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June 21, 1979

Issues Paper

Accounting for
Allowances for Losses on Certain Real Estate and Loans and Receivables Collateralized by Real Estate

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Prepared by

Accounting Standards Division

Accounting Standards Executive Committee

American Institute of Certified Public Accountants

TABLE OF CONTENTS

	Page
Introduction	1
Scope of Paper	1
Background	3
Provisions of SOP 75-2 as Amended	3
FASB Statement No. 15	5
S&L Audit and Accounting Guide	9
Proposed SOP on Allowances for Losses	9
Estimated Net Realizable Value	12
Bank Audit Guide and Practice in the Banking Industry	13
Summary and Comparison of Current Requirements	16
Definitions	18
Issues Relating to Troubled Loans	21
Method Followed	21
Estimated Net Realizable Value of the Collateral	22
Interest Holding Cost	26
Arguments against including interest holding cost	26
Arguments for including interest holding cost	30
Circumstances Requiring Loss Allowances	34
Consistency among Industries	36
Issues Relating to Real Estate	39
Advisory Conclusions	41

Introduction

1. Accounting for allowances for losses on real estate and on loans and receivables collateralized by real estate and related issues have received considerable attention in recent accounting literature. AcSEC's Statement of Position 75-2, Accounting Practices of Real Estate Investment Trusts, as amended by SOP 78-2, the AICPA Industry Audit Guide, Audit and Accounting Guide for Savings and Loan Associations, and AcSEC's proposed SOP, Accounting for Allowances for Losses on Certain Real Estate and Loans and Receivables Collateralized by Real Estate recommend accounting for such allowances based on the net realizable value of the underlying real estate. A proposed revision of the AICPA Industry Guide for Banks submitted concurrently with this paper does not state a position on accounting for such allowancess pending resolution of the issues raised in this paper. Also, FASB Statement No. 15 prescribes the accounting by debtors and creditors for transactions described as troubled debt restructurings, and some believe that its provisions, which are not based on estimated net realizable value, have significant implications for accounting for allowances on real estate loans and receivables without regard to whether a troubled debt restructuring is involved.

Scope of Paper

2. This paper addresses issues concerning the determination of allowances for losses on certain real estate and loans and

receivables collateralized by real estate. The primary emphasis is on what are later defined as troubled loans. The major issues relating to troubled loans are:

a. What method should be followed in determining allowances for losses?

b. Should the allowance be based primarily on an evaluation of the estimated net realizable value of the collateral?

c. If the answer to (c) is "yes," should a factor for interest holding cost be considered in determining estimated net realizable value?

d. Should interest holding cost be determined on the basis of a risk rate or on the basis of an entity's average cost of capital?

These issues should be considered both generally from the perspective of all major lenders to the real estate industry and from the perspective of specific types of lenders, particularly banks. A related question, which is separately addressed, is whether there should be consistency among different types of lenders such as banks and S&Ls.

3. Since the answers to the basic questions may depend on differences in circumstances, the following questions are also raised: What should be the basis of a loss allowance

- When a restructuring is not probable?
- When a modification of terms is probable?
- When a modification of terms occurs?
- After a modification of terms has occurred?

4. The paper does not address loans on which foreclosure is considered probable. In those circumstances, there is general agreement that the allowance for losses should be determined by the difference between the recorded investment in the loan and the fair market value of the collateral. Providing such an allowance is deemed to present the carrying amount of the loan at the best estimate of the amount that will be recovered. Moreover, such a provision is deemed to measure the amount of the loss that would be recognized under FASB Statement No. 15 when the loan is foreclosed.

5. The paper also addresses some collateral issues relating to entities other than banks (paragraphs 56 and 57) on allowances for losses on investments in real estate acquired by foreclosure and on problem real estate investments. The primary collateral issues are whether and in what circumstances should allowances be provided on the basis of estimated net realizable value and to what extent, if any, and on what basis should an interest holding cost be reflected in determining estimated net realizabled value.

Background

Provisions of SOP 75-2 as Amended

6. On June 27, 1975, the AICPA's Accounting Standards Division submitted SOP 75-2, Accounting Practices of Real Estate Investment Trusts (REITs), to the Financial Accounting Standards Board.

