performance obligation, if revenue is recognized over time or at a point in time (*Step 5*, see additional discussion in **Question 5.3**). This process may result in differences from the accounting prescribed by paragraphs 360-20-40-61 through 40-64 because (a) Subtopic 360-20 requires identification of a single unit of account compared to the Step 2 process in Topic 606 (that may result in more than one unit of account), (b) Step 3 of Topic 606 defines the overall *transaction price* differently than Subtopic 360-20 (specifically it requires an entity to estimate variable consideration up-front if certain criteria are met), (c) Subtopic 360-20 requires an entity to recognize the same rate of profit on the land sale and the development contract whereas Step 4 of Topic 606 requires the entity to allocate the transaction price to the performance obligations (if there is more than one) based on relative stand-alone selling prices, and (d) Subtopic 360-20 requires the use of percentage-of-completion to recognize revenue whereas Step 5 of Topic 606 requires an entity to evaluate each performance obligation to determine if it is satisfied over time, and if not, it is satisfied at a point in time. These differences may result in differences in the amount and timing of revenue recognized on the property sale and the development contract; however, if the sale and development are a single performance obligation satisfied over time and the seller/developer uses a cost-to-cost input method for measuring the progress, the accounting under Topic 606 and Subtopic 360-20 may be similar (see **Question 5.3**).

STEP 3: DETERMINE THE TRANSACTION PRICE

Question 3.1: How does a seller's right to participate in a property's future profits affect the determination of the transaction price for the sale of that property?

Answer 3.1: The right to future profits is variable consideration and is estimated upfront to determine the *transaction price* (the amount of consideration to which the entity expects to be entitled). Variable consideration included in the transaction price is subject to a constraint (see paragraphs 606-10-32-11 through 32-14) and is reassessed on an ongoing basis until the uncertainty is resolved. An entity may only include estimates of variable consideration in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Accordingly, a seller will include in the total transaction price its expectations of its share of future profits to the extent that it concludes it is probable a significant reversal in the amount of cumulative revenue recognized will not occur. Paragraph 606-10-32-12 requires a seller to consider both the likelihood and the magnitude of a potential revenue reversal and includes the following factors that could increase the likelihood or the magnitude of a revenue reversal:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience or other evidence with similar types of contracts is limited, or that experience or other evidence has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

The seller will update the estimated transaction price each reporting period to reflect the current circumstances at each reporting date.

The guidance on determining the transaction price applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Under paragraph 360-20-40-64, if the seller will participate in future profits from the property without risk of loss (such as participation in operating profits or residual values without further obligation), and the sale otherwise qualifies for recognition of profit by the full accrual method, the contingent future profits are recognized when realized. Accordingly, application of Topic 606 may result in earlier revenue (or gain) recognition for these provisions when the cumulative amount of revenue recognized is probable of not being subject to a risk of significant revenue reversal (i.e., because the constraint, in many cases, may not reduce the variable consideration associated with the future profits interest all the way to zero). When inclusion of those future amounts in the transaction price is not appropriate (because it is not probable that those future amounts would not result in a significant reversal of the cumulative revenue (or gain)) the resulting accounting under Topic 606 may be substantially equivalent to current accounting under Subtopic 360-20.

EXAMPLE 3.1: Sale of Property with Future Profits Interest

Description of the Arrangement

ABC Corp. sells a newly-constructed retail property with a cost of $1,200,000 to DEF Corp. for $2,000,000 in cash and a right to receive 5% of future operating profits from the property over a 10-year earn-out period. ABC has no ongoing performance obligation related to the operations of the property. Because the in-place leases generally have fixed lease payments for the first two years of the earn-out period, ABC concludes it is probable it will receive a payout of $50,000 in variable consideration relating to years one and two (based on the contractual fixed lease payments in those two years and its experience with similar properties and tenants) but is less certain about its expected payouts in years three through ten (because the lease payments the buyer of the property will receive in those years shift from fixed payments to entirely contingent payments based on the lessees' third party sales). Accordingly, ABC concludes it is probable a significant reversal of $2,050,000 (the contractual selling price plus $50,000 of the variable consideration related to years one and two of the earn-out period) will not occur. ABC is unable to support a higher *transaction price* because it believes the contingent rent provisions in the underlying leases taking effect in year three of the earn-out period result in a broad range of possible additional consideration amounts that are highly susceptible to outside factors (there is a lack of basis to reasonably estimate the property's operating profits based on the lessees' third party sales and therefore there is no higher amount of cumulative revenue/profit that would not be subject to a risk of significant reversal).

Evaluation

Profit of $850,000 ($2,000,000 contractual selling price + $50,000[3] in variable consideration – $1,200,000 cost) is recognized when control of the property transfers. The $50,000 of variable consideration is included in the *transaction price* because it is probable a significant reversal in revenue of $2,050,000 (the cumulative amount of revenue recognized) will not occur. Contingent future profit payments for years three through ten of the earn-out period are not recognized when control of the property initially transfers, but are recognized when it becomes probable that some or all of those amounts are no longer subject to a risk of significant revenue reversal.

If the leases instead were structured with some level of fixed base rent in years three through ten (in addition to the contingent rent provisions), ABC would have also included those base rent amounts in the *transaction price* if it concluded it was probable a significant reversal of the new cumulative amount of revenue recognized (i.e., the $2,000,000 contractual selling price plus the $50,000 of variable consideration for years one and two plus ABC's share of profits inclusive of the base rent for years three through ten) would not occur.

[3] Note the impact of the time value of money is not considered when consideration is variable and the timing of that consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or entity (see paragraph 606-10-32-17(b)).

Question 3.2: Is a change in estimate relative to the measure of progress towards satisfaction of the performance obligation on a construction contract subject to the revenue recognition constraint discussed in paragraphs 606-10-32-11 through 32-14?

Answer 3.2: The objective of the constraint on variable consideration is to recognize revenue only to the extent it is probable the cumulative amount of revenue recognized is not subject to a risk of significant revenue reversal due to variability in the transaction price. While a construction contractor may experience revenue reversals as a result of a change in its measure of progress toward complete satisfaction of a performance obligation, such reversals do not represent changes in the ultimate consideration to which the developer is entitled. Accordingly, the risk associated with a change in timing of total revenue is not evaluated under the constraint. However, significant changes in timing may (a) call into question the contractor's ability to reasonably estimate its progress as discussed in paragraphs 606-10-25-36 through 25-37, and (b) suggest the contractor should evaluate the need for a provision for anticipated losses on the contract within the scope of paragraphs 605-35-25-45 through 25-49 (which have largely been retained from previous guidance).

Question 3.3: What discount rate is used in accounting for the time value of money for a property management service contract prepaid in conjunction with an all-cash operating property sale (assuming the property sale and the property management service contract are two performance obligations)?

Answer 3.3: As discussed in paragraphs 606-10-32-15 and 32-20, because the objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price the customer would have paid if it had paid cash for the promised goods or services when or as they transfer, a seller determines the discount rate by identifying the rate that discounts the stand-alone selling price of the property management services to the allocated transaction price. The discount rate should be the rate that would exist in a separate financing transaction between the buyer and the seller at contract inception and would reflect the credit characteristics of the party receiving financing in the contract (in this case, the seller), as well as any collateral or security provided by the buyer or the seller (including assets transferred in the contract).

Note, however, that the transaction price is adjusted to reflect the time value of money only if the financing component is significant *to the contract*, not necessarily significant to one or more of the separate performance obligations. Accordingly, the financing component associated with the property management services is analyzed relative to the *transaction price* of the contract as a whole (i.e., the transaction price for the sale of the property and property management services combined). Further, if any factor in paragraph 606-10-32-17 exists (i.e., the customer makes an advance payment and the timing of the transfer of goods or services is at the customer's discretion, a substantial amount of the consideration is contingent on a future event outside the parties' control, or the difference between the promised consideration and the cash selling price arises for reasons other than financing), a contract does not have a significant financing component even if the timing of payments and the transfer of control of the goods or services differs significantly. As a practical expedient, a seller need not account for a financing component when the period between when it transfers a good or service and when the customer pays for such good or service will be one year or less.

The guidance on determining the transaction price applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-43(d) addresses the accounting when a seller agrees to manage the property for the buyer after the sale without compensation or at compensation less than prevailing rates. It requires that (a) the compensation for the services be imputed when the sale is recognized and be recognized in income as the services are performed over the term of the management contract, and (b) the remaining sales price (i.e., the residual) be attributed to the sale of the property. While the property management fee revenue continues to be recognized over the service period under Topic 606, (a) the imputed value (which represents the present value of the market rate of the services) likely will differ from the allocated transaction price (based on relative stand-alone selling prices under paragraph 606-10-32-29; see **Question 4.1** for further discussion), and (b) Topic 606 requires the seller to gross-up the revenue amount and recognize interest expense if the financing component associated with the prepayment of the management services is significant to the contract.

