

FINANCIAL ACCOUNTING SERIES



ACCOUNTING STANDARDS UPDATE

No. 2011-10
December 2011

Property, Plant, and Equipment (Topic 360)

Derecognition of in Substance Real Estate—
a Scope Clarification

a consensus of the FASB Emerging Issues Task Force

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Subtopic 810-10, Consolidation—Overall, requires that a parent deconsolidate a subsidiary if the parent ceases to have a controlling financial interest in the subsidiary (except for a sale of in substance real estate). However, in situations other than a sale of in substance real estate, differing views exist in practice on whether the parent of an in substance real estate subsidiary must satisfy the criteria in Subtopic 360-20, Property, Plant, and Equipment—Real Estate Sales, in order to derecognize the in substance real estate.

The objective of this Update is to resolve the diversity in practice about whether the guidance in Subtopic 360-20 applies to a parent that ceases to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt. This Update does not address whether the guidance in Subtopic 360-20 would apply to other circumstances when a parent ceases to have a controlling financial interest in a subsidiary that is in substance real estate.

Who Is Affected by the Amendments in This Update?

The amendments in this Update affect entities that cease to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt.

What Are the Main Provisions?

Under the amendments in this Update, when a parent (reporting entity) ceases to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt, the reporting entity should apply the guidance in Subtopic 360-20 to determine whether it should derecognize the in substance real estate. Generally, a reporting entity would not satisfy the requirements to derecognize the in substance real estate before the legal transfer of the real estate to the lender and the extinguishment of the related nonrecourse indebtedness. That is, even if the reporting entity ceases to have a controlling financial interest under Subtopic 810-10, the reporting entity would continue to include the real estate, debt, and the results of the subsidiary's operations in its consolidated financial statements until legal title to the real estate is transferred to legally satisfy the debt.

How Do the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments in this Update clarify the scope of current U.S. GAAP. The amendments will resolve the diversity in practice about whether the guidance in Subtopic 360-20 applies to the derecognition of in substance real estate when the parent ceases to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate because of a default by the subsidiary on its nonrecourse debt. That guidance will improve current U.S. GAAP by eliminating the diversity in practice and emphasizing that the accounting for such transactions is based on their substance rather than their form.

When Will the Amendments Be Effective?

The amendments in this Update should be applied on a prospective basis to deconsolidation events occurring after the effective date. Prior periods should not be adjusted even if the reporting entity has continuing involvement with previously derecognized in substance real estate entities.

For public entities, the amendments in this Update are effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2012. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2013, and interim and annual periods thereafter. Early adoption is permitted.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

The amendments in this Update do not eliminate the existing differences in accounting and reporting between U.S. GAAP and IFRS. IFRS guidance on accounting for decreases in ownership of subsidiaries may apply to all subsidiaries, even those that involve in substance real estate.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–7. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 360-20

2. Amend paragraph 360-20-15-3, with a link to transition paragraph 360-20-65-2, as follows:

Property, Plant, and Equipment—Real Estate Sales

Scope and Scope Exceptions

> Transactions

360-20-15-3 The guidance in this Subtopic applies to the following transactions and activities:

- a. All sales of real estate, including real estate with property improvements or integral equipment. The terms *property improvements* and *integral equipment* as they are used in this Subtopic refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.
- b. Sales of property improvements or integral equipment subject to an existing lease of the underlying land should be accounted for in accordance with paragraphs 360-20-40-56 through 40-59.
- c. The sale or transfer of an investment in the form of a financial asset that is in substance real estate.
- d. The sale of timberlands or farms (that is, land with trees or crops attached to it).
- e. Real estate time-sharing transactions (see Topic 978).

- f. Loss of a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate because of a default by the subsidiary on its nonrecourse debt.

3. Add paragraphs 360-20-55-68 through 55-77 and their related headings, with a link to transition paragraph 360-20-65-2, as follows:

Implementation Guidance and Illustrations

> Illustrations

> > Example 8: Conveyance of Real Estate to the Lender in Full Satisfaction of the Entity's Obligation

360-20-55-68 This Example illustrates the application of paragraph 360-20-40-5 for a parent (reporting entity) to derecognize the in substance real estate when the reporting entity ceases to have a controlling financial interest (as described in Subtopic 810-10) in the in substance real estate subsidiary as a result of a default by the subsidiary on its nonrecourse debt.