The primary purpose of that SOP was to establish the basis for determining allowancss for losses on real estate loans and receivables of REITs. Since REITs lend only to the real estate industry, conditions in that industry seriously affect their lending activities and the recoverability of their loans and receivables. SOP 75-2 was issued during a period when REITs were experiencing serious financial difficulties because of the impact of significant financial problems in the real estate industry. The SOP concludes that:

> ...in the real estate industry, interest is clearly an economic cost of holding property... In the case of a REIT, the division believes that the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

7. The SOP recommended that real estate investment trusts periodically evaluate individual real estate loans and foreclosed properties held for sale and provide allowances for losses to adjust the carrying amounts of the individual assets at each evaluation date to their estimated net realizable value (see paragraphs 18 and 19 of this paper) or, in the case of foreclosed properties, to their estimated selling price on an immediate liquidation basis if the REIT is unable or unwilling to hold the properties because of liquidity problems or other reasons. The SOP recommended that the net estimated realizable value at the date of foreclosure should become the cost basis of a foreclosed property that a REIT elects to hold as a long-term investment.

8. While the SOP notes that its conclusions may also be appropriate

for companies "which are not REITs but which are engaged in the business of making loans on or investing in real estate," its scope is restricted to REITs.

9. In its Status Report of September 9, 1975 (No. 28), the FASB reported that it "does not presently contemplate taking any action with respect to the AICPA statement of position (on REITs) and has no present plan to add the subject of the AICPA statement of position to its agenda." The Status Report also expressed the Board's view that "in recommending a particular method for making a reasonable estimate of loss on loans receivable and foreclosed properties of real estate investment trusts, the AICPA statement of position does not conflict with FASB Statement No. 5." The Status Report took particular note of the SOP's specific recommendations on (a) the inclusion of estimated interest holding costs in determining losses on real estate loans and foreclosed properties and (b) the calculation of those costs, and continued: "The Board takes no position on either of those features of the recommended method for estimating asset impairment."

10. SOP 75-2 was amended in May 1978 by SOP 78-2, to conform the recommendations of SOP 75-2 to the provisions of FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

FASB Statement No. 15

11. FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, issued in June 1977, prescribes the

accounting by debtors and creditors, including REITs, for troubled debt restructurings consummated after December 31, 1977. Paragraph 2 of that Statement contains the following definition of a troubled debt restructuring:

> A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt becaused the creditor concludes that step will maximize recovery of its investment.

A note to that paragraph states:

> Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term troubled debt restructuring in this Statement.

Among other things, the Statement requires assets received or transferred in a troubled debt restructuring to be valued at their fair value (as defined in the statement) when the restructuring occurs. The fair value of a property as measured under FASB Statement 15 may differ materially from its esti-

mated net realizable value as measured under the recommendations on losses from loans in Statement of Position 75-2.

12. FASB Statement No. 15 also requires that a modification of terms of a loan receivable be accounted for prospectively and not as a change in the recorded investment (see note 17 of FASB Statement No. 15) in the receivable unless total future cash payments as specified by the new terms are insufficient to liquidate the recorded investment. The excess of future cash receipts, including both receipts designated as interest and receipts designated as principal, specified by a modification over the recorded investment in the receivable is required to be recognized as interest income over the life of the restructured agreement in such a way that a constant level rate of interest is reported on the remaining balance of the recorded investment in the receivable, the recorded investment is required to be reduced to an amount equal to the future cash receipts specified. The amount of the reduction is a loss to be recognized in accordance with paragraph 35 of FASB Statement No. 15.

13. Paragraph 1 of FASB Statement No. 15 states:

> The statement does not cover accounting for allowances for estimated uncollectible amounts and does not prescribe or proscribe particular methods for estimating amounts of uncollectible receivables.

In specifying the accounting for a troubled debt restructuring involving a modification of terms in paragraph 30 of FASB State-

ment No. 15, the Board states the following in a note (footnote 18) to that paragraph.

> In this Statement, total future cash receipts includes related accrued interest, if any, at the time of the restructuring that continues to be receivable under the new terms. Uncertainty of collection of noncontingent amounts specified by the new terms (see paragraph 32 for inclusion of contingent amounts) is not a factor in applying paragraphs 30-32 but should, of course, be considered in accounting for allowances for uncollectible amounts.

