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ACCOUNTING CONSIDERATIONS RELATING TO DEVELOPERS OF CONDOMINIUM PROJECTS

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INTRODUCTION

Interest in the concept of condominium ownership in the United States has been rapidly increasing in recent years. This article discusses accounting considerations relating to profit recognition by developers and sellers of condominium projects. It also touches briefly on the historical development of the condominium concept, some of the distinctions between condominiums and cooperatives, and the differences between fee and leasehold condominiums. While the discussions in this article are directed primarily towards condominiums, many of the principles involved are also applicable to cooperatives. References made to legal requirements are for illustrative purposes and should not be construed as providing guidance on legal matters.

CONCEPT

A condominium is a form of ownership that contemplates more than a casual relationship with other owners. An individual is deeded his own homestead along with an undivided interest in common areas and facilities which are jointly controlled with other owners. Common areas may include swimming pools, sauna baths, golf courses, and other amenities. Alternatively, common areas may merely include hallways, basements, storage areas, heating and air conditioning systems, and elevators.

A cooperative form of ownership arises when a corporate entity owns the land and improvements, generally subject to financing mortgages, or leases them on a long-term basis. Equity shares of the corporation are owned by tenant/owners who have proprietary leases subject to the obligations of the corporation. There is no individual ownership as in the case of condominiums.

Historical Development

The condominium form of ownership is not unique to the United States. Italy, Germany, France and other countries had statutes denot-

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ing this type of ownership long before "condominium" became a common real estate term and concept in the United States.[1] It was not really until the enactment of the Housing Act of 1961[2] that condominiums began to gain popularity in this country. But it was not the Act itself, which allowed the issuance of mortgage insurance by the FHA,[3] that caused this popularity; rather, it was the enabling legislation adopted by the individual states permitting and protecting condominium ownership[4] — as well as permitting its financing by regulated lending institutions — that helped the concept come of age.

Forms and Types of Condominiums

Condominiums generally take two forms: leasehold condominiums and fee condominiums. Leasehold condominiums are those in which the developer retains title to the land and, in some cases, the improvements, and leases it to the individual condominium lessees on a long-term basis. Leasehold condominiums, however, are not permitted in certain states.[5] Fee condominiums are characterized by ownership of the land by the individual condominium buyers.

Condominiums may be of several types. The most typical are high-rise apartments, townhouses, garden apartments, high-rise office suites, shopping centers, and certain recreational centers. Combinations of the foregoing individual types are also possible.

Profit Recognition on Condominium Projects

There are two basic methods of profit recognition which are generally appropriate for condominium projects: the completed contract method and the percentage of completion method. These methods are

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1 For a discussion of international development of condominium enabling legislation, see 1 P. Rohan & M. Reskin, Condominium Law and Practice § 2.01 *et seq.* (1973) [hereinafter cited as Rohan and Reskin]; Leyser, *The Ownership of Flats — A Comparative Study*, 7 Int'l & Comp. L.Q. 31 (1958).

2 12 U.S.C. § 1715y (1970).

3 *See* 1 Rohan and Reskin § 9.02.

4 *See, e.g.*, Fla. Stat. Ann. §§ 711.01-.23 (1969); Hawaii Rev. Stat. § 514-1 *et seq.* (1968); N.Y. Real Prop. Law § 339-d *et seq.* (McKinney 1968); Wis. Stat. Ann. § 703.01 *et seq.* (Supp. 1974). For an exhaustive list of state condominium enabling legislation, see 1A Rohan and Reskin App. B-1.

5 Those enabling statutes which define condominium ownership as conveying a fee interest in the common elements impliedly prohibit a project based on a leasehold. *See, e.g.*, Ill. Stat. Ann. ch. 30, § 302(g) (1969); Kan. Stat. Ann. § 58-3102(b) (Supp. 1973). Some states, however, expressly permit leasehold condominiums. *See* Cal. Civ. Code § 783 (Supp. 1974); Fla. Stat. Ann. § 711.08(1) (Supp. 1974) (not less than a 98-year term); Ga. Code Ann. ch. 85-16B, §§ 85-1603b(f)(1), (m) (Supp. 1973); Minn. Stat. Ann. §§ 515.02 (3), (14) (Supp. 1974) (lease of not less than 50 years); Miss. Code Ann. §§ 896-03(F), 896-04 (Supp. 1972). New York has recently enacted a provision permitting nonresidential leasehold condominiums. *See* N.Y. Sess. Laws [1974], ch. 1056, § 1(11) (McKinney).