360-20-55-69 This Example uses the following assumptions:

- a. A reporting entity establishes a single-purpose entity with \$200,000 of equity to purchase commercial real estate
- b. The single-purpose entity is wholly owned and consolidated by the reporting entity
- c. The single-purpose entity borrows \$1 million from a lender on a nonrecourse basis (for which the lender's recourse is limited to the assets of the single-purpose entity) to acquire real estate for \$1.2 million
- d. The single-purpose entity has no other significant assets or liabilities other than the real estate and related nonrecourse debt
- e. The reporting entity's ownership interest in the single-purpose entity is considered in substance real estate.

Years later, the carrying value and fair value of the real estate and the carrying value of the debt are as follows.

[For ease of readability, the table is not underlined as new text.]

As of June 30, 20X1, before the impairment loss on real estate

Carrying value of real estate	\$ 1,000,000
Fair value of real estate	\$ 600,000
Carrying amount of related nonrecourse indebtedness	\$ 800,000

As of December 30, 20X1, before the transfer of real estate

Carrying value of real estate	\$ 600,000
Fair value of real estate	\$ 600,000
Carrying amount of related nonrecourse indebtedness	\$ 800,000

For simplicity purposes, this Example ignores the recurring accounting that is associated with the continuing ownership of real estate (for example, depreciation and other property expenses) and the associated indebtedness (for example, debt service paid or accrual of interest if unpaid) in the period between June 30, 20X1, and December 31, 20X1. Also, for simplicity purposes, this Example ignores consideration of Subtopic 470-60 with respect to measurement and disclosure (derecognition of in substance real estate is addressed by this Subtopic as illustrated in this Example).

360-20-55-70 By applying the guidance in paragraphs 360-10-35-16 through 35-36 for long-lived assets classified as held and used, the entity recognizes a \$400,000 impairment loss on the real estate on June 30, 20X1. The entity applies the guidance in this Topic that requires that it measure the impairment loss without regard to the carrying amount of the single-purpose entity's nonrecourse indebtedness.

360-20-55-71 As of September 30, 20X1, the single-purpose entity defaults on its obligation to the lender and expects to transfer the ownership of the real estate to the lender to satisfy the nonrecourse obligation. As a result of defaulting on the obligation, the reporting entity applies the guidance in Topic 810 and concludes that it ceases to have a controlling financial interest in the single-purpose entity. Although the reporting entity has a plan to transfer ownership of the real estate to the lender, a transfer has not occurred as of the reporting date and, therefore, the derecognition criteria in paragraph 360-20-40-7 have not been met. The reporting entity should not derecognize the in substance real estate as of September 30, 20X1.

360-20-55-72 On December 31, 20X1, an exchange of the real estate for a release from the nonrecourse indebtedness (in accordance with paragraph 405-20-40-1) occurs, and a sale is consummated in accordance with paragraph 360-20-40-7. The reporting entity need not evaluate the adequacy of the lender's investment in accordance with paragraphs 360-20-40-15 through 40-16 because the single-purpose entity has been completely released from its nonrecourse indebtedness and has received all consideration to which it is entitled. If the single-purpose entity was not fully released or had not received all amounts it

was entitled to, then the initial and continuing investment requirements for the full accrual method of profit recognition would be applicable. Therefore, upon completion of the exchange and satisfaction of the requirements for the full accrual method of profit recognition, the reporting entity would report a \$200,000 gain as a result of the release (extinguishment) of the nonrecourse indebtedness.

360-20-55-73 The reporting entity would need to consider whether the single-purpose entity has been fully released from the nonrecourse indebtedness and whether it or the reporting entity has other related and continuing obligations to the lender (through, for example, a guarantee or other forms of contingent consideration) and then evaluate whether it has conveyed the usual risks and rewards of ownership. If the reporting entity provides a guarantee or if the lender has recourse to the reporting entity or other assets of the reporting entity, the reporting entity would need to assess the nature of the continuing involvement in accordance with this Subtopic.