Appendix B of FASB Statement No. 15, "Basis for Conclusions," contains the following:

> 59. Paragraph 1 also states that the statement does not establish standards of financial accounting and reporting for allowances for uncollectible amounts and does not prescribe or proscribe particular methods for estimating amounts of uncollectible receivables. Several respondents to the Exposure Draft urged the Board to adopt the method of accounting for uncollectible amounts based on the net realized value of collateral property set forth in statement of position 75-2, "Accounting Practices of Real Estate Investment Trusts," issued June 27, 1975 by the Accounting Standards Division of the American Institute of Certified Public Accountants. Others noted potential conflicts between the Exposure Draft and the AICPA publication and requested clarification. Still others urged the Board to reject the method for estimating amounts of uncollectible receivables in statement of position 75-2.
>
> 60. Since this statement neither prescribes nor proscribes particular methods for estimating uncollectible amounts of receivables, it takes no position on whether the net realizable value of collateral is a proper basis for estimating allowances for uncollectible amounts of receivables. However, the accounting prescribed in this statement for assets received in troubled debt restructurings differs from that in statement of position 75-2, for reasons given in paragraph 65-105, and the accounting prescribed in this statement governs.

S & L Audit and Accounting Guide

14. The Audit and Accounting Guide for Savings and Loan Associations issued in April 1979 requires that

> The allowance for losses on a large portfolio of loans secured by single-family residences or multiple housing with relatively few units may be determined and evaluated statistically based on the volume of loans made, loans outstanding, and historical loss experience. Large loans for other residential housing, commercial property, land, or properties under development should be reviewed individually.
>
> Allowances for losses on doubtful or troubled loans should be based on estimated net realizable value, as discussed in the subsequent section, unless it is probable, in accordance with FASB Statement No. 5, Accounting for Contingencies, that loans will be foreclosed; in which case, allowance for losses should be based on fair value as defined in FASB Statement No. 15.

The guide also provides that a loan receivable whose terms are modified in a troubled debt restructuring should be evaluated at the time of the restructuring and periodically thereafter and that an allowance for loss should be established based on estimated net realizable value.

Proposed SOP on Allowancess for Losses

15. In a draft SOP sent to the FASB in June 1978 on "Accounting for Allowances for Losses on Certain Real Estate and Loans and Receivables Collateralized by Real Estate," the division proposed to extend the recommendations in SOP 75-2 to "covered loans and foreclosed properties" and "covered real estate" of all entities that are not REITs, savings and loan associations, or banks. REITs, S&Ls, and banks were excluded from the proposed SOP because

SOP 75-2 contained similar provisions for REITs and AcSEC expected the S&L and bank audit guides to provide specific guidance in those industries. AcSEC urges the FASB to reconsider the proposed statement of position when this paper is considered.

16. Covered loans (troubled loans) consist of loans and receivables directly collateralized by real estate and firm commitments to extend such credit in circumstancess in which a borrower has been unable to meet his obligations or in which conditions indicate that it is probable that the borrower will not be able to meet his obligations to a lender. Such conditions include, but are not limited to the following:

- Significant defaults, including missed payments of either principal or interest, exist under the terms of the loan agreement.
- A troubled debt restructuring is probable.
- The terms of a debt have been modified in a troubled debt restructuring.
- A substitution or addition of debtors has occurred in a troubled debt restructuring.
- The credit worthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings, liens filed against his assets, and so forth.
- Cost overruns, mechanics' liens, or delays in construction are being experienced on the

project that collateralizes the loan or receivable.

- Adverse market conditions related to sales, rentals, or other external factors cast doubt on the economic viability of the project that collateralizes the loan or receivable.

17. Covered real estate (primarily held for sale or for development and sale) includes all real estate not acquired by foreclosure except the following types of real estate investments:

- Real property used by the owner in the owner's business (for example, manufacturing facilities and home office space).
- Revenue producing property held for investment and not for sale (unless evidence exists that the real estate may be offered for sale).
- Land under development or specifically held for development into property to be used in the owner's business or into revenue producing property to be held for investment and not for sale (unless evidence exists that the land may be offered for sale).