bases of profit recognition rather than bases for sales recognition. Both methods are predicated on a sale or exchange transaction having taken place. The following paragraphs summarize some of the thinking expressed by the Committee on Accounting for Real Estate Transactions of the American Institute of Certified Public Accountants (AICPA).[6]

The AICPA Committee has concluded that "[a] sale is consummated [for accounting purposes,] when the parties are bound by the terms of a contract, all consideration has been exchanged, and all conditions precedent to closing have been performed."[7] A buyer must have an investment "large enough to give . . . [him] a stake in the property sufficient that the risk of loss through default motivates him to honor his obligation to a seller."[8] Generally, this initial commitment for the purchase of condominiums must be represented by an unrestricted and nonrefundable down payment of five to ten percent of the sales value, depending upon whether the condominium is to be used as a primary or secondary residence. These relatively small down payment percentages are allowable only when there is a reasonable basis to substantiate collectibility of a receivable from the buyer. However, the condominium seller typically "cashes out" at closing through the buyer's permanent financing arrangements. If, on the other hand, the seller accepts a note as partial consideration, the buyer's continuing investment should be at least equivalent to a level payment over the terms of customary third party financing.

The AICPA Committee has addressed itself specifically to profit recognition on condominium projects:

> Single-family units in condominium projects are often sold individually. Recognizing a profit on the sale of individual units is often appropriate, provided the transaction meets all conditions for profit recognition at time of sale as to collectibility of sales price and ability to estimate costs not yet incurred. Profit should not be recognized, however, unless construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund, sufficient units have already been sold to assure that the property will not revert to rental property, and aggregate sales proceeds can be estimated reasonably. The profit to be rec-

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[6] COMMITTEE ON ACCOUNTING FOR REAL ESTATE TRANSACTIONS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING FOR PROFIT RECOGNITION ON SALES OF REAL ESTATE (1973) [hereinafter cited as AICPA ACCOUNTING GUIDE].

The Committee on Accounting for Real Estate Transactions was established in August, 1971 to appraise accounting practices in the real estate industry other than those relating to retail sales of lots. *Id.* at 1. The latter has been given independent consideration by the Committee on Land Development Companies. *See* note 17 *infra*.

[7] *Id.* at 4-5.

[8] *Id.* at 5.

> ognized should be calculated on the basis of the percentage of completion of the project times the gross profit on the units sold. For this purpose, the project may be defined as a building, a group of buildings, a single structure or a complete project, depending on the circumstances.[9]

Under the simplest application of the completed contract method, income is generally recognized when an exchange transaction takes place (usually at closing) and the condominium project is completed or virtually completed. A permanent certificate of occupancy is typically issued, and the seller "cashes out," with his only remaining obligation relating to ordinary construction warranties.

As indicated earlier, the occurrence of a sales transaction is the basis for profit recognition on the percentage of completion method. The timing of the sale is somewhat complicated since some of the traditional elements of real estate transactions are usually missing (for example, closing, receipt of a mortgage note, or a "cash-out"). Since these elements are missing, it is critical that the sales contracts, and the surrounding circumstances, are such that there is a firm, fully committed buyer. In this regard, the contract itself must be noncancellable, an adequate nonrefundable down payment must have been received, the condominium documents (declaration of condominium, etc.) must have been accepted by the buyer, and the buyer must have obtained a firm financing commitment. Lack of any of the foregoing suggests that a sales transaction has not taken place, since the seller would still be at a substantially greater risk than that associated with the actual construction of the project. Specific discussions relating to the application of the percentage of completion method appear in subsequent sections of this article.

