

EXHIBIT 3
Exchange of Real Property:
Commercial Substance—Change in Entity-Specific Value

Best Products, Inc., a frozen foods wholesaler, owns a number of warehouses in New York and New Jersey. The company also owns undeveloped land in Delaware that was originally expected to be the point of its southward expansion. Recently, senior management placed the southern expansion on hold and decided to focus its plans on northern New York. The undeveloped land cost \$60,000 six years ago and now has a fair value of \$90,000. Best concludes that it will not incur an impairment charge related to this change in strategy.

Through its broker, Best finds another company that owns undeveloped land in Best's target region in northern New York and is willing to exchange it for Best's Delaware property. Though differing in acreage, the fair values of both properties are the same. Best's management expects that this new property will provide synergistic benefits with its existing warehouses with regard to product location and consolidation, reduced transportation costs, and pricing advantages. The new property is also close to a local airport that provides Best with other business opportunities and efficiencies. Best will transfer all of the risks and rewards of ownership and have no substantial continuing involvement in the Delaware property.

Analysis

Prior GAAP. Though SFAS 66 provides guidance on profit recognition and related real estate accounting matters, it specifically excludes (para. 1) exchanges of real estate from its scope. However, these transactions are specifically considered as exchanges of similar productive assets under APBO 29 (para. 7). Accordingly, the gain of \$30,000 (\$90,000 market value less \$60,000 cost) would be deferred, and the new land would be recorded at its book value of \$60,000. The following journal entry illustrates this exchange:

Dr. Undeveloped Land, New	\$60,000	
Cr. Undeveloped Land, Old		\$60,000

SFAS 153. Though the fair value of the properties is the same, management finds that the synergistic benefits of the new location and future cost savings are indicative of an enhanced entity-specific value favorable to Best. Consistent with SFAC 7, preliminary projections of probability-weighted cash flows suggest that the entity-specific value of the new property is approximately \$35,000 greater than the land relinquished. This difference is significant when compared to the fair values of the land exchanged (\$90,000). Therefore, management concludes that the exchange has commercial substance. The transaction satisfies the definition of "exchange" in SFAS 153 because Best will have no substantial continuing involvement in the Delaware property.

Best will record the property received at its fair value of \$90,000 and recognize a gain of \$30,000. Note that the entity-specific value is used only to determine whether the transaction has commercial substance. It does not impact the value of the asset for financial statement purposes. The journal entry to record this transaction is as follows:

Dr. Undeveloped Land, New	\$90,000	
Cr. Undeveloped Land, Old		\$60,000
Cr. Gain on Exchange		30,000

For tax purposes, no gain would be recognized on this exchange. Best will, however, have a deferred tax liability under SFAS 109.