Estimated Net Realizable Value

18. SOP 75-2, the S & L audit guide, and the proposed SOP on allowances for losses recommend that allowances for losses be determined on the basis of periodic evaluation of the estimated net realizable value of the underlying real estate. Estimated net realizable value is defined as the estimated selling price the property will bring if offered for sale in the open market, allowing a reasonable time to find a purchaser, plus other estimated revenues from the property during the estimated holding period, reduced by at least the following:

- The estimated costs to complete or improve the property to the condition used in determining the estimated selling price.
- The estimated costs to dispose of the property.
- The estimated costs to hold the property to the estimated point of sale, including interest, property taxes, legal fees, and other cash requirements of the project.

19. In determining interest holding costs under the three documents, the interest rate is based on the average cost of all capital (debt and equity). The rate is calculated by dividing debt interest costs by the aggregate of equity capital and debt. Debt interest costs normally are based on interest rates used for accruing interest at the date of the balance sheet. However, information available before the financial statements are issued (for example, renegotiation of the entity's debt) is considered in

determining whether those rates are appropriate. The stated objective is to arrive at rates that would, in light of existing agreements, correspond with the constant effective rates to be used for accruing interest on debt during the estimated holding period of the property. However, under the proposed SOP the amount of interest holding costs on covered real estate would be based on the average cost of all capital or the amount resulting from using the entity's accounting policy for capitalizing interest if that amount was larger to avoid provisions for interest holding costs based on a rate lower than that used by the entity to capitalize interest on the property.

Bank Audit Guide and Practice in the Banking Industry

20. The proposed revision of the bank audit guide states that generally accepted accounting principles require that a bank maintain a reasonable allowance for loan losses applicable to all categories of loans through periodic charges to operating expenses. The guide states that, if it is probable that a loan will be foreclosed, an allowance for loss based on fair value should be established. For loans whose terms are modified in a troubled debt restructuring with no assets transferred or equity interest granted, the guided states that no allowance for loss is required, unless the carrying amount of the loans exceeds the total future cash payments specified by the new

terms. The guide has no separate provisions for accounting for allowancess for losses on loans and receivables collateralized by real estate.

21. The provisions of the guide are said to be consistent with longstanding practices in the industry and the nature of lending activity in the industry. In current practice, banks evaluate the carrying value of loans collateralized by real estate in their periodic evaluation of their loan portfolios and the adequacy of the related allowances for loan losses. Bank portfolios are usually substantially diversified by types of loans, industry exposure, types of collateral, and other risk considerations. Furthermore, in most instances, loans collateralized by real estate -- other than those collateralized by single family houses or multiple family dwellings with a limited number of units -- constitute a relatively small portion of a bank's overall portfolio. In their real estate lending activities, banks evaluate the financial condition of borrowers as well as the specific assets from which they may be forced to seek recovery of loan principal and, under traditional real estate lending arrangements, have, from the outset of a loan, the right to force a refinancing or outright liquidation of the collateral if the borrower defaults.

22. Banks traditionally have provided allowances for loan losses on their total portfolios based on the identified

exposure as well as the unidentified risks inherent in the overall portfolios. Credit policies and practices take into consideration the diversification of the total portfolio and the relative ability of a particular bank to service all types of loans, including the ability to carry troubled loans until ultimate realization of the principal amount of the loan. Those policies and practices are said to be designed to spread the lending risk and to maintain an interest margin sufficient to provide a reasonable yield on the overall portfolio. By structuring assets and liabilities so that noninterest or low interest earning assets are supported by higher interest earning assets, by low cost funds or by funds on which no interest is paid, a bank's management expects to obtain a reasonable net positive yield at any given point in time. As a reflection of this philosophy, an increasing number of banks are presenting in their income statements, interest income net of the provision for possible loan losses.

23. Bank management considers troubled loans collateralized by real estate and the expected future cash flow from such loans in its evaluation. For example, for collateralized loans for which the source of repayment depends principally on the realization of the underlying collateral, management considers the likelihood that cash flow will be sufficient to repay fully the principal and interest. The evaluation of the aggregate cash flow on a nondiscounted basis may require an allowanced for loan losses or

a reversal of accrued interest by the lender if it is determined that the cash flow will be insufficient to repay the recorded investment in the receivable or may require the classification of a loan as "nonaccrual" if only the collection of future interest is doubtful. However, classification of a loan as "nonaccrual" does not require that any portion of the allowance for loan losses be allocated to such a loan if management considers the recorded investment in the receivable to be fully collectible.

24. The ability of management to estimate the potential losses on individual loans and past loan loss experience are only two of the factors considered in evaluating the overall adequacy of the allowance for loan losses. Management also considers other relevant factors that have a bearing on the adequacy of the allowance for loan losses. Also, many banks allocate a portion of their allowances to cover specifically identified risks in their loan portfolios and the remainder, which is often material to the total allowance, to cover inherent risks in their portfolios that are not specifically identified.

Summary and Comparison of Current Requirements

25. The table on the following page presents a summary and comparison of the bases for determining allowances for losses on loans collateralized by real estate and real estate acquired by foreclosure under SOP 75-2 as amended, the Audit and Accounting

COMPARISON OF ACCOUNTING TREATMENT FOR DETERMINING ALLOWANCES FOR LOSSES UNDER AICPA DOCUMENTS

	SOP 75-2 As Amended	S & L Audit Guide	Proposed SOP on Allowances for Losses
A. Allowancess for losses on troubled real estate loans			
No Restructuring	NRV-CC	NRV-CC	NRV-CC
Foreclosure probable	FMV	FMV	FMV
Modification probable	NRV-CC	Not covered	NRV-CC
At date of modification	NRV-CC (1)	NRV-CC	NRV-CC
After modification	NRV-CC (1)	NRV-CC	NRV-CC
B. Allowances for losses on real estate			
Acquired in foreclosure	NRV-CC	NRV-CC	NRV-CC
Other specified real estate	Not covered	Not covered	NRV-CC

(1) Treatment is not specifically required but can be inferred from overall conclusion of document.

NOTE: No position is stated in the proposed Bank Audit Guide on any of these issues pending resolution of the issues addressed in this paper.

Guide for Savings and Loans Associations, and the proposed SOP on accounting for allowances for losses. As indicated in paragraphs 11 to 13 of this paper, FASB Statement No. 15 governs accounting for troubled debt restructurings and all of the AICPA documents conform to those requirements. Thus the recorded investment in a loan involved in a troubled debt restructuring is as follows:

- If the restructuring involves a foreclosure, the recorded investment is the fair market value of the asset acquired or to be acquired.
- If the restructuring involves a modification of terms, the recorded investment before the allowance for loss is the lower of the recorded amount before the restructuring and the total cash to be received on the restructured loan.

Definitions

26. Terms used in this paper are defined as follows:

- Troubled Real Estate Loans. Troubled real estate loans are loans and receivables collateralized by real estate in circumstances in which a borrower

has been unable to meet his obligations or in which conditions indicate that it is probable that the borrower will not be able to meet his obligations. Conditions such as those described in paragraph 16 of this paper are indications of a troubled real estate loan. In a troubled loan situation, a creditor usually looks to the specific collateral as the primary source of recovery of principal and interest.

- Estimated Net Realizable Value. Estimated net realizable value is the estimated selling price a property will bring in the open market, allowing a reasonable time to find a purchaser, plus other estimated revenues from the property during the holding period, reduced by the items described in paragraph 18 of this paper.

- Fair Market Value. Fair market value, as defined in FASB Statement No. 15, is the amount an entity could reasonably expect to receive in a current sale between a willing seller and a willing buyer in a transaction that is other than a forced or liquidation sale.

- Net Realizable Value -- Cost of Capital (NRV-CC). Net realizable value -- cost of capital is estimated net realizable value as defined with estimated interest holding cost determined using the entity's average cost of capital (as defined in paragraph 19 of this paper).
- Net Realizable Value -- Risk Rate of Return (NRV-RR). Net realizable value -- risk rate of return is estimated net realizable value as defined with interest holding cost determined on the basis of a risk rate of return.
- Average Cost of Capital. The average cost of capital is the interest rate determined by dividing an entity's debt interest costs by the aggregate of equity and debt capital (as defined in SOP 75-2 and as discussed in paragraph 19 of this paper).
- Risk Rate of Return. The risk rate of return is the currrent market rate for comparable risks.
- Troubled Debt Restructuring. A troubled debt restructuring is a restructuring as defined in FASB Statement No. 15 (see paragraph 11 of this paper).

- Probable. The term probable is used in this paper as defined in FASB Statement No. 5.
- Recorded Investment in a Receivable. Recorded investment in a receivable, as defined in FASB Statement No. 15, represents the face amount of the receivable increased or decreased by applicable accrued interest and unamortized premiums, discount, finance charges, or acquisition costs. It may also, reflect a previous write down of the investment.

Issues Relating to Troubled Loans

Method Followed

27. Entitles that provide allowances for losses on troubled real estate loans usually use one of the following methods.

- Systematic Provisions. The provision for losses is determined in a manner intended to result in systematic charges to income on a consistent basis. The provisions may be based, for example, on a moving average of prior losses or on a percentage of income or it may be the amount required to arrive at an allowance that represents a certain percentage of the amounts invested.
- Individual Evaluation. The provisions for losses is the amount required to create an allowance based on an evaluation of the individual investments.

- Combined Method. The provision for losses is comprised of specific amounts for at least major real estate properties and loans, increased by an amount that generally represents a percentage of the amounts invested.

28. REITs and S&Ls are now required to use the individual evaluation method. The AcSEC proposed SOP recommends the individual evaluation method. An issue is whether the individual evaluation method should be required for all financial institutions and in all circumstances. The arguments for and against the method are covered in the discussion of other issues.

Estimated Net Realizable Value of the Collateral

29. A threshold issue is: Should the allowance for losses on troubled real estate loans be based primarily on the evaluation of the estimated net realizable value of the collateral? Some believe that the recoverability of the creditor's investment in the loan depends primarily on the disposition of the collateral. Paragraph 15 of the AICPA Industry Accounting Guide "Accounting for Profit Recognition on Sales of Real Estate," states

> A real estate sale differs from most business transactions because a significant portion of the consideration is often a note or other receivable collectible over

> a relatively long period, and the receivable is normally not supported by the full faith and credit of the buyer. Thus, often the only recourse of the seller on default by the buyer is to recover the property sold. For legal and business reasons, sellers usually limit themselves to foreclosure to remedy defaults, even if the terms of the agreements provide for full recourse against the buyers.

That view clearly implies that the creditor in a troubled real estate loan situation must look almost exclusively to the collateral.

30. Arguments presented in SOP 75-2 and in AcSEC proposed SOP on loss allowances are as follows:

> When it appears that an original borrower will be unable to make the payments required by the terms of his loan, a creditor has several alternatives. It can place the loan in a "work-out" status with the expectation that the effect of the loan on the creditor's financial position will be improved through careful monitoring of the borrower's activities coupled with continued advances on the loan when necessary. It may renegotiate the terms of the loan with the original borrower with the hope that more liberal lending terms will result in at least partial recovery of principal and interest. It may search for another borrower to assume management of the real estate collateralizing the loan and to assume responsibility for the loan. It may initiate foreclosure proceedings or accept a deed in lieu of foreclosure to obtain title to the property collateralizing the loan.
>
> Foreclosure proceedings, which depend on the jurisdiction where property is located and the complexity of the borrower's financial arrangements, may be time consuming. However, once the property has been foreclosed, the entity has two alternative courses of action: to dispose of the property or to hold it for investment. In either case, the entity may have to invest additional money to bring the property to salable or income-producing condition.

31. Some believe that the holder of a troubled real estate loan remains essentially a creditor and that the loan should continue to be evaluated on the basis of its collectibility. They also argue that the conclusions in FASB Statement No. 15 on troubled debt restructurings support their view. They point out that the creditor-debtor relationship is clearly supported by the conclusions in FASB Statement No. 15 on troubled debt restructurings involving a modification of terms.

32. They argue that following the principles set forth in FASB Statement No. 15, in the absence of a transaction or an exchange of assets or equity interests between the debtor and creditor, no write down of the receivables would be required if the recorded investment in the receivable at the date of debt restructuring is expected to be fully collectible from future cash flow. Since no transaction has occurred and no asset has been received, creditors having troubled loans collateralized by real estate continue to be creditors and do not own the real estate collateral. To evaluate such loans on the basis of ownership of real property when the creditor-debtor relationship still exists is at variance with the spirit and concepts of FASB Statement No. 15. Paragraph 145 of that statement clearly delineates the basic concept:

> The Board concluded that since a troubled debt restructuring involving modification of terms of debt does not involve transfers of resources or obligations, restructured debt should continue to be accounted for in the existing accounting framework on the basis of the recorded investment in the receivable.

33. Those who believe that the evaluation should not be restricted to the collateral believe that the conclusion in FASB Statement No. 15 regarding the attributes to be measured when debt is restructured has direct implications for the measurement of asset impairment by the creditor before the restructuring because the attributes available for measurement at the date of restructuring probably are identical to those available during the period between the date a receivable is acquired and the date of restructuring. Accordingly, for a troubled debt restructuring involving a modification of terms, the appropriate attribute to be measured in determining an allowance for loan losses is the total future cash receipts with loss limited to circumstances in which total future cash receipts are less than the recorded investment.

34. They believe that, if no transaction has occurred, the basis of accounting for loans should not change under generally accepted accounting principles. In support of that view they cite the following from FASB Statement No. 15.

> A creditor holds a receivable with the expectation that the future cash receipts, both those designated as interest and those designated as face amount, specified by the terms of the agreement will provide a return of the creditor's investment in that receivable and a return on the investment (interest income). (Paragraph 106)
>
> The difference between the amount a creditor invests in a receivable and the amount it receives from the debtor's payments of interest

> and face amount is the return on the investment (interest income) for the entire period the receivable is held. (Paragraph 108)

They believe that those concepts are basically consistent with the accounting used by banks for loans and related allowances for loan losses and that to change the existing practice on a piecemeal basis for troubled loans collateralized by real estate would violate those concepts.

Interest Holding Cost

35. If allowances are to be based on the estimated net realizable value of the collateral, the most significant issue is: Should a factor for interest holding cost be reflected in the determination of estimated net realizable value?

Arguments against including interest holding cost

36. Some do not believe that interest holding costs should be considered in the determination of estimated net realizable value. They point out that, with limited exceptions, interest has been traditionally considered a period cost. They believe that the issue is part of the broader issue of recognition of the cost of capital and that it is inappropriate to reach a conclusion on that issue until the broader issue has been resolved. They therefore believe interest holding cost is a cost of future periods and should only be recognized in those periods. They contend that providing for future interst costs in valuation allowances merely shifts the cost from future years to the present. They believe that reflecting interest holding costs in loan loss allowances is inconsistent with the purpose of such allowances, which is to measure the ex-

tent to which the principal may not be collected. They believe that interest expense represents a charge for the use of economic resources over a period of time and normally should be considered a period cost rather than a capital expenditure.

37. Moreover, some believe that including interest holding cost abandons the historical cost basis of accounting and introduces a form of current value accounting. They also believe that such a departure from historical cost should not be made until the FASB has completed its project on the conceptual framework for financial accounting and reporting. The application of the interest-cost-to-carry concept, they maintain, could result in the recognition of unrealized gains (losses) merely because of changes in the average interest cost to carry from one period to another, thereby resulting in changes in carrying amounts that do not represent changes in either historical cost or current value.

38. In addition, some proponents of the view that interest cost should not be included as a holding cost in the evaluation of loans believe that such a practice would result in an unacceptable volatility of earnings. They argue that generally accepted accounting principles require that the adequacy of allowances for loan losses be reevaluated at least as frequently as financial statements are issued to the public, typically on a quarterly basis. Accordingly, under the interest-cost-to-carry concept, there would

be a need to reestimate at those dates the current average interest cost to carry as well as the length of the holding period. The mechanical application of this process, given merely the passage of time, will usually result in a lower allowance for loan losses and could increase the potential for periodic earnings fluctuations similar in nature to those resulting from the application of FASB Statement No. 8, "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," which is currently being reexamined by the FