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October 8, 1979

Issues Paper

ACCOUNTING BY INVESTORS FOR DISTRIBUTIONS RECEIVED IN EXCESS OF THEIR INVESTMENT IN A JOINT VENTURE

(An Addendum to the July 17, 1979 Issues Paper on Joint Venture Accounting)

Prepared by

Accounting Standards Executive Committee

Accounting Standards Division

American Institute of Certified Public Accountants

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ACCOUNTING BY INVESTORS FOR DISTRIBUTIONS RECEIVED IN EXCESS OF THEIR INVESTMENT IN A JOINT VENTURE

An Addendum to the July 17, 1979
Issues Paper on Joint Venture Accounting

1. The July 17, 1979 issues paper, "Joint Venture Accounting," submitted to the FASB on July 20, 1979 raises a collateral issue in the section on Interentity Relationships and Transactions (page 39) on accounting for distributions to an investor whose investment had been reduced to zero. Paragraph 39(e) of the paper states

> Under some circumstances, a venture may continue to make distributions to its investors out of funds generated from cash flows after the equity of an investor had been reduced to zero. How should an investor account for distributions from a venture out of cash flow when the investor's equity in the venture is reduced by losses to zero?

This paper is an amplification of that issue with particular emphasis on real estate ventures. The purpose of the paper is to discuss the accounting by a noncontrolling investor in a real estate venture that reports on the equity method for the receipt of cash distributions in excess of its investment in a venture when the distributions are not refundable by agreement or by law and the investor is not liable for the obligations of the venture or is not otherwise committed to provide financial support to the venture. Accounting for such distributions has become an emerging practice problem in the real estate industry.

Background

2. Noncontrolling investors in real estate ventures are generally required to account for their investments under the equity method. As a result of operating losses of or of cash distributions by the venture, the carrying amount of the investment may be reduced to zero. A venture reporting losses may continue to make distributions out of net cash generated from operating properties because, for example, depreciation charges may exceed the reported losses and amounts required for the amortization of mortgage debt. A venture may also make such distributions from the proceeds of financings or refinancings.

Accounting for Operating Losses

3. The authoritative literature on accounting by an investor in a venture for losses in excess of the investor's investment is clear: the investor's equity in losses of the venture in excess of its investment (including loans and advances) need not be reported unless the investor is liable for the obligations of the venture or is otherwise committed to provide financial support to the venture; an investor liable for the obligations of the venture or otherwise committed to provide financial support reports such losses as a liability. That is in accordance with APB Opinion 18 and SOP 78-1. Paragraph 19(i) of APB Opinion 18 states

> An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

A footnote (Footnote 10) to that paragraphs states

> An investor should, however, provide for additional losses when the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired.

Also, paragraph 15 of SOP 78-9 recommends accounting for investments in real estate ventures that is consistent with APB Opinion 18. That paragraph states:

> 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. 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.

A footnote (Footnote 2) adds the following:

> 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 non-recurring 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.

Distributions from Operations

4. Net income reflects charges for depreciation. Distributable funds generated from operations, on the other hand, are usually equal to net income increased by depreciation charges and decreased by mortgage principal amortization. Thus, distributable cash from operations may exceed net income in the early years of operations by the difference between depreciation and mortgage principal amortization. Cash distributions from venture operations are generally made from available cash flow, irrespective of the results of operations. Thus, distributions could significantly exceed net income or could be made even when net losses are reported. In some cases, such distributions exceed the carrying amounts of the investments or are received after operating losses have reduced the carrying amounts of the investments to zero.

Distributions from Financings

5. Since financing by institutional lenders is commonly based on the value of the collateral rather than the cost of the property to the borrower, cash distributions from ventures may also be made from the proceeds of financings or refinancings of a venture's properties. An investor may receive such distributions after the carrying amount of its investment has been reduced to zero. That could occur for ventures involved in any kind of real estate investment or development, but as a practical matter, usually occurs only for investments in income properties. This paper, however, discusses the problem without distinguishing types of projects in which ventures may invest. Also, for the purposes of this paper, no distinction is made between recourse and nonrecourse debt because a noncontrolling investor's obligation to return distributions received from a venture is not affected by whether the venture obtained the funds from recourse or nonrecourse financing.

Emerging Practice Problem

6. The problem is how to account under the equity method for cash distributions received by noncontrolling investors whose investment accounts have been reduced to zero. If cash distributions received are refundable or the investor is liable for the obligations of the venture or is otherwise committed to provide financial support to the venture (such as for a general partner in a general or limited partnership), excess distributions should be reported as a liability. Accounting for the receipt of cash distributions in excess of the carrying amount of an investment is not clear in

other situations (such as for a limited partner's investment in a limited partnership or a common stock investment in a corporate real estate venture).

