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Statement of position on accounting for investments in real estate ventures, December 29, 1978 : proposal to the Financial Accounting Standards Board; Statement of position 78-09;

American Institute of Certified Public Accountants. Accounting Standards Division. Committee on Real Estate Accounting

Statement of Position

78-9

on

Accounting for Investments in Real Estate Ventures

December 29, 1978

Proposal to the
Financial Accounting Standards Board

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Investments in Real Estate Ventures, has been prepared on behalf of the division by the AICPA Committee on Real Estate Accounting and approved by the AICPA Accounting Standards Executive Committee.

The statement presents the division's recommendations on accounting for investments in real estate ventures (corporate joint ventures, general and limited partnerships, and undivided interests). The recommendations are primarily an application of the existing authoritative accounting literature to the specialized accounting problems related to such investments and are intended to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your staff at your convenience.

Sincerely

Arthur R. Wyatt

Arthur R. Wyatt
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

Accounting Standards Division

Accounting Standards Executive Committee

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Accounting Standards

THOMAS W. MCRAE, *Manager*
Accounting Standards

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Accounting for Investments in Real Estate Ventures

Introduction

1. Ownership of real estate or real estate development projects by two or more entities may take several forms. The most common forms are as follows:

a. *A corporate joint venture*—a corporation owned and operated by a small group of ventures to accomplish a mutually beneficial venture or project, as described in paragraph 3 of APB Opinion 18.
b. *A general partnership*—an association in which each partner has unlimited liability.
c. *A limited partnership*—an association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.
d. *An undivided interest*—an ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

In this statement of position, the terms *real estate venture* and *venture* apply to all of the ownership arrangements described in this paragraph.

2. These forms of ownership differ in legal form and economic substance, and the authoritative accounting literature dealing with the specialized accounting problems related to such investments is limited. In practice, those accounting problems are dealt with in a variety of ways, and the division believes narrowing the range of those alternative practices is desirable.

3. This statement of position presents the division's recommendations on accounting for investments in real estate

ventures in financial statements prepared in conformity with generally accepted accounting principles. It does not apply to regulated investment companies and other entities that are required to account for investments at quoted market value or fair value.

The Applicability of the Equity Method of Accounting

Corporate Joint Ventures

4. APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.

5. Paragraph 3 of APB Opinion 18 states that "an entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." A subsidiary, according to that opinion, refers to

> . . . a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Accordingly, an investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. Minority shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in APB Opinion 18 or in FASB Statement no. 12.

General Partnerships

6. The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions

of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income.[1] Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by APB Opinion 11 is appropriate. Thus, the differences, if any, between income or loss recorded by a partner under the equity method and the partner's share of distributable taxable income or loss from the partnership should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

7. The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph 25). The power to control

[1] Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph 11.

may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or refinancing of principal partnership assets must be approved by one or more of the other partners. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18.

Limited Partnerships

8. The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Also, differences between income or losses recognized for financial reporting purposes and the investor's share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

9. The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be

deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph 7 only if the substance of the partnership or other agreements provides for control by the general partners.

10. The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18, as discussed in paragraphs 6 and 7, or by the cost method, as discussed in paragraph 8, as appropriate.

Undivided Interests

11. In an interpretation of APB Opinion 18 issued by the staff of the American Institute of Certified Public Accountants in November, 1971, the staff concluded that most of the provisions of paragraph 19 of APB Opinion 18 generally would be appropriate in accounting for partnerships and unincorporated ventures, but that if

> . . . the investor-venturer owns an undivided interest in each asset and is proportionately (i.e., severally) liable for its share of each liability, the provisions of the equity method set forth in paragraph 19 (c) of the Opinion may not apply in some industries. For example, where it is the established industry practice . . . , the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

If real property owned by undivided interests is subject to joint control by the owners, the division believes that investor-venturers should not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Such property is subject to joint control if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, the division believes that such investments should be presented in the same manner as investments in noncontrolled partnerships. If, however, the approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned and each investor is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for indebtedness it incurs in connection with its interest in the property, the investment may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture.

General Matters

Disclosure

12. The division believes that investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion 18 in determining the disclosures to be made in their financial statements.

Statement of Changes in Financial Position

13. APB Opinion 19, which governs the form and content of statements of changes in financial position, requires disclosure of working capital or cash provided from operations. The investor's share of a real estate venture's earnings reported under the equity method, to the extent that such earnings are not distributed in the period earned, should not be included in the amount reported as working capital or cash provided by operations, except to the extent distributions should be accrued as a current receivable under generally accepted accounting principles.