EXAMPLE 3.2: Sale of Property with Property Prepaid Management Services

Description of the Arrangement

ABC Corp. sells a hotel with a carrying amount of $1,500,000 to a customer and agrees to manage the hotel for three years. The buyer pays $2,000,000 in cash at the date of sale for both the sale of the hotel and the management services. Two performance obligations are identified and the *transaction price* allocated to the performance obligations is $1,714,286 for the sale of the hotel and $285,714 for the future property management services (see Example 4.1 for illustration) based on the stand-alone selling prices of $1,800,000 for the hotel without the services and $100,000 per year for the property management services. ABC determines that the financing component is significant to the contract[4] and the property management services will be delivered ratably over the three-year service period.

Evaluation

Because ABC has determined that the financing component is significant to the contract, it establishes an initial contract liability of $285,714 and accrues interest expense each period on the "principal" balance at the rate that discounts the cash selling price of the property management services ($300,000, or $100,000 per year for 3 years) to the promised consideration (i.e., $285,714). That rate (the rate implicit in the contract) is 3.19%. This rate (and the resulting interest expense amounts below) assume monthly "payments" on the contract liability equal to $8,333.33 ($300,000 over 36 months) to reflect the property management services being delivered over time.

One way to account for this would be as follows:

At inception:

Dr. Cash	285,714 (1)	
Cr. Contract liability		285,714
To reflect the cash received allocated to the property management services		
Dr. Cash	1,714,286 (2)	
Dr. Cost of sales	1,500,000	
Cr. Property and equipment		1,500,000
Cr. Revenue		1,714,286
To record revenue and cost of sales on the sale of the hotel		
(1) + (2) = $2,000,000 cash consideration received from buyer		

Year 1:

Dr. Interest expense	7,783	
Cr. Contract Liability		7,783
To accrue the aggregate annual interest expense on the contract liability		
Dr. Contract liability	100,000	
Cr. Revenue		100,000
To recognize the year one property management service revenue		

Year 2:

Dr. Interest expense	4,794	
Cr. Contract liability		4,794
To accrue the aggregate annual interest expense on the contract liability		
Dr. Contract liability	100,000	
Cr. Revenue		100,000
To recognize the year two property management service revenue		

Year 3:

Dr. Interest expense	1,709	
Cr. Contract liability		1,709
To accrue the aggregate annual interest expense on the contract liability		
Dr. Contract liability	100,000	
Cr. Revenue		100,000
To recognize the year three property management service revenue		

[4] The transaction price is adjusted for the time value of money only if the financing component is significant to the contract. This illustration also assumes the rate implicit in the contract is reasonable relative to what the seller's (ABC's) borrowing rate would be in a separate financing transaction.

STEP 4: ALLOCATE THE TRANSACTION PRICE

Question 4.1: How is the transaction price allocated in a contract that transfers control of a property and also requires a seller to provide ongoing property management services to a customer? What if the buyer is not a customer?

Answer 4.1: When the sale of the property and the property management services are separate performance obligations (see paragraph 606-10-25-15), the transaction price generally is allocated based on relative stand-alone selling prices (i.e., the price at which an entity would sell a promised good or service separately to a customer). This allocation process also will result in a proportionate allocation of any "discount" (i.e., the difference between the *transaction price* and the sum of the stand-alone selling prices) to each of the performance obligations (the sale of the property and the management services). However, an entity instead should allocate a discount entirely to one or more of the performance obligations if all of the following criteria are met (see paragraph 606-10-32-37):

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

b. The entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the good or services in each bundle; and

c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

As most real estate companies do not offer a wide range of bundled goods or services, we believe in most cases all of the above criteria generally will not be met and therefore allocation of any discount would be done on a relative stand-alone selling price basis. See Example 4.1.

We believe the guidance on allocating the transaction price for customer transactions also applies by analogy to noncustomer transactions even though Subtopic 610-20 does not address transactions with a noncustomer with more than one performance obligation.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-43(d) addresses the accounting when a seller agrees to manage the property for the buyer after the sale without compensation or at compensation less than prevailing rates. It requires that (a) the compensation for the services be imputed when the sale is recognized and be recognized in income as the services are performed over the term of the management contract, and (b) the remaining sales price (i.e., the residual) be attributed to the sale of the property. While the property management fee revenue continues to be recognized over the service period under Topic 606, (a) the imputed value (which represents the present value of the market rate of the services) likely will differ from the allocated transaction price (based on relative stand-alone selling prices under paragraph 606-10-32-29), and (b) Topic 606 requires the seller to gross-up the revenue amount and recognize interest expense if the financing component associated with the prepayment of the management services is significant to the contract (see **Question 3.3** for additional discussion).

EXAMPLE 4.1: Sale of Property with Property Ongoing Management Services

Description of the Arrangement

ABC Corp. sells a hotel with a carrying amount of $1,500,000 to a customer and agrees to manage the hotel for three years for total consideration of $2,000,000 payable in cash upon closing of the sale of the hotel. The estimated stand-alone selling price of the hotel and the management services are $1,800,000 and $100,000 per year, respectively. Assume (a) the customer makes no ongoing payments for the services, (b) the financing component is determined to be not significant to the contract[5], and (c) the criteria for allocating the overall discount entirely to one of the performance obligations are not met (see paragraph 606-10-32-37).

Evaluation

The total transaction price of $2,000,000 is allocated to the two separate performance obligations based on relative stand-alone selling prices:

Combined stand-alone selling price: $2,100,000 = $1,800,000 (property stand-alone selling price) + $300,000 (property management services stand-alone selling price at $100,000 each year for 3 years)

Property relative stand-alone selling price = $1,800,000 ÷ $2,100,000 × $2,000,000 = $1,714,286

Property management services relative stand-alone selling price = $300,000 ÷ $2,100,000 × $2,000,000 = $285,714

Profit of $214,286 is recognized when control of the property is transferred ($1,714,286 – $1,500,000) and $285,714 of property management service fee revenue is recognized over the three-year service period as the performance obligation is satisfied.

If the arrangement instead also provided for ongoing payments of $10,000 per year for the property management services, the process for allocating the total transaction price of $2,030,000 ($2,000,000 payable at closing + $30,000 in ongoing payments of $10,000 per year for three years) would follow the same approach as illustrated above (similarly assuming the financing component is not significant to the contract[5] and the discount is not allocated entirely to one of the performance obligations):

The total transaction price of $2,030,000 would be allocated to the two separate performance obligations based on relative stand-alone selling prices:

Combined stand-alone selling price: $2,100,000 = $1,800,000 (property stand-alone selling price) + $300,000 (property management services stand-alone selling price at $100,000 each year for 3 years)

Property relative stand-alone selling price = $1,800,000 ÷ $2,100,000 × $2,030,000 = $1,740,000

Property management services relative stand-alone selling price = $300,000 ÷ $2,100,000 × $2,030,000 = $290,000

Profit of $240,000 is recognized when control of the property is transferred ($1,740,000 – $1,500,000) and $290,000 of property management service fee revenue is recognized over the three-year service period as the performance obligation is satisfied.

[5] See Example 3.2 for an illustration of the accounting if the financing component is significant to the contract.

STEP 5: RECOGNIZE REVENUE

Question 5.1: At what point does control typically transfer in a real estate sale where the performance obligation is only the transfer of property?

Answer 5.1: Paragraph 606-10-25-23 states an entity recognizes revenue when it satisfies a performance obligation by transferring control of the good or service to the customer. An asset is considered "transferred" when or as the customer obtains control of the asset. Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Paragraph 606-10-25-24 requires an entity to determine at contract inception whether it satisfies the performance obligation over time or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A performance obligation to deliver a single asset (or group of assets) on a single settlement date is typically satisfied at a point in time because none of the paragraph 606-10-25-27 criteria are met and there is no progress to measure.

For performance obligations satisfied at a point in time, paragraph 606-10-25-30 provides the following indicators that control has transferred:

- The entity has a present right to payment for the asset
- The customer has legal title to the asset
- The entity has transferred physical possession of the asset
- The customer has the significant risks and rewards of ownership of the asset
- The customer has accepted the asset

We believe in the context of property sales in the U.S., the guidance generally suggests that control transfers at closing, as the closing date is the point in time when most of the above factors typically are met. The Board reached a view consistent with this when it addressed the issue of control transfer in real estate transactions within the scope of ASU 2011-10, *Derecognition of In Substance Real-Estate:*

> BC10. Therefore, an entity would look to the definition and indicators of control in the proposed revenue recognition guidance to determine when the counterparty to the transaction obtains control of the asset (that is, real estate) and when to derecognize the real estate. Under the proposed revenue recognition guidance, indicators that the customer has obtained control of a good or service include, among others, the fact that the customer has legal title and physical possession.

While transfer of control often occurs at closing, the seller needs to consider the facts and circumstances of the particular transaction. **Question 5.5** addresses a situation where we believe control may transfer before closing.

The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-7 states:

> A sale shall not be considered consummated until all of the following conditions are met:
>
> a. The parties are bound by the terms of a contract.
>
> b. All consideration has been exchanged.
>
> c. Any permanent financing for which the seller is responsible has been arranged.
>
> d. All conditions precedent to closing have been performed. Paragraph 360-20-40-28 provides an exception to this requirement if the seller is constructing office buildings, condominiums, shopping centers, or similar structures.

Usually, those four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a pre-closing.