360-20-55-74 Paragraphs 360-20-55-68 through 55-72 illustrate when the single-purpose entity exchanges real estate at the same time as and in exchange for a release from the related nonrecourse indebtedness. In some circumstances, the single-purpose entity might legally transfer the real estate to the lender without contemporaneously obtaining evidence of a legal release of its related indebtedness from the lender. In those circumstances, in accordance with paragraph 405-20-40-1(b), the transfer of real estate accomplishes a legal release of the reporting entity, unless the reporting entity has provided a guarantee to the lender or the lender has recourse to the reporting entity or other assets of the reporting entity.

> > Example 9: Effect of Loss of a Controlling Financial Interest in an Entity That Is in Substance Real Estate

360-20-55-75 This Example illustrates the application of paragraph 360-20-40-5 to determine the effect of a loss of a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate as a result of a default by the subsidiary on its nonrecourse debt.

360-20-55-76 For this Example, assume the same facts as those in Example 8. Also assume that the reporting entity ceases to have a controlling financial interest in the single-purpose entity as a result of default on its nonrecourse obligation and would otherwise be required to deconsolidate the single-purpose entity in accordance with Topic 810. However, the reporting entity and the lender wish to defer the income and transfer tax consequences of a legal transfer of the property and a legal extinguishment of the related debt. The reporting entity and lender agree to maintain their existing legal relationship until a third-party purchaser of the property is identified. Accordingly, the parties agree that the single-purpose entity will not make future payments to the lender, the reporting entity retains its legal ownership of all of the equity of the single-purpose entity, and the debt remains legally outstanding. During the time that the property continues to be held by the single-purpose entity, the lender makes substantially

all of the operating decisions with respect to the property and receives all of the cash flows from the property's operations. The reporting entity does not expect to have future participation in the management or economics of the single-purpose entity (because the fair value of the property is significantly less than the carrying amount of the related indebtedness). In addition, the reporting entity has waived its rights of ownership of the single-purpose entity, which provides the lender with the ability to foreclose and otherwise sell or transfer the underlying property without the reporting entity's consent. However, the reporting entity does have the ability to cure the event of default and retain ownership of the real estate.

360-20-55-77 In this Example, derecognition of the in substance real estate by the reporting entity in its consolidated statement of financial position is not appropriate before the date that the reporting entity's interest in the real estate is conveyed to the lender or a third-party purchaser and the single-purpose entity is released from its debt obligation.

4. Add paragraph 360-20-65-2 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2011-10, Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification

360-20-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2011-10, Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification:

- a. The pending content that links to this paragraph shall be effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2012, except for **nonpublic entities**, which shall apply the pending content that links to this paragraph for fiscal years ending after December 15, 2013, and interim and annual periods thereafter.
- b. Earlier application of the pending content that links to this paragraph is permitted.
- c. An entity shall apply the pending content that links to this paragraph prospectively to deconsolidation events (as a result of default by an in substance real estate entity on its nonrecourse obligation) occurring on or after the effective date. Prior periods are not to be adjusted even if the reporting entity has continuing involvement with previously derecognized in substance real estate entities.
- d. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the pending content that links to this paragraph.

Amendments to Subtopic 810-10

5. Add paragraph 810-10-40-3B, with a link to transition paragraph 360-20-65-2, as follows:

Consolidation—Overall

Derecognition

> Deconsolidation of a Subsidiary or Derecognition of a Group of Assets

810-10-40-3A The deconsolidation and derecognition guidance in this Section applies to the following:

- a. A subsidiary that is a **nonprofit activity** or a business, except for either of the following:
 1. A sale of in substance real estate (for guidance on a sale of in substance real estate, see Subtopic 360-20 or 976-605)
 2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360).
- b. A group of assets that is a nonprofit activity or a business, except for either of the following:
 1. A sale of in substance real estate (for guidance on a sale of in substance real estate, see Subtopic 360-20 or 976-605)
 2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360).
- c. A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
 1. Topic 605 on revenue recognition
 2. Topic 845 on exchanges of nonmonetary assets
 3. Topic 860 on transferring and servicing financial assets
 4. Topic 932 on conveyances of mineral rights and related transactions
 5. Topic 360 or 976 on sales of in substance real estate.

810-10-40-3B The deconsolidation and derecognition guidance in this Section does not apply to a parent that ceases to have a controlling financial interest (as described in this Subtopic) in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt. For guidance in these circumstances, see Subtopic 360-20, including the related implementation guidance in paragraphs 360-20-55-68 through 55-77.

6. Amend paragraph 360-20-00-1 as follows:

360-20-00-1 ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
360-20-15-3	Amended	2011-10	12/14/2011
360-20-55-68 through 55-77	Added	2011-10	12/14/2011
360-20-65-2	Added	2011-10	12/14/2011

7. Amend paragraph 810-10-00-1 by adding the following item to the table as follows:

810-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
810-10-40-3B	Added	2011-10	12/14/2011

The amendments in this Update were adopted by the affirmative vote of five members of the Financial Accounting Standards Board. Messrs. Linsmeier and Smith dissented.

Messrs. Linsmeier and Smith object to the issuance of the amendments in this Accounting Standards Update because they do not believe it is appropriate to rely on the criteria in Subtopic 360-20 to derecognize businesses considered to be in substance real estate. Both Board members dissented to the issuance of Accounting Standards Update No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*, which clarified that the scope of Subtopic 810-10 excludes transactions involving nonprofit activities and businesses that are considered in substance real estate. While both Board members would not object to applying the amendments in this Update to real estate assets, they believe it is not appropriate to apply it to real estate businesses. In their view, Topic 810 appropriately considers control to be the fundamental condition that should be considered in evaluating whether an entity should be consolidated. Under the amendments in this Update, a business that is considered to be in substance real estate could continue to be recognized by the legal owner despite that owner's lack of control of that business. (Control is frequently lost when there is an event of default.) Messrs. Linsmeier and Smith do not believe it is appropriate to

continue to recognize the real estate associated with that business once control has been lost.

Members of the Financial Accounting Standards Board:

Leslie F. Seidman, *Chairman*
Daryl E. Buck
Russell G. Golden
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Task Force's considerations in reaching the conclusions in this Update. It includes the Board's basis for ratifying the Task Force conclusions when needed to supplement the Task Force's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

Background Information and Basis for Conclusions

BC2. Deconsolidation of a subsidiary is required whenever the parent no longer holds a controlling financial interest in the entity in accordance with Topic 810. However, if the entity being deconsolidated is in substance real estate, there are differing views in practice about whether the parent must also satisfy the criteria in Subtopic 360-20 in order to derecognize the in substance real estate in its financial statements.

BC3. For example, the parent (reporting entity) of an in substance real estate subsidiary may cease to have a controlling financial interest (as described in Subtopic 810-10) in the subsidiary as a result of default by the subsidiary on its nonrecourse debt. If the reporting entity is required to apply the guidance in Subtopic 360-20 when the entity is considered to be in substance real estate, then, generally, the reporting entity would not satisfy the requirements to derecognize the real estate before the legal transfer of the real estate to the lender and the extinguishment of the related nonrecourse indebtedness. As a result, the reporting entity would continue to include the real estate, debt, and the results of the entity's operations in its consolidated financial statements and would derecognize the assets (including real estate) and liabilities (including the related nonrecourse debt) only when legal title to the real estate is transferred to legally satisfy the debt. That is, even if the reporting entity ceases to have a controlling financial interest under Subtopic 810-10, the reporting entity would be precluded from derecognizing the assets (including real estate) and liabilities (including the related nonrecourse debt).

BC4. In January 2010, the FASB issued Accounting Standards Update No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*, which addresses implementation issues related to the change in ownership provisions in Subtopic

810-10 (formerly issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*). The guidance in Subtopic 810-10 was amended such that the decrease in ownership provisions of that Subtopic does not apply to sales of in substance real estate.

BC5. After the issuance of Update 2010-02, questions arose about the transactions that would be within the scope of Subtopic 360-20. A Working Group was formed to assist the staff in advising the Task Force about how the criteria in Subtopic 360-20 would be applied in situations other than legal form sales or transfers. The Task Force considered various transactions (which included recommendations from the Working Group on those various transactions) that may be considered other than a sale or transfer from the perspective of a parent of an in substance real estate subsidiary and from the perspective of a lender. Ultimately, the Task Force decided to address only whether Subtopic 360-20 would apply to the loss of control (as described in Subtopic 810-10) of an in substance real estate entity when that loss of control is the result of default on the subsidiary's nonrecourse debt.

BC6. At the June 23, 2011 EITF meeting, the Task Force reached a consensus-for-exposure that when a parent of an in substance real estate subsidiary ceases to have a controlling financial interest (as described in Subtopic 810-10) in the subsidiary because of a default by the subsidiary on its nonrecourse debt, the parent should apply the guidance in Subtopic 360-20 to determine whether to derecognize the in substance real estate. The Task Force also decided to provide illustrative examples of the application of Subtopic 360-20 for those specific situations. In reaching its consensus-for-exposure, the Task Force noted the following: (a) the same derecognition requirements (Subtopic 360-20) should apply regardless of whether the real estate is owned directly by the reporting entity or indirectly through the reporting entity's in substance real estate subsidiary, (b) Subtopic 360-10 requires a two-step impairment approach and does not permit the reporting entity to consider the carrying amount of the subsidiary's nonrecourse debt when evaluating the real estate asset for impairment, and (c) it would not be appropriate for the reporting entity to derecognize the in substance real estate subsidiary's nonrecourse debt before it has been legally released from its obligation in accordance with Subtopic 405-20, *Liabilities—Extinguishments of Liabilities*. A proposed Accounting Standards Update was issued on July 20, 2011, with a comment period that ended on October 3, 2011. Twelve comment letters were received on the proposed Update.

BC7. At the November 3, 2011 EITF meeting, the Task Force considered the comments received on the proposed Update and affirmed its consensus-for-exposure as a consensus. Furthermore, on the basis of the feedback received, the Task Force recommended that the FASB chairman add a project to its agenda to address lender's accounting in situations in which a borrower ceases to have a controlling financial interest in an in substance real estate entity because of a default on its nonrecourse debt. A Task Force member also

observed that as a result of the narrow scope of the consensus, diversity in practice may continue in circumstances in which an investor loses control of a subsidiary that is in substance real estate and that event is not within the scope of this consensus.

BC8. On the basis of the recommendation of the Task Force and the comments received on the proposed Update, the FASB chairman added a research project to the Board's agenda to explore when an entity that consists of a nonfinancial asset or nonfinancial assets should be accounted for as an in substance asset or as an entity. In consideration of this research project being added to the Board's agenda, the Board clarified that the amendments in this Update do not address lender's accounting.

Interaction with the Proposed Joint Revenue Recognition Project

BC9. In the FASB and IASB's joint revenue recognition project, the Boards have tentatively decided that an entity should apply the recognition and measurement principles of the proposed revenue guidance for the derecognition of nonfinancial assets (including entities that are in substance real estate) that are not an output of an entity's ordinary activities, for the following:

- a. Intangible assets within the scope of Topic 350, Intangibles—Goodwill and Other
- b. Property, plant, and equipment (for example, real estate) that is within the scope of Topic 360.

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.

BC11. The proposed revenue recognition guidance would supersede the real estate sales guidance in Subtopic 360-20 when finalized. As noted in paragraph BC9, an entity would derecognize an investment in the form of a financial asset that is considered to be in substance real estate in accordance with the proposed revenue recognition guidance.

Effective Date and Transition

BC12. The Task Force decided that the amendments in this Update should be effective for public entities as of the beginning of a fiscal reporting year, and interim periods within that year, that begins after June 15, 2012.

BC13. The Task Force considered the amount of time that nonpublic entities would need to adopt the amendments in this Update, including the education cycle for many preparers and auditors of nonpublic entities, and decided that for such entities the amendments should be effective for annual periods ending after December 15, 2013, and interim and annual periods thereafter.

BC14. The Task Force decided that the amendments in this Update should be applied prospectively. The Task Force considered the feedback received from comment letter respondents and Working Group members indicating that the information needed to retrospectively apply the consensus may not be readily available or determinable and may result in implementation difficulties that would outweigh the benefits of improved comparability of financial statements.

Benefits and Costs

BC15. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Task Force's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC16. The amendments in this Update should be applied prospectively, and no additional disclosures are required. As such, the Task Force does not anticipate that entities will incur significant costs as a result of the amendments in this Update.

Amendments to the XBRL Taxonomy

There are no proposed amendments to the XBRL taxonomy as a result of the amendments in this Update.