Investor Accounting for Losses

General

14. Some investors have suggested that their equity in losses of a real estate venture need not be recorded under the equity method of accounting as long as the value of their investment has not been impaired; for example, if it is expected that the venture's assets can be sold for more than their carrying value. The division believes that investors should record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles, without regard to unrealized increases in the estimated fair value of the venture's assets.

Accounting for an Investor's Share of Losses in Excess of Its Investment, Including Loans and Advances

15. The division believes that an investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture should record its equity in real estate venture losses in excess of its investment, including loans and advances.[2] The following are examples of such circumstances:

a. The investor has a legal obligation as a guarantor or general partner.

b. The investor has indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

16. An investor in a real estate venture should report its recorded share of losses in excess of its investment, including loans and advances, as a liability in its financial statements.

[2] An investor, though not liable or otherwise committed to provide additional financial support, should provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero though the underlying profitable pattern of an investee is unimpaired.

17. If an investor does not recognize venture losses in excess of its investment, loans, and advances and the venture subsequently reports net income, the investor should resume applying the equity method only after its share of such net income equals the share of net losses not recognized during the period in which equity accounting was suspended.

18. If it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses.[3] When the venture subsequently reports income, those remaining investors should record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess losses they previously recorded. The division also believes that an investor who is deemed by other investors to be unable to bear its share of losses should continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.

19. The division believes that the accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement no. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, the division believes that each investor should look primarily to the fair value of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses.[4] However, there may be satisfactory alternative evidence of an ability and willingness

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[3] This recommendation does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of the investor's creditors are limited to the investors' respective interests in such property.

[4] An investor may not be able to apply the general rule to an investment in an undivided interest because the extent to which the interests of other investors are encumbered by liens may not be known.

of other investors to bear their allocable share of losses. Such evidence might be, for example, that those investors previously made loans or contributions to support cash deficits, possess satisfactory financial standing (as may be evidenced by satisfactory credit ratings), or have provided adequately collateralized guarantees.

Loss in Value of an Investment, Including Loans and Advances, Other Than a Temporary Decline

20. A loss in value of an investment, including loans and advances, other than a temporary decline should be recognized under the accounting principles that apply to a loss in value of long-term assets. Such a loss in value may be indicated, for example, by a decision by other investors to cease providing support or reduce their financial commitment to the venture.

Other Accounting Matters Related to the Use of the Equity Method

Eliminating Interentity Profits and Losses

21. As noted elsewhere in this statement, APB Opinion 18 should be used as a guide when applying the equity method. Paragraph 19(a) of that opinion provides that, in applying the equity method, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee company were consolidated. The division believes that intercompany profit should be eliminated by the investor in relation to the investor's ownership interest in the investee, except that an investor that controls the investee and enters into a transaction with the investee should eliminate all of the intercompany profit on assets remaining within the group.

22. The AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate,* sets out similar rules in paragraph 58:

> A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the

buyer. No profit should be recognized if the seller controls the buyer . . . until realized from transactions with outside parties through sale or operations of the property.

23. The division believes that if a transaction with a real estate venture confirms that there has been a loss in the value of the asset sold that is other than temporary and that has not been recognized previously, the loss should be recognized on the books of the transferor.

Accounting Principles Used by the Venture

24. In the real estate industry, the accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from generally accepted accounting principles. If the financial statements of the investor are to be prepared in conformity with generally accepted accounting principles, such variances that are material should be eliminated in applying the equity method.

Allocation Ratios for the Determination of Investor Income

25. Venture agreements may designate different allocations among the investors of the venture's *(a)* profits and losses, *(b)* specified costs and expenses, *(c)* distributions of cash from operations, and *(d)* distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph 19. The division believes that in order to determine the investor's share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation. The division believes that specified profit and loss allocation ratios should not be used to determine an inves-

tor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets

26. Differences between the carrying amount of an investment in a real estate venture and the investor's equity in the underlying net assets recorded by the venture may arise, for example, from unrecognized profit on transfers of real estate to the venture or differences in accounting methods. In addition, differences may arise from the acquisition of an investment in a venture at a price different from the investor's share of the net assets as recorded on the books of the venture.