We believe the conditions required to support consummation of a sale under Subtopic 360-20 are similar to the indicators of the point in time when control transfers under Topic 606. However, Subtopic 360-20 prevents derecognition even when a sale is consummated in certain circumstances (e.g., when the initial and continuing investment requirements are not met or when certain types of continuing involvement are present suggesting that the risks and rewards of ownership have not transferred) whereas Topic 606 requires revenue recognition (and therefore derecognition) at the point in time control transfers (which is based on *indicators*, not *criteria*) as long as a contract exists. Consequently, derecognition under Topic 606 may occur at an earlier point than under Subtopic 360-20. See **Question 1.1** for additional discussion on how initial and continuing investments are considered in determining the timing of derecognition under Topic 606.

Note also that Topic 606 does not provide an exception for a seller constructing office buildings, condominiums, shopping centers, or similar structures (like paragraph 360-20-40-7(d) above). See **Question 5.4** for additional discussion of when control of a condominium unit (or similar structure) transfers under Topic 606.

Question 5.2: When does control typically transfer in a real estate construction contract (e.g., for the development of property improvements such as a building, infrastructure, or amenities on land owned by the customer) where the contract represents a single performance obligation for the construction services?

Answer 5.2: Paragraph 606-10-25-23 states an entity recognizes revenue when it satisfies a performance obligation by transferring control of the good or service to the customer. An asset or service is considered "transferred" when or as the customer obtains control of the asset. Paragraph 606-10-25-24 requires an entity to determine at contract inception whether it satisfies the performance obligation over time or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

Under paragraph 606-10-25-27, an entity transfers control of a good or service over time if at least one of the following criteria are met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

This criterion primarily is applicable to traditional service contracts (e.g., property management services) where the customer is benefitting on a periodic basis as the entity performs (e.g., as the property is being managed) as opposed to service contracts where an asset is being constructed or enhanced on the customer's behalf. When a customer's asset is being constructed or enhanced, further analysis is necessary under criterion (b) (and criterion (c) below if criterion (b) is not met).

b. The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced; or

We believe this criterion generally will be met in a real estate construction contract when the customer owns the underlying land and takes control of the property improvements as construction progresses. In that case, the customer generally is able to direct the use of, and obtain substantially all of the remaining benefits from, those improvements during construction. In considering the benefits of an asset identified in paragraph 606-10-25-25, we note that generally during the construction period, the customer is able to use the property improvements to enhance the value of other assets (e.g., the land the customer owns on which the improvements are built), sell or exchange the property (including the partially completed improvements), and pledge the property (with the partially completed improvements) to secure a loan. This presumes the customer controls and holds legal title to the land on which the improvements are being constructed; however, a similar analysis may apply if the customer is leasing the underlying land but owns the property improvements. A developer will not meet this criterion, however, if it (as opposed to the customer) controls the property and/or the improvements until construction is complete. This may occur in constructing condominium units (or similar structures). See **Question 5.4** for additional discussion.

c. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

While only one criterion in paragraph 606-10-25-27 needs to be met in order to conclude a performance obligation is satisfied over time, we believe this criterion may also be met in a real estate construction contract provided the customer owns the underlying land and takes control of the property improvements as construction progresses because the developer's performance generally does not create an asset with alternative use to the developer. This is the case because the property improvements being constructed (e.g., building, infrastructure, or amenities) generally are controlled by the customer (and are affixed to land controlled by the customer) and therefore the developer generally is legally and practically prohibited from directing the improvements for any other use (as discussed in paragraph 606-10-25-28).

However, in order to meet this criterion, the developer also must have an enforceable right to payment for performance completed to date (which often is the case when a contract requires periodic payments as construction progresses).

If at least one of the criteria in paragraph 606-10-25-27 is met, revenue on the construction services performance obligation is recognized over time as satisfying the performance obligation progresses.

The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Contractors currently apply either the percentage-of-completion method or the completed-contract method under paragraph 605-35-25-1. Use of Subtopic 605-35's percentage-of-completion method depends on the ability to make reliable estimates of the extent of progress toward completion, contract revenues and contract costs and generally is considered the preferable method since contractors are expected to be able to reliably make such estimates (see paragraph 605-35-25-57).

The percentage-of-completion method recognizes income as work on a contract progresses. There are two different approaches for determining the amount of periodic revenue to recognize under paragraphs 605-35-25-82 through 25-84. One approach (Method A) is to multiply the total estimated contract revenue by the percentage of completion (based on an input or output measure; see paragraphs 605-35-25-70 through 25-81) and subtract from it the revenue recognized in prior periods. The other approach (Method B) is to add the periodic gross profit to the costs incurred during the period. The periodic gross profit under this method is computed by multiplying the total estimated gross profit by the percentage of completion and subtracting from it the gross profit recognized in prior periods. If an entity is using the cost-to-cost method for measuring progress (see paragraph 605-35-25-79 through 25-81), it generally will arrive at substantially the same periodic revenue recognition under either approach.

Topic 606 does not allow an entity to elect an accounting policy for its pattern of revenue recognition. Revenue for performance obligations meeting one of the criteria in paragraph 606-10-25-27 is recognized over time using the pattern that best depicts the entity's satisfaction of its performance obligation, so if a contractor had historically been accounting for those contracts under the completed-contract method, the change to Topic 606's over-time revenue recognition will be significant. If the contractor had been using the percentage-of-completion method, the effect of transitioning to Topic 606 on its pattern of revenue recognition will, in part, depend on whether it meets the over time criteria in Topic 606, how it measures its progress currently, and whether it currently uses Method A or Method B (which is not permissible under Topic 606). For example, a contractor using the cost-to-cost method to measure progress under Topic 606 may arrive at a similar revenue and gross profit recognition pattern for its contracts satisfied over time if it had historically used a cost-to-cost measure while a contractor using a measure other than cost-to-cost and historically using Method B above may not because Topics 606 and 340 de-link the accounting for contract revenue and contract costs (so there may not always be a constant profit margin).

Question 5.3: When does control typically transfer in a property sale with an accompanying construction contract (e.g., for the development of property improvements such as a building, infrastructure, amenities, etc.)?

Answer 5.3: As discussed in **Question 2.2**, a seller/developer first needs to determine whether the contract contains one or two performance obligations.

If the property sale and the construction services are two performance obligations, the transaction price is allocated based on relative stand-alone selling prices and each performance obligation is evaluated to determine whether revenue is recognized over time or at a point in time. As discussed in **Question 5.1**, control of property often transfers at a point in time and as discussed in **Question 5.2**, construction services (as a stand-alone performance obligation) are often, but not always, satisfied over time.

If the property sale and the construction contract comprise a single performance obligation, the entity will need to analyze whether the single performance obligation is satisfied at a point in time (e.g., upon delivery of the completed property, including improvements) or over time (as title to the land is transferred and construction progresses on the improvements affixed to the customer-owned land). If title to the land transfers to the customer before construction begins and the customer owns the improvements as they are being constructed, we believe the analysis of the over-time criteria relative to the single combined performance obligation may be similar to the analysis in **Question 5.2** (i.e., the contract will often meet the criterion in paragraph 606-10-25-27(b) because the seller/developer's performance creates or enhances an asset that the customer controls as the asset is created or enhanced). When there is just one performance obligation for both the land sale and the construction services, however, the total revenue recognized over time represents the total *transaction price* (including the contract consideration for both elements) and progress toward satisfaction of that single performance obligation is also measured relative to both elements (see Example 5.1).

When there is a single performance obligation and the customer does not hold title to the land or have legal ownership of the improvements affixed to the land as construction progresses (e.g., in some contracts to construct condominium units or similar structures), it may be difficult to conclude the performance obligation is satisfied over time. See additional discussion in **Question 5.4**.

The guidance on control transfer applies to both customer and noncustomer transactions.

EXAMPLE 5.1: Sale of Land with Construction Contract

Description of the Arrangement

ABC Corp. sells land with a carrying amount of $400,000 to DEF Corp. for $1,000,000. Additionally, ABC agrees to build an access road and fitness center for an additional $500,000 (estimated cost of $400,000). Assume the sale of the land and the construction of the access road and fitness center are a single performance obligation (see additional discussion in **Question 2.2**) and DEF obtains the title to the land at closing (before construction of the access road and fitness center begin).

Evaluation

Because the sale of the land and construction of the access road and fitness center are a single performance obligation and ABC's performance (i.e., delivery of title to the land to DEF and the ongoing construction of the improvements on DEF's land) creates and enhances an asset (i.e., the property) that DEF controls as it is created or enhanced, ABC concludes its performance obligation is satisfied over time. ABC uses an input method to recognize revenue on the basis of its efforts toward complete satisfaction of the performance obligation relative to the total expected effort to the satisfaction of that performance obligation.

Using costs incurred to measure its progress, ABC recognizes $750,000 of revenue ($1,500,000 x ($400,000 ÷ $800,000)) and $350,000 (50% × $700,000) of profit at the time of the land sale:

Measure of progress on a cost-to-cost basis: $400,000 (land cost at closing) ÷ $800,000 (total expected costs) = 50%

Total profit: $1,500,000 ($1,000,000 + $500,000) – $800,000 ($400,000 + $400,000 in total costs) = $700,000

The remaining revenue and profit of $750,000 and $350,000, respectively, will be recognized over time as ABC constructs the access road and fitness center.

Question 5.4: Can the seller/developer of a condominium unit (or similar structure) recognize revenue over time as construction of the unit progresses (e.g., on a percentage-of-completion basis) if title to the completed unit does not transfer until construction is completed (see Question 0.6 for discussion of the unit of account for such sales under Topic 606)?

Answer 5.4: In order to recognize revenue over time, at least one of the following criteria (see paragraph 606-10-25-27) must be met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

As discussed in **Question 5.2**, this criterion primarily is applicable to traditional service contracts (e.g., property management services) where the customer is benefitting on a periodic basis as the entity performs (e.g., as the property is being managed) as opposed to service contracts where an asset is being constructed or enhanced on the customer's behalf. When an asset is being constructed or enhanced on a customer's behalf, further analysis is necessary under criterion (b) (and criterion (c) below if criterion (b) is not met).

b. The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced; or

In many cases, we believe the buyer of a condominium unit is unable to direct the use of, and obtain substantially all of the remaining benefits from, the unit during construction as title to the real estate typically does not transfer until construction of the unit is complete and the sale closes. When considering the benefits identified in paragraph 606-10-25-25, the buyer generally is unable to use the unit to produce goods or provide services, use the unit to enhance the value of other assets, use the unit to settle liabilities or reduce expenses, sell or exchange the unit, or pledge the unit to secure a loan because it does not hold title to the real estate until the sale closes. Further, the buyer generally does not direct the use of the unit during construction because it does not hold legal title or have physical possession.

c. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

Paragraphs 606-140-55-173 through 55-182 illustrate various scenarios where a seller/developer is constructing a unit in a multi-unit residential complex with differing customer payment structures.

The first example (paragraphs 606-10-55-174 through 55-175) presumes the buyer pays a deposit on entering into the contract and the remainder of the contract price is payable upon completion of construction when the buyer obtains physical possession of the unit. If the customer defaults on the contract before completion, the seller/developer only has a right to the deposit amount. In that case, the seller/developer does not have a right to payment for work completed to date so criterion (c) is not met.

The second example (paragraphs 606-10-55-176 through 55-180) presumes the buyer makes progress payments during construction, the contract has substantive terms that preclude the seller/developer from being able to direct the unit to another customer, the contract precludes the buyer from terminating the contract unless the seller/developer does not perform, and if the buyer defaults on its payments, the seller/developer has the right to all of the consideration promised in the contract if it completes the unit. In this fact pattern, the seller/developer concludes criterion (c) is met because (a) the unit does not have an alternative use (i.e., the contract precludes the seller/developer from transferring the unit to another customer – see additional discussion below), and (b) the seller/developer has an enforceable right to payment for performance completed to date (because the buyer must pay all of the consideration promised in the contract if the seller/developer completes the unit). However, paragraph 606-10-55-179 also indicates the legal practices in the particular jurisdiction are relevant in arriving at this conclusion. This is the case because if the contract terms provide for the right to payment for performance completed to date but the legal practices in the particular jurisdiction do not allow for enforcement of that right, criterion (c) would not be met.

The third example (paragraphs 606-10-55-181 through 55-182) presumes the same facts as the previous example except in the event of buyer default, the seller/developer can require the buyer to perform as required under the contract or it can cancel the contract in exchange for retention of the unit under construction and a penalty in proportion to the contract price. In this example, the seller/developer has the right to payment for performance completed to date because it could enforce its right to that payment. This is the case even though the seller/developer also could choose to accept the unit under construction and a penalty instead. That choice does not affect the assessment as long as the seller/developer's right to require the buyer to continue to perform under the contract is enforceable.

It is also important to note that while the examples primarily focus on the right to payment, even if a seller/developer does have the right to payment for performance completed to date (as discussed in examples two and three), a seller/developer still needs to conclude the unit cannot be directed to another buyer either contractually during construction or practically (i.e., without incurring significant economic loss; see paragraph 606-10-55-10) when it is completed (see paragraph 606-10-25-28). We believe in many cases, because buyers of condominium units typically cannot specify major structural changes to the design of the unit, the seller/developer often will be able to practically direct the unit to another buyer after completion. In that case, a substantive contractual restriction during construction would need to be in place to meet this requirement. All facts and circumstances should be considered.

If none of the criteria in paragraph 606-10-25-27 are met for satisfying a performance obligation over time, the performance obligation is satisfied at a point in time and the seller/developer would recognize revenue on the sale of a unit when control transfers to the buyer, generally at closing as discussed in **Question 5.1**. We believe that in the U.S., condominium sales contracts generally are structured similar to example one above, resulting in point in time revenue recognition when control of the completed unit transfers to the buyer at closing.

If the seller/developer has a further obligation to develop an amenity in connection with the sale of the unit (and presumably the undivided interest in the common area), the seller/developer would consider the guidance in **Questions 2.1** and **2.2** on determining whether the arrangement comprises one or two performance obligations and **Question 5.3** on the timing of revenue recognition.

Comparison to Legacy U.S. GAAP

If individual units in condominium projects or time-sharing interests are being sold separately, paragraph 360-20-40-50 requires profit to be recognized by the percentage-of-completion method on the sale of individual units or interests if construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest, sufficient units have already been sold to assure that the entire property will not revert to rental property, sales prices are collectible, and aggregate sales proceeds and costs can be reasonably estimated.

Topic 606 results in a change from Subtopic 360-20. Sellers/developers historically may have applied the percentage-of-completion method, measuring progress on a cost-to-cost basis relative to the project as a whole and applying that measure of progress to the estimated gross profit on an individual unit sold. The unit would be considered "sold" for this purpose if the criteria in paragraph 360-20-40-50 were met (which was typically before closing occurred). Under Topic 606, sellers/developers generally are required to separately account for each contract with an individual customer (unless the entity reasonably expects the effect on the financial statements of using a portfolio (or project) approach not to differ materially from applying the guidance to the individual contracts, which we believe would be difficult to demonstrate as discussed in **Question 0.6**) and will not recognize revenue/profit until (or as) control of the individual unit transfers (which often may not be until the buyer takes possession of the unit at closing).

EXAMPLE 5.2: Sale of a Condominium Unit

Description of the Arrangement

ABC Corp. is developing a condominium building and begins marketing individual units during construction. On January 1, 20X3, ABC enters into a sales contract with two customers to sell one unit to each. Each unit's sales price is $300,000 with an estimated cost of $180,000. Each buyer provides a 5% down-payment. Construction on the building is 50% complete. The buyers are expected to take possession of the units (and settle all remaining consideration) one year later on January 1, 20X4; however, during construction ABC retains control of the building and the improvements. In the event the buyers cancel the contracts, ABC has a right only to the deposit amount.

Evaluation

Because the arrangement does not meet any of the criteria for satisfying a performance obligation over time, ABC recognizes revenue at the point in time control transfers to the buyers, generally when the buyers take possession of the units on January 1, 20X4.

Question 5.5: When does control transfer in a standstill arrangement where the owner of an in substance real estate entity that defaults on nonrecourse debt loses its controlling financial interest in the entity, but the lender chooses to maintain the legal relationship until a buyer can be identified?

Answer 5.5: Paragraph 810-10-40-3B requires an owner/borrower to apply Subtopic 610-20 in evaluating derecognition on the loss of a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is an in substance nonfinancial asset (e.g., in substance real estate) because of a default by the subsidiary on its nonrecourse debt. The deconsolidation guidance in Subtopic 810-10 does not apply to those transactions.

The owner/borrower looks to the indicators of control in Topic 606 to determine when the lender obtains "control" (i.e., the ability to direct the use and obtain substantially all of the remaining benefits) of the real estate. As the over-time criteria generally would not be met, an entity would need to determine the point in time the customer (the lender in this situation) obtains control of the asset. Paragraph 606-10-25-30 provides the following indicators to determine the point in time that control has transferred to the customer:

- The entity has a present right to payment for the asset
- The customer has legal title to the asset
- The entity has transferred physical possession of the asset
- The customer has the significant risks and rewards of ownership of the asset
- The customer has accepted the asset

Although the lender is the only party with the legal right to benefit from changes in the fair value of the property because it often has right to the ongoing cash flow of the property to service the debt (suggesting it has the significant risks and rewards of ownership which is one of the indicators that control has transferred), and the power to direct the activities that most significantly affect the property's economic performance, the owner/borrower retains legal title and physical possession. While the transfer of legal title and physical possession generally are key indicators of control in the context of real estate sale transactions (see **Question 5.1**), we believe further analysis is necessary under these circumstances. Paragraph 606-10-25-30(c) states that physical possession may not coincide with control of an asset, for example, in some repurchase or consignment arrangements (where the customer has physical possession but the seller has control) and in some bill-and-hold transactions (where the seller has physical possession but the customer controls). Specifically, paragraph 606-10-55-83 states that for a customer (or lender in this situation) to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria should be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