Seller's Continuing Involvement

The completed contract and the percentage of completion methods contemplate that the sales value is determinable (the most common element entering into the determination of sales value is the discount on the receivable taken) and that the seller will have no significant continuing involvement in the property. The concept of continuing involvement is complex in real estate accounting, although it has had limited application to the typical condominium development. In real estate transactions, continuing involvement may take various forms and degrees. Some of the key questions that must be answered in evaluating that involvement are: a) does the seller retain a non-passive commit-

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[9] *Id.* at 19-20.

ment (risk) in the continuing operations or eventual resale or refinancing of the property, which commitment has a bearing upon his eventually receiving or retaining the full selling price? b) does the seller retain benefits (rewards) of ownership or operation of the property, indicating that his relationship to the property has not been substantially severed? and c) can the continuing involvement of the seller be separated from the "sale" transaction itself in determining the reasonableness of the stipulated selling price?

Essentially, a seller who retains the continuing risks of ownership has not substantively sold the property. In other words, the seller is more like a co-venturer or one engaging in a form of sale and leaseback where he should recognize profit over the period for which he is committed to retain risks. These types of arrangements can exist in a rental pool condominium.[10] Thus, if a condominium seller is committed to the continuing management of the property, or if he must bear the operating risks for long periods, a sale for financial reporting purposes probably has not occurred. On the other hand, a seller may be able to justify profit recognition if he has reduced his continuing involvement to that of a managing agent under a terminable contract (one typical to managing any apartment building) and does not assume the risks of ownership.

It is difficult to provide definitive guidance on these matters, since every transaction has its unique characteristics. However, in all cases one must determine where the risks reside and analyze carefully the implicit ramifications of using various legal devices (such as limited partnerships or other contractual forms). "Profit now and risks later" is an accounting anomaly.

Sale of Improvements and Concurrent Lease of Land

As previously indicated, leasehold condominiums are permissible in some states.[11] There is also the possibility of leasing recreational facilities to the condominium buyers on a long-term basis. The reasons

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[10] The Securities and Exchange Commission (SEC) defines the rental pool condominium as

> a device whereby the promoter or a third party undertakes to rent the unit on behalf of the actual owner during that period of time when the unit is not in use by the owner. The rents received and the expenses attributable to rental of all the units in the project are combined and the individual owner receives a ratable share of the rental proceeds regardless of whether his individual unit was actually rented.

SEC Securities Act Release No. 5347 (Jan. 4, 1973), at 82,539. The SEC has indicated that certain of these arrangements may be subject to registration under federal securities laws. *Id.*

[11] *See* note 5 *supra*.

for leasing, rather than selling, may include the desire for a continuing long-term future cash flow and the avoidance of a sale so that income taxes will not be payable on a gain.

There are differing opinions relating to the accounting treatment that should be afforded recreational leases and concurrent land leases of leasehold condominiums where the lessor is the developer. One school of thought is that, since the condominium unit purchasers must sign leases either individually or through an association, the sales price is not separable from the leasing activity. Accordingly, discounted future lease payments should be considered in evaluating the recording of the sales and the related profit or loss thereon. This position is strengthened when the arrangements are "net net leases," thereby effectively passing most, if not all, risks of ownership to the condominium purchasers. If net leases are not involved, the concept of including discounted future rentals as part of the sales value is complicated by the need to quantify future costs relating to the leased areas (maintenance, insurance, taxes, for example).

Another approach is to consider the future rentals to be, in essence, executory in nature and ascribe no value to this "contingent" consideration. Under this view, the lease arrangements are regarded as being separable from the sale transaction and the leases are accounted for under the operating method. If the lease arrangements are not reasonable in light of the operating risks retained by the lessor, the resulting continuing involvement may overshadow any immediate profit recognition.

The AICPA Committee indicates that

> the sales value of the property . . . should include the present value of the lease payments specified in the lease over the term of the primary indebtedness on the improvements or over the customary term of primary debt instruments on the type of improvements involved. Present value of the specified lease payments should be computed at an interest or discount rate appropriate for primary debt if the lease is not subordinated or for secondary debt if the lease is subordinated to loans with prior liens . . . .

The lease affects only the tests of the buyer's initial investment

> if the lease is between the buyer and a third party lessor. If the seller of the improvements is also the lessor of the land, however, the lease also affects the calculation of profit on the sale of improvements.[12]

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[12] AICPA ACCOUNTING GUIDE, *supra* note 6, at 10.

It should be noted, however, that the Committee does not permit profit on the sale of improvements to be increased as a result of the inclusion of the present value of leases in the sales value.[13]

In an extreme and perhaps unlikely case, it is possible that inclusion of the lease in the sales value would require a seller to defer profit due to inadequate buyer commitment, even though the seller has "cashed out" on the stated sales price. In this situation, the leased portion of the total condominium development would have to be greatly disproportionate to the property that was actually deeded to the buyers. In cases where substantial risks of ownership are retained by the seller, the entire transaction (including the condominium apartment sale) should be accorded profit deferral.

Application of Percentage of Completion Accounting to Condominium Projects

Developers of single-family residential properties normally use the completed contract method of recognizing profit. Since this is the "prevalent method," the question often asked is why the percentage of completion is acceptable accounting for certain vertical single family developments and is generally not used for the more traditional horizontal single family developments. The answer to this question may be found in accounting literature relating to construction contractors. Generally, such contractors record earnings using a percentage of completion method for long-term construction projects. Condominium projects are often carried on for periods of time extending over several accounting periods. Unlike single family houses, individual units in a high-rise project cannot be completed as single units. To a large extent, high-rise construction might be characterized as "all or none" — a builder cannot stop halfway.

On the other hand, a condominium project containing segmented and separable structures which are not constructed over long periods of time, such as attached townhouses containing five or six units each, should generally be accounted for under the completed contract method. In practice, the completed contract method really means the completed closing method with appropriate deferral of revenues allocable to completion of common areas. So, in essence, all projects should be on a percentage of completion method in one fashion or another.

Criteria for Use of the Percentage of Completion Method

As stated previously, profit should not be recognized until an exchange transaction — a sale — has taken place. Additional conditions

[13] *Id.* at 10-11.

which should be satisfied prior to the recognition of profit are noted by the AICPA Committee.[14]

The Committee also states that a seller's previous experience is necessary to estimate the costs and profits.[15] If a developer is a relative novice and has neither the experience nor the track record for reliably estimating costs and sales values, use of the percentage of completion method appears inappropriate. Percentage of completion may even be inappropriate for experienced developers who have not adequately researched and tested the market for their products. There are many uncertainties involved in estimating sales values; high-rises within a few blocks of each other may experience completely different consumer acceptance or the money market for mortgages may change, thereby affecting the marketability of a long-term development.

The AICPA Committee holds that sufficient units must have been sold to assure that the property will not revert to rental property,[16] presumably on the theory that if reversion to rental property occurs, a joint venture of sorts has ensued rather than a sale eligible for profit recognition. A minimum number of sales may also be required by governmental agencies or by financial institutions who have made permanent mortgage financing commitments. All minimum sales must be made, whether required by law or contract, before any profit recognition is appropriate. These factors, as well as any others that may be appropriate, should be considered fully before the percentage of completion method is adopted.

Mechanics

After the various tests, requirements, and limitations as to the use of percentage of completion accounting have been dealt with, the mechanics of applying the method are relatively simple. The key factor — the extent of percentage of completion — may be based on performance or may be based on cost relationships. Performance is usually measured by engineering or architectural estimates and not on the basis of rationales about management or sales performances geared to front-loading of profits. Percentage of completion based on cost relationships is probably the most common method used and, in simple terms, the percentage is the result of dividing construction costs to date by estimated total construction costs. This percentage is then applied to the estimated gross profit on sales to date to arrive at the profit recognizable to date. It is the author's view that land and other "one time"

[14] *Id.* at 19-20.
[15] *Id.* at 15.
[16] *Id.* at 20.

costs should not enter into the determination of the percentage but must enter into the calculation of the total estimated gross profit.

Other Factors

Allocation of Costs

One of the various other factors to be considered when accounting for condominium projects is the allocation of costs. Generally, the first element to be allocated in a multiphase development is the raw land cost. The allocation may be based on relative values, areas (square footage, for example), specific identification, or combinations of these methods. A word of caution should be added: the specific identification method may not be appropriate in large developments since premiums, in excess of inherent land values, are often paid for the last parcels acquired. It appears that allocations based on relative values would be appropriate in most circumstances.

Costs of individual structures should be accumulated separately and allocated to the condominium units using a relative value approach. Costs associated with common areas are often more difficult to allocate, especially if the common areas relate to several phases of the development. In cases of multiphase long-term developments, an obligation usually exists to complete the common areas even if subsequent phases are not constructed. In these circumstances, careful consideration of all the surrounding facts, including the financing commitments, market studies, and financial capabilities of the developer, may very well indicate that common area costs should be allocated entirely to the "committed" areas — or first phases — which are to be developed.

Amenities which are not expected to be deeded as common areas are often planned as self-sustaining operations, or as operations not expected to be self-sustaining but to be used as selling tools, or as a combination of both (for example, situations where the amenities are expected to be self-sustaining after an initial "free membership period"). If the amenities are expected to be self-sustaining, costs should be accumulated on a specific identification basis to the extent practicable. "Free membership period" operating losses of amenities expected to be self-sustaining should be projected and allocated to condominium units on a relative value approach.

With respect to facilities which are not expected to be self-sustaining (that is, facilities not expected to provide a return sufficient to cover both costs of operation and recovery of construction costs), all unrecoverable costs incurred in developing the facility should be charged to cost of sales of the related properties, on a pro rata basis, unless it can be demonstrated that the facility constitutes a productive selling aid. In such event, the facility should be depreciated over the shorter of the period during which properties applicable to the area are expected to be sold or the estimated useful life of the amenity after giving effect to the present value which can be realized from a future sale of the facility.

Guaranteed Maximum Maintenance Charges

Some developers guarantee that monthly maintenance charges will not exceed a stipulated amount. These guarantees should be based upon the best estimate possible, since to do otherwise might subject the seller to charges of misleading the buyer. However, if it is subsequently determined that the estimates were erroneous or unreliable, estimated nonreimbursable maintenance costs should enter into the determination of the estimated profit on sales.

Carrying Costs on Unsold Units

Certain costs relating to unsold condominium units will continue even after construction is completed. Examples of such costs are interest, taxes, maintenance, and insurance. It is common practice in real estate accounting to capitalize interest and taxes on land, up to its net realizable value, until the land has reached a saleable condition. With respect to condominiums, *all* carrying costs should be estimated at the inception of the project and allocated to all units in the project. In other words, the first units sold should absorb a portion of the costs related to carrying unsold units. In the event that estimates require revision, a proportionate part of the adjustment relating to units sold should be reflected in current operations. An upward revision of estimated carrying costs may be the first indication that the project is experiencing problems with either construction or consumer acceptance — or perhaps both. If problems are involved and the recovery of costs becomes doubtful, an adjustment reducing accumulated costs to net realizable value may be necessary. In some cases, a provision for ultimate losses may also be needed.

Selling, General, and Administrative Expenses

Condominium developers should generally account for selling, general, and administrative expenses in the manner prescribed in an AICPA industry accounting guide entitled *Accounting for Retail Land*

Sales.[17] As a general rule, these costs should be expensed, although capitalization and deferral is permitted under certain circumstances. Specifically, the costs that may be capitalized or deferred are carrying costs and direct selling expenses. Direct selling costs (for example, commissions paid to salesmen) may be deferred if the profit relating to the sale is deferred. In certain rare cases — for example, when a special purpose joint venture is involved — selling, general, and administrative expenses may be deferred as pre-operating expenses if revenue is not being recognized. However, as soon as the entity becomes operational (that is, it is no longer in the development stage), operating costs should be expensed as incurred and deferred expenses amortized over an appropriate period.

As in any other business enterprise, deferral of costs must be predicated on the expectation that such costs will be recoverable from operations. All costs deferred or capitalized — including, but not limited to land improvements, carrying costs, and direct selling expenses — must not exceed their estimated net realizable values.

CONCLUSION

Accounting for condominiums, while unique in many respects, is fundamentally the same as accounting for any long-term activity where uncertainties are involved. A key factor to be considered is the interrelationship and inseparability of the real estate sale and the construction activity. With proper planning and judgment, the seemingly monumental cost accounting problems can usually be solved without traumatic repercussions. There is nothing mysterious about condominiums — accounting for them is simply a matter of using caution and common sense.

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[17] COMMITTEE ON LAND DEVELOPMENT COMPANIES OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING FOR RETAIL LAND SALES (1972).