27. Differences that arise from a business combination with a venture accounted for as a purchase should be accounted for in accordance with the provisions of APB Opinion 16. The division believes that an excess of the cost of the investment acquired over the equity in the underlying net assets usually would be ascribed to the fair values of real property interest owned by the venture. Any cost in excess of amounts assigned to identifiable tangible or intangible assets acquired is an intangible asset that should be amortized in a systematic manner related to the purpose of the venture. Because of the limited life and limited purpose usually inherent in real estate ventures, the division believes that the benefits from such an intangible asset generally decline as the property is sold or depreciated, and therefore amortization of that intangible asset should be recorded in relation to cost of sales or depreciation. The period of amortization should not, however, exceed forty years.

28. Paragraph 19(b) of APB Opinion 18 provides that the difference between the cost of an investment and the amount of the underlying equity in net assets of the investee "should affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary." The differences should be recognized by the investor as an adjustment to the amount of the venturer's depreciation, cost of sales, or other expenses, as appropriate, in recording income or loss from the venture on the equity basis.

Accounting by the Investor for Certain Transactions With a Real Estate Venture

Capital Contributions

29. *Contribution of Cash.* If all investors contribute cash at the formation of the real estate venture, each investor should record its investment at the amount of the cash contributed.

30. *Contribution of Real Estate.* The division believes an investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. The division believes that an investor should not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. The division understands, however, that some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph 36 of this statement on accounting for sales of real estate to a venture by an investor apply to those transactions. An example of such a transaction is one in which investor *A* contributes to a venture real estate with a fair value of $2,000 and investor *B* contributes cash in the amount of $1,000 which is immediately withdrawn by investor *A*, and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor *A* is not committed to

reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor *A* of a one-half interest in the real estate in exchange for cash. A minority of the division disagrees with the conclusion that an investor contributing real estate to a real estate venture should record its investment at the cost of the real estate contributed. They believe that profit recognition by such an investor to the extent of the other investors' interests in the profits and losses of the venture may be appropriate if the other investors contribute cash or other hard assets (such as marketable securities) for their interests and the investor contributing the real estate has no continuing involvement with the real estate that would require deferral of profit under the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*. The majority of the division believes that unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of an earnings process.

31. An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the carrying amount of the property with the cash contributed by the other investors. That situation might indicate that the investor contributing the property has suffered a loss that should be recognized.

32. *Contribution of Services or Intangibles.* The division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

Income From Loans or Advances to a Venture

33. Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) should be accounted for as distributions rather than as interest income by the investors.

34. An investor-lender that does not capitalize interest on its own real estate construction and development projects should account for interest on loans and advances that are not in substance capital contributions in accordance with the recommendations in this paragraph.

a. All interest income on the investor's loans or advances to the venture should be deferred if either of the following conditions is present.
   (i) Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.
   (ii) There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.

b. If neither of the conditions in (*a*) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture should be recorded as earned.

c. If the conditions in (*a*) or (*b*) are not present, a portion of interest income from loans and advances to a venture should be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed in paragraphs 18 and 19 for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.

35. Pending completion of the Financial Accounting Standard Board's interest project, the division makes no recommendation on accounting for interest income from loans or advances to a real estate venture by an investor that capitalizes interest on its own real estate and development projects.

Sales of Real Estate to a Venture

36. Sales of real estate by an investor to a real estate venture are subject to all of the provisions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.

Sales of Services to a Venture

37. If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

a. The substance of the transaction does not significantly differ from its form.

b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.

c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

Purchases of Real Estate or Services From a Venture

38. An investor should not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.

Accounting for the Sale of an Interest in a Real Estate Venture

39. The division believes that 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 guidelines set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate.*

40. Subject to the provisions of paragraph 39, an investor should recognize a gain or loss on a sale of its investment in a real estate venture equal to the difference at the time of sale between the selling price and the investor's carrying amount of the portion of the investment sold. Deferred taxes related to timing differences should be recognized.

Transition

41. The division recommends applying this statement of position to financial statements issued for fiscal years and interim periods beginning after December 24, 1978. Adjustments resulting from a change in accounting method to comply with the recommendations in this statement should be applied retroactively, if material, and, to enhance comparability between periods, financial statements presented for the periods affected should be restated for as many periods as is practicable to give retroactive effect to such adjustments and to changes in presentation. The division encourages earlier application of the recommendations in this statement for fiscal years beginning before December 25, 1978, in financial statements not previously issued.