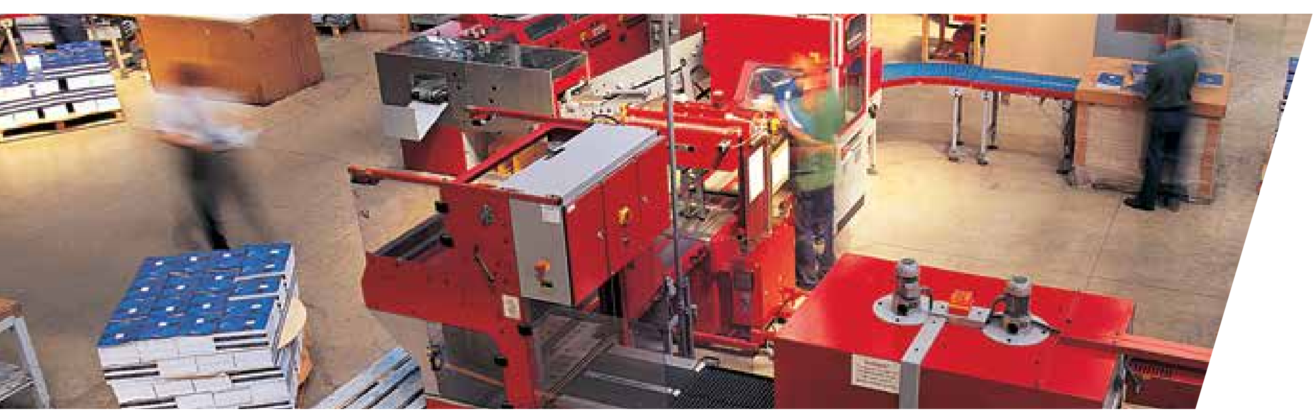
We believe in many standstill arrangements, all of the above criteria will be met, resulting in the conclusion that the lender would be deemed to have control even though the borrower maintains physical possession. In consideration of the last criterion, while the borrower continues to operate the property during the standstill period (and therefore arguably "uses" it), the lender may have the right to receive as debt service payments substantially all of the cash flows arising from the property's operations. In addition, the borrower generally does not have the ability to sell the property to another party, or otherwise have the power to direct the activities that most significantly affect the property's economic performance (as determined by the application of Subtopic 810-10).

We believe the control analysis during the standstill period also is similar to the analysis performed when there is a repurchase option in place as discussed in paragraphs 606-10-55-66 through 55-71. That guidance indicates that the holder of an option to acquire the asset (the lender in this situation) may presently control the asset even though the other party has physical possession.

Comparison to Legacy U.S. GAAP

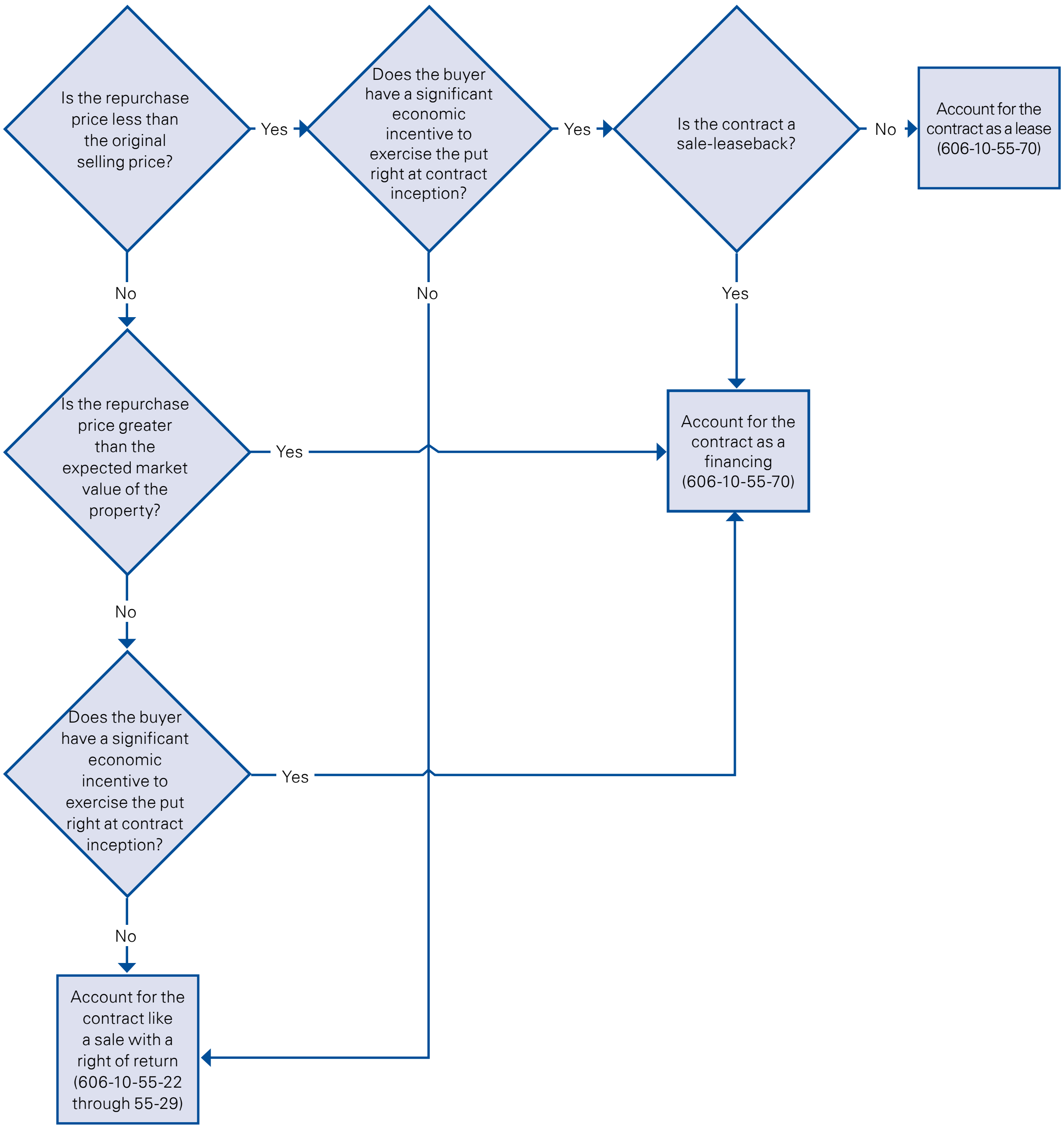
Paragraph 360-20-15-3(f) indicates the loss of a controlling financial interest in a subsidiary that is in substance real estate because of a default by the subsidiary on its nonrecourse debt is evaluated using the guidance applicable to the derecognition of real estate as opposed to the deconsolidation guidance under Subtopic 810-10. This scope-out from Subtopic 810-10 has been retained in the amendments made to paragraph 810-10-40-3B for subsidiaries that are in substance real estate and additionally has been broadened to all such transactions that involve nonfinancial assets and in substance nonfinancial assets. However, rather than those transactions being subject to Subtopic 360-20, they now are subject to Subtopic 610-20.

While these transactions remain subject to the derecognition guidance applicable to transfers of nonfinancial assets/in substance nonfinancial assets, the application of the new guidance differs from the existing guidance in Subtopic 360-20. Derecognition of the asset occurs under Subtopics 610-20/606-10 when *control* of the asset transfers, which may occur before derecognition under Subtopic 360-20.



Question 5.6: Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller provides the buyer with an option to put the property back to the seller?

Answer 5.6: Paragraphs 606-10-55-72 through 55-78 provide guidance on accounting for a seller's obligation to repurchase a property at the buyer's request (a put option). The accounting for these transactions generally depends on the relationships between the repurchase price, the original selling price and the market value of the property. The analysis is as follows:



To determine whether the buyer has a significant economic incentive to exercise its put right, the seller considers the facts and circumstances including the relationship of the repurchase price to the expected market value of the property at the date of the repurchase (including consideration of the time value of money) and the amount of time until the right expires. If the repurchase price is expected to significantly exceed the market value of the property, this may indicate the customer has a significant economic incentive to exercise the put option.

If the seller accounts for the contract as a financing arrangement under paragraph 606-10-55-70, it continues to recognize the property and also recognizes a financial liability initially equal to the consideration received from the buyer. The seller recognizes amounts paid to the buyer over that amount as interest expense (see paragraphs 606-10-55-70 and 55-71). If the option lapses unexercised, the seller derecognizes the property and the liability and recognizes revenue (or gain) at that time.

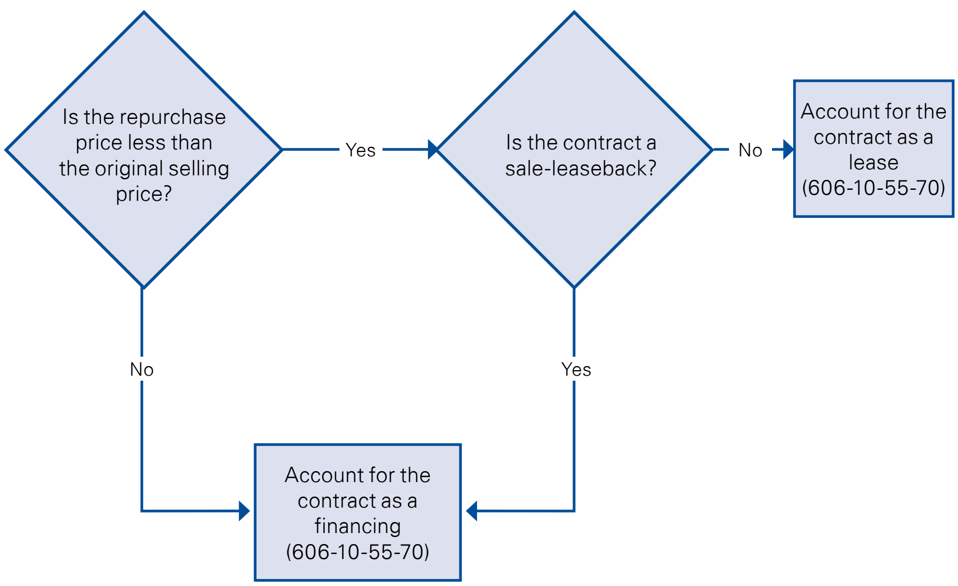
The guidance on control transfer applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-38 requires a sale of real estate to be accounted for as a financing, leasing, or profit-sharing arrangement any time the seller has an obligation to repurchase the property. Topic 606 results in a change for transactions with a put option when either (a) the repurchase price is lower than the original selling price of the property and the buyer does not have a significant economic incentive to exercise its option, or (b) the repurchase price is greater than or equal to the original selling price of the property but less than or equal to the expected market value of the property, and the buyer does not have a significant economic incentive to exercise its option. In these two circumstances, Topic 606 requires the seller to account for the put option as a right of return, which does not affect revenue recognition unless the property is expected to be returned. In other circumstances, while Subtopic 360-20 and Topic 606 both may result in lease or financing accounting, there is no option under Topic 606 to apply a profit-sharing model.

Question 5.7: Has control transferred under Topic 606 if, in connection with the sale of real estate, the seller obtains the right to repurchase the property?

Answer 5.7: Paragraphs 606-10-55-68 through 55-71 provide guidance on accounting for a seller's right to repurchase a property (a call option). A seller's right under a call option (or obligation under a forward agreement) to repurchase the property precludes transfer of control to the buyer because the buyer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the property even though it may have physical possession of the property. Whether the contract is accounted for as a lease or a financing depends on the relationship between the repurchase price and the original selling price. The analysis is as follows:



While an option to repurchase the property at fair value arguably allows the buyer to obtain substantially all of the remaining benefits from the property, it limits the buyer's ability to direct the use of the asset. Accordingly, we believe sales subject to a seller's call option exercisable at fair value are accounted for as a leasing or financing arrangement depending on the expectation of the property's fair value over the option period relative to the original selling price. We expect these transactions generally will be accounted for as financing arrangements.

This guidance applies to both conditional and unconditional rights and does not permit or require an assessment of the probability that a conditional right will become unconditional. However, we believe if the condition that makes the right exercisable is controlled by the buyer (e.g., in an anti-speculation clause whereby the seller is provided the right to repurchase the property if the buyer fails to comply with certain provisions of the sales contract), then a seller generally considers whether the customer has the economic incentive to trigger the seller's right to repurchase (similar to the analysis described in paragraphs 606-10-55-72 through 55-78 on evaluating customer put options). As discussed in **Question 5.6**, if the buyer has an economic incentive not to comply with the contract (and therefore trigger the seller's right to repurchase the asset), or there is greater than a remote likelihood the buyer will not comply for other reasons notwithstanding its ability to comply with the contract, the contract is accounted for as a lease or a financing arrangement depending on the relationship between the repurchase price and the original selling price as previously discussed. If the buyer does not have a significant economic incentive to trigger the seller's right to repurchase the asset and it is remote that the buyer would trigger the seller's repurchase right for other reasons, the seller follows the guidance on sales with a right of return under paragraphs 606-10-55-22 through 55-29 (revenue is not recognized if the property is expected to be returned).

Comparison to Legacy U.S. GAAP

Because paragraph 360-20-40-38 requires a sale of real estate to be accounted for as a financing, leasing, or profit-sharing arrangement if the seller has a right to repurchase the property (except for anti-speculation clauses, see below), Topic 606 does not substantially change the accounting for these transactions, except there is no option under Topic 606 to apply a profit-sharing model.

Specifically with respect to anti-speculation clauses, paragraph 360-20-40-39 states:

> Land sale agreements sometimes contain anti-speculation clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Anti-speculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of the sales contract, the seller has the right, but not the obligation, to reacquire the property. The seller's contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. A number of factors might lead one to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. A probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

Accordingly, we believe Topic 606 does not substantially change the accounting for transactions with anti-speculation clauses, provided the buyer does not have a significant economic incentive to trigger the seller's repurchase right and it is remote the buyer will trigger the seller's repurchase right for other reasons.

Question 5.8: Is a right of first refusal (or a right of first offer) considered an obligation or right to repurchase the property?

Answer 5.8: We do not believe a right of first refusal based on a bona fide offer by a third party constitutes an obligation or right to repurchase the property because the buyer can act in its best interest and is not economically or contractually compelled to accept the offer from a seller (and therefore has the ability to direct the use of and obtain substantially all of the remaining benefits from the property).

We believe a similar conclusion applies to a right of first offer (which allows the seller to make an offer to the buyer before the buyer solicits or receives offers from third parties) as long as the buyer can act in its best interest and is not economically or contractually compelled to accept the offer and the seller is not economically compelled to make an offer.

The guidance applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-38 (and paragraph 840-40-25-13 in the context of sale-leaseback transactions) indicates a right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. Accordingly, we do not believe there will be any change to the accounting for rights of first refusal or rights of first offer in real estate sale contracts under Topic 606.

Question 5.9: How should a seller evaluate transfer of control in the context of a partial sale; for example, on the sale of less than 100% of the seller's ownership interest in an entity considered an in substance nonfinancial asset (see Question 0.2 for discussion of which sales of ownership interests in real estate entities are within the scope of Subtopics 610-20/606-10 versus Subtopic 810-10)?

Answer 5.9: Partial sales of real estate typically occur in the following ways:

a. A seller contributes a wholly-owned property (or an interest in a real estate entity considered an in substance real estate/in substance nonfinancial asset) to a newly formed venture and simultaneously receives cash from a third party to buy a partial ownership interest in that newly formed venture. The cash may come directly from the third party to the seller or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a *controlling* interest in the venture post-sale and no interest in the third party.

b. Same facts as (a) except the seller retains only a *noncontrolling* interest in the venture post-sale and no interest in the third party.

c. A seller contributes a wholly-owned property (or an interest in a real estate entity considered an in substance real estate/in substance nonfinancial asset) to a newly formed, wholly-owned venture. Sometime later, it sells a partial ownership interest in the venture to a third party for cash. The cash may come directly from the third party to the seller or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a *controlling* interest in the venture post-sale and no interest in the third party.

d. Same facts as (c) except the seller retains only a *noncontrolling* interest in the venture post-sale and no interest in the third party.

Paragraph 970-323-30-3 states an investor contributing real estate to a venture must record its investment in the venture at the cost of the contributed real estate (with no profit recognition) regardless of what other investors may contribute to the same venture because this transaction is a contribution of capital. However, the guidance also states that sometimes these equity contributions are in substance sales because the seller withdraws the other investors' contributed cash from the venture (to compensate it for the sale of the partial interest) and it has no commitment to reinvest that cash. In those cases, the seller should look to the revenue recognition guidance to determine if revenue/profit recognition is appropriate (Topic 606 for customer transactions or Subtopic 610-20 (via 360-10-40-3A through 40-3C) for noncustomer transactions). Paragraph 970-323-30-3 includes an example of an in substance sale where the seller receives cash for a 50% interest in the venture and accounts for transaction as a sale of 50% of its interest to the third party.

Currently, there are alternative views on how to apply the revenue recognition guidance in these circumstances. While the seller is selling a partial ownership interest in the venture (and may be transferring control of that equity interest, as control is defined in Topic 606), it may or may not be giving up control of the underlying property (because it may continue to consolidate the venture under Subtopic 810-10, and therefore continue to recognize the property in its consolidated financial statements post-sale).

One view (View A) is the control transfer provisions of Topic 606 apply to the partial ownership interest sold without regard to whether the seller retains a controlling financial interest in the venture. Proponents of View A cite (a) paragraph 970-323-40-1, which indicates a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and should be evaluated under the same guidance applicable to any other sale of real estate, and (2) paragraph 970-323-30-3, which includes the example that presumes partial profit recognition without specific consideration of whether the venture continues to be consolidated by the seller.

Under View A, all the scenarios described above ((a) through (d)) are accounted for similarly. The initial contribution of the real estate (or in substance real estate) results in no immediate profit recognition, but when the partial ownership interest is sold for cash (either simultaneously or sometime later), the seller applies Topic 606's control transfer principles relative to the partial ownership interest without regard to whether it retains a controlling financial interest in the venture. When (or as) control of the partial ownership interest is transferred, the seller recognizes profit equal to the *transaction price* received from the third party (i.e., the buyer of the partial ownership interest) minus the carrying amount of the partial interest sold. Opponents of View A believe the seller's unit of account when considering the application of Topic 606 (or Subtopic 610-20) to a sale of real estate is the asset that the seller controls before the transaction. If the seller controls the entire underlying property, opponents of View A believe the buyer must obtain control of the entire underlying property for the seller to recognize a sale. If the seller has a noncontrolling interest in an entity that holds the underlying property, opponents of View A believe the buyer must obtain control of the seller's entire noncontrolling interest for the seller to recognize a sale.

A second view (View B) is that the control transfer provisions of Topic 606 apply to the partial ownership interest sold, but only if the seller no longer retains a controlling financial interest in the venture. Proponents of View B cite paragraph 970-323-35-15, which states that a sale of property in which the seller holds or acquires an equity interest in the buyer results in recognizing only the part of the profit proportionate to the outside interest in the buyer and *no profit is recognized if the seller controls the buyer until it is realized from transactions with outside parties through sale or operations of the property* (emphasis added). Proponents of View B interpret this paragraph's reference to the "buyer" to be the venture so no immediate profit can be recognized when the seller retains a controlling financial interest in the venture (i.e., in scenarios (a) and (c) above, profit would be deferred until realized through sale or operations of the underlying real estate). Proponents of View B also observe its consistency with the guidance in paragraph 805-30-30-8, which precludes profit recognition on the transfer of a nonfinancial asset in exchange for a controlling financial interest in the transferee in a business combination (on the basis that the transferor/acquirer has control of the transferred asset before and after transfer/acquisition). Opponents of View B believe paragraph 970-323-35-15's reference to the "buyer" means the buyer of the partial interest (i.e., the third party) because the guidance in paragraphs 970-323-40-1 and 30-3 imply the partial interest is the asset being sold, not the underlying real estate.

A third view (View C) is that the seller must relinquish its controlling financial interest in the venture under Subtopic 810-10 in order to recognize profit. Unlike View B though, upon loss of the controlling financial interest in the venture, the seller treats the fair value of its retained interest like consideration received and recognizes 100% profit at the sale date and the retained interest at fair value (versus only partial profit for the portion sold under View B). Alternatively, if the seller retains control (sells a noncontrolling interest), no profit is recognized and the difference between the consideration received and the amount by which the noncontrolling interest needs to be adjusted is recorded in additional paid-in capital (versus a deferred profit on the partial interest sold under View B). Opponents of both Views B and C argue (a) these transactions are specifically outside the scope of Subtopic 810-10 and therefore continued consolidation of the venture is not relevant, and (b) prohibiting immediate profit recognition because the seller has not relinquished its controlling financial interest in the venture conflicts with the partial profit recognition language in paragraphs 970-323-30-3 and 35-15.

A fourth view (View D) is that the control transfer provisions of Topic 606 apply to the underlying real estate (or in substance real estate). Under View D, the seller recognizes no profit unless/until the third party can direct the use and obtain substantially all of the remaining benefits of the underlying property. While the total amount of profit under this view may the same as the amount recognized under View C, that profit recognition may be delayed even beyond deconsolidation of the venture because the seller could lose its controlling financial interest in the venture (as described in Subtopic 810-10) before the third party can *direct* the use and obtain *substantially all* of the remaining benefits of the property under Topic 606. Opponents believe View D conflicts with the partial profit recognition language in paragraphs 970-323-30-3 and 35-15.

The following table summarizes the results of applying each of the views above assuming the seller owns 100% of the real estate venture before the transaction and 60% after (sale of 40%), the *transaction price* (equal to the fair value of the 40% interest) is \$120, and the carrying amount of the seller's 100% interest at the time of sale is \$100. The seller continues to consolidate the venture post-transaction.

View	Profit at Sale Date	Notes
A	**\$80** = \$120 – (\$100 × 40%)	Immediate profit recognition on the partial interest sold
B	**\$0**	No immediate profit recognition because the seller retains a controlling financial interest; gain of \$80 is deferred until realized through third-party sale of the property or operations
C	**\$0**	No immediate profit recognition because the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of \$80
D	**\$0**	No immediate profit recognition because the buyer does not have *control* (i.e., *substantially all* of the remaining benefits) of the underlying property and the seller retains a controlling financial interest; gain is recognized at the sale date through an adjustment to equity of \$80

The following table summarizes the results of applying each of the views above assuming the seller owns 100% of the real estate venture before the transaction and 40% after (sale of 60%), the *transaction price* (equal to the fair value of the 60% interest) is \$180, and the carrying amount of the seller's 100% interest at the time of sale is \$100. The seller holds only a noncontrolling interest post-transaction.

View	Profit at Sale Date	Notes
A	**\$120** = \$180 – (\$100 × 60%)	Immediate profit recognition on the partial interest sold; retained interest accounted for under the equity method
B	**\$120** = \$180 – (\$100 × 60%)	Immediate profit recognition on the partial interest sold because seller no longer holds a controlling financial interest; retained interest accounted for under the equity method
C	**\$200** = (\$180 ÷ 60%)[3] – \$100	Immediate profit recognition based on a sale of the entire 100% interest with the fair value of the 40% retained interest treated as consideration received; retained interest accounted for under the equity method
D	**\$0**	No immediate profit recognition because the buyer does not have *control* (i.e., *substantially all* of the remaining benefits) of the underlying property; seller continues to recognize the property and recognizes a liability for any cash or other assets received.

[3] This calculation results in the implied fair value of a 100% interest. If the fair value of a 60% interest is \$180, the implied fair value of the 100% interest is \$180 ÷ 60%, or \$300.

This issue is expected to be addressed in the FASB's project on clarifying the definition of a business. That project is intended to clarify the definition of a business with the objective of addressing whether transactions involving in substance nonfinancial assets (held directly or in a subsidiary) should be accounted for as acquisitions (or disposals) of nonfinancial assets or as acquisitions (or disposals) of businesses. The project will include clarifying the guidance for partial sales or transfers and the corresponding acquisition of partial interests in a nonfinancial asset or assets. Until the Board reaches conclusions on this project, there may be diversity in practice on this issue.

We believe the accounting for these transactions would be the same regardless of whether the third party is a customer or a noncustomer.

Question 5.10: Does the guidance on partial sales discussed in Question 5.9 apply when the venture owns operating real estate that meets the definition of a *business*?

Answer 5.10: Generally yes, because an ownership interest in a venture owning operating real estate often is an in substance nonfinancial asset even if it also meets the definition of a *business*. As discussed in **Question 0.2**, land plus property improvements and integral equipment collectively are considered "in substance real estate," so sales of those assets are accounted for under Subtopic 610-20 (or Topic 606 if the sale is to a customer, via the guidance in Section 360-10-40) even if all (or part) of the operations of the property otherwise meet the definition of a business for which derecognition would normally be accounted for under Subtopic 810-10 (paragraphs 810-10-40-3A and 810-10-45-21A exclude the transfer of in substance nonfinancial assets from Subtopic 810-10's guidance on accounting for the deconsolidation, and decrease in ownership, of a subsidiary/business).

If the interest in the venture is **not** considered an in substance nonfinancial asset and the venture is a business (after considering the guidance in **Question 0.2**), partial sales are accounted for under Subtopic 810-10 (illustrated as View C in **Question 5.9**), resulting in 100% profit recognition when the seller no longer consolidates post-transaction and $0 profit recognition when the seller continues to consolidate post-transaction.

Comparison to Legacy U.S. GAAP

Paragraphs 360-20-40-46 through 40-49 define a sale as a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. Profit equal to the difference between the sales value and the proportionate cost of the partial interest sold is recognized if the buyer is independent of the seller, collection of the sales price is reasonably assured and the seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest. If these conditions are not met and:

- Collection of the sales price is not reasonably assured, the seller applies the cost recovery or installment method of recognizing profit.
- The buyer is not independent of the seller (for example, if the seller holds or acquires an equity interest in the buyer), the seller recognizes the part of the profit proportionate to the outside interests in the buyer at the date of sale.
- The seller controls the buyer, no profit on the sale is recognized until it is realized from transactions with outside parties through sale or operations of the property.
- The seller is required to support the operations of the property after the sale, the accounting is based on the nature of the support obligation.

Paragraphs 970-323-30-3, 35-15 and 40-1 also illustrate/address partial sales where (a) the buyer is not independent of the seller because it holds or acquires an equity interest in the buyer, and (b) the seller controls the buyer.

While the scope of Subtopic 360-20 (as amended by the new standard) has been limited to sale-leasebacks of real estate (and therefore paragraphs 360-20-40-46 through 40-49 no longer apply to partial sales of real estate that do not involve leasebacks), few substantive amendments were made to paragraphs 970-323-30-3, 35-15 and 40-1. As discussed above, one potential interpretation of this is that similar to current U.S. GAAP, Topic 606 (or Subtopic 610-20) requires profit recognition on at least some partial sale transactions when/as the seller transfers control of the partial interest itself (with the profit equal to the difference between the transaction price and the carrying amount of the partial interest sold). However, it is unclear whether all partial sales will be accounted for similarly.

Currently there is some diversity in practice in the accounting for the sale of a noncontrolling interest in a real estate venture when the seller retains a controlling interest in the venture. Many sellers do not recognize a sale or immediate profit in such transactions, but some sellers recognize those transactions as partial sales with partial profit recognition. Under the new guidance, diversity is likely to increase as the interaction between the revenue standard and the deconsolidation guidance in Subtopic 810-10 is less clear. Potential views are described in **Question 5.9**. We understand the FASB is considering these issues, among others, in its project on clarifying the definition of a business; however, the timing of completion of that project is unclear.

Question 5.11: Is a "buy-sell" clause allowing either of the investors to make an offer to acquire the other investor's interest in an entity that holds real estate considered an obligation or right to repurchase the property from the perspective of the investor that sold the real estate to the entity?

Answer 5.11: Frequently, in order to facilitate a partial sale transaction, a seller will contribute property to a newly-formed entity and a third-party will contribute cash so that the seller can take a simultaneous cash distribution for the sale to that third party of an ownership interest in the entity. A contractual buy-sell clause may be included in the terms of the sale that enables both investors in the jointly-owned entity to offer to buy the other investor's interest. In some cases, a buy-sell clause may be executed at any time; in other cases, only at a specified future date or if specified circumstances arise. When an offer is made under the buy-sell clause, the recipient of the offer can elect to sell its interest for the offered amount or buy the offeror's interest at the offered amount. Generally, once an offer is made, the offeror is contractually required to buy the other investor's interest or sell its interest at the offered amount, depending on the other investor's election. A buy-sell clause can specify that the offer be at fair value, at a contractually specified amount, or at an amount determined by the offeror.

We do not believe a buy-sell clause, in and of itself, precludes the buyer from obtaining control unless it gives the buyer an in substance option to put its interest back to the seller or gives the seller an in substance option to acquire the buyer's interest in the property. If the buy-sell clause is an in substance put or call option, the guidance in **Questions 5.6** and **5.7** is applied.

A buy-sell clause may be considered an in substance option in circumstances where the buyer cannot act independently from the seller or the seller is economically compelled to reacquire the other investor's interest in the jointly owned entity (thereby reacquiring the property) as those circumstances suggest that the buyer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the property are limited. We believe the following indicators (which are not meant to be all-inclusive) may suggest the buyer has not obtained control:

a. The price specified in the buy-sell agreement indicates that the parties have already negotiated for the seller to acquire the buyer's interest (e.g., the fixed-price specified in the buy-sell clause relative to the fair value of the buyer's interest economically compels the seller to acquire the buyer's interest or economically compels the buyer to sell its interest to the seller).

b. The seller has a strategic necessity or an investment strategy that indicates that it cannot relinquish its ownership rights to the buyer and therefore the seller is compelled to reacquire full ownership of the real estate.

c. The seller has arrangements with the jointly owned entity, such as management or third-party leasing arrangements, that may economically compel the seller to reacquire the real estate to retain the economic benefits (e.g., leasing commissions from lessees) or escape the negative economic consequences (e.g., a below-market contract with the entity) of such arrangements.

d. Tax implications economically compel the seller to acquire the buyer's interest in the entity (thereby reacquiring the real estate).

e. Tax implications economically compel the buyer to sell its interest in the entity to the seller.

f. The buyer is financially unable to acquire the seller's interest. A requirement for an appraisal or for the offer price to be at fair value may provide protection to the buyer in these circumstances and provide evidence that the buyer is financially unable to acquire the seller's interest. However, a requirement for an appraisal may not be evidence of compulsion in other situations.

g. The buy-sell clause stipulates a specified rate of return to the buyer (or seller), indicating that the buyer may not fully participate in the rewards of ownership from the real estate.

h. The buyer has a strategic necessity or an investment strategy that requires it to sell its interest to the seller.

i. The buyer is legally restricted from acquiring the seller's interest.

j. The real estate is integrated into the seller's business, so that the buyer does not have alternative means available, such as sale to an independent third party, to realize its economic interest.

We believe this guidance applies to both customer and noncustomer transactions.

Comparison to Legacy U.S. GAAP

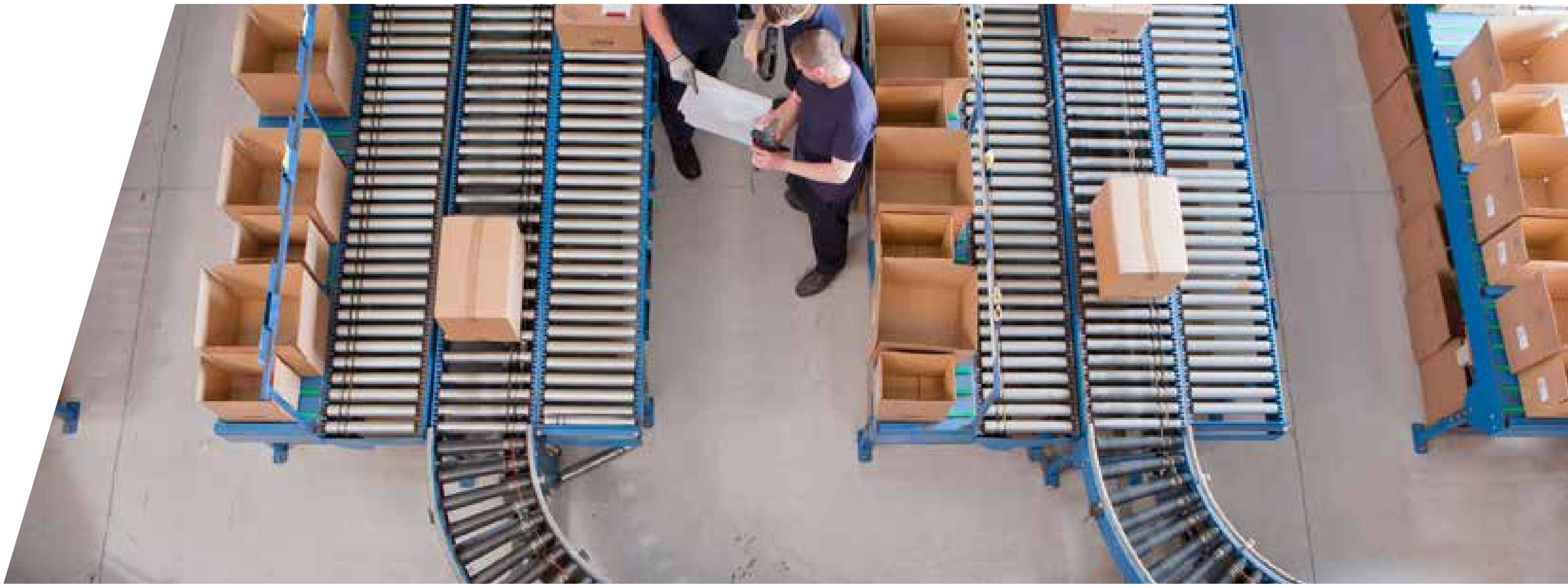
Paragraphs 360-20-40-38 and 55-21A indicate a buy-sell clause, in and of itself, does not constitute a prohibited form of continuing involvement that would preclude profit recognition on the sale of the partial interest, but would need to be evaluated in light of all the relevant facts and circumstances to determine whether its terms indicate that the seller has transferred the usual risks and rewards of ownership and does not have substantial continuing involvement. That is, a buy-sell clause must be evaluated to determine whether it gives the buyer an in substance option to put its interest back to the seller or gives the seller an in substance option to acquire the buyer's interest in the real estate. Accordingly, we believe the analysis of whether a buy-sell clause is an in substance put or call option under Subtopic 360-20 is similar to the analysis under Topic 606, although the resulting accounting may differ depending on the facts and circumstances as discussed in **Questions 5.6** and **5.7**.

Question 5.12: What is the accounting consequence when a general partner in a limited partnership sells a property to the partnership for cash (contributed by the limited partners) and a significant receivable (i.e., a sale of a partial ownership interest in an entity that is considered in substance real estate)?

Answer 5.12: Under Topic 606, the seller first determines if a contract exists given the significance of the receivable (see **Questions 1.1** and **1.2** for discussion of the evaluating whether a contract exists and the resulting accounting if it does not). Next, it determines if, and when, control transfers, which may depend on the facts and circumstances of the transaction and the ultimate interpretation of the guidance on partial sales (see **Question 5.9**).

Comparison to Legacy U.S. GAAP

Paragraph 360-20-40-40 requires a seller who (a) retains a general partnership interest in the entity that purchases its property, and (b) holds a receivable from the limited partnership for a significant part of the sales price (defined as a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property) to account for the transaction as a financing, leasing or profit-sharing arrangement. Topic 606 may result in a change because revenue/profit recognition may be appropriate if a contract exists and control has transferred (i.e., the mere existence of the general partner interest and significant receivable does not preclude revenue/profit recognition under Topic 606 as it does under Subtopic 360-20).



For more information or guidance on these issues, please contact any member of our national real estate leadership team or our real estate revenue recognition network.

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We would like to thank the following individuals in our Department of Professional Practice for their contributions to this publication: Kimber Bascom, Brandon Kano, Paul Munter, Jeremy Peters, and Angie Storm.

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