7. Although this problem has existed for some time, it has only recently become common for investors to receive distributions in excess of their investment accounts either from operations or from the proceeds of financings or refinancings. However, excess distributions are now occurring from both sources, principally because of the effects of inflation. Therefore, accounting for such distributions has become an important emerging practice problem in the real estate industry.

8. There is no authoritative literature on how to account for such distributions. Although in concept the equity method is commonly understood to be merely an extension of the consolidation concept, APB 18 and SOP 78-9 provide for a suspension of the equity method in recording losses from operations in excess of the investment. Furthermore, there is no clear authoritative literature on how to account for such distributions under the cost method, although investors generally reflect the distributions as income under that method.

Alternative Methods of Accounting

9. Two methods have been advocated to account under the equity method for cash distributions received in excess of a noncontrolling investor's investment when the amounts received are not refundable by agreement or by law and the investor is not liable for the obligations of the venture and is not otherwise committed to provide financial support to the venture. Some believe that the investor should account for the distributions as a deferred credit or a liability. Others believe that the investor should account for the distributions as income.[1]

Arguments for Accounting for the Distributions as Deferred Credits or Liabilities

10. Arguments advanced for accounting for the distributions as deferred credits or liabilities are:

a. The equity method is merely an extension of the consolidation method and the entity concept underlying that method. Under the consolidation method such amounts are not recognized as income of the consolidated entity.

b. Distributions from cash flow from operations or from the proceeds of financing have not traditionally been recognized as income under generally accepted accounting principles.

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[1] This paper does not discuss the income tax implications for the investor of recognizing such amounts as income.

c. Since an investee may not recognize funds provided by operations or from the proceeds of financing as income under generally accepted accounting principles, the receipt by an investor of distributions from that source does not represent the culmination of the earnings process.

d. Under the theory of implied support, an investor may be presumed to have an obligation to provide support to the investee, even though the investor does not have a legal obligation to return the distributions. The recognition of such distributions as income would imply that the investor had abandoned the investment and would not be consistent with the implied support theory underlying accounting for investments.

e. Under generally accepted accounting principles, gains from the appreciation of assets are only recognized on the basis of exchange transactions. The distribution should not, therefore, be recognized as gains from appreciation because the investor has neither sold nor abandoned the investment.

f. Under the equity method, cash distributions received by an investor reduce the carrying amount of the investment and are not recognized as income. To base the recognition of cash distributions on an investment as income on whether the carrying amount of the investment is above or below zero would be purely arbitrary.

Arguments for Income Recognition

11. Arguments advanced for accounting for the distributions as income are:

a. Since the equity method is suspended for operating losses when the carrying amount of an investment is reduced to zero (APB Opinion 18 and SOP 78-9), the method should also be suspended for cash distributions received after the carrying amount of an investment is reduced to zero. If the equity method is suspended, some believe that the cost method, under which cash distribution in excess of the carrying amount of an investment have traditionally been recognized as income, is the appropriate method to account for such distributions, since that is the method that an equity method, in effect, switches

to when operating losses reduce the carrying amount of the investment to zero. Others believe that, since the investor has invested in the entity, not the property owned by the entity, and is not in control of the entity, the cost recovery method is appropriate. Under that method cash receipts in excess of cost are recognized as income.[2]

b. The recognition of the distribution as income is consistent with the realization concept in accounting. Since the investor has received cash with no obligation to repay the amount and has no obligation to incur additional costs, the investor has realized, at least to the extent of the cash received in excess of the cost of the investment, appreciation in the value of that investment and should recognize the amount as income.

c. If the credit results from refinancings, a sale transaction may be presumed since the investor no longer has any risks of ownership or loss and will only share in future gains. By abandoning the investment, the investor would be required to recognize the gain. Paragraph 44 of the AICPA Accounting Guide, "Accounting for Profit Recogntion on Sales of Real Estate," indicates that the participation

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[2]The cost recovery method has also been suggested as an alternative to the equity method for investments of the type under consideration.

in operating profits or residual values without further obligation does not prohibit profit recognition on a sale of real estate if no costs are deferred.

d. If the credit results from refinancings, the refinancing transaction (presumably approved by the investors) results in a sale of a senior call on revenues (preference income) to the lender. All the risks of ownership of the investment and a significant portion of the rewards (preference income) have in substance been transferred to the lender with no risk of loss to the investor. The investor has only an upside potential.

e. Transactions and obligations of the venture should not affect the investor's accounting for the amounts received as distributions from the venture when the investor has no further risk of loss.

* * * * * * *

Advisory Conclusion

12. The Accounting Standards Executive Committee agreed (10 to 4, with 1 abstention) on the following advisory conclusion on the issue discussed in this paper.

> A noncontrolling investor in a real estate venture should account for cash distributions received in excess of its investment in a venture as income when (a) the distributions are not refundable by agreement or by law and (b) the investor is not liable for the obligations of the venture and is not otherwise committed to provide financial support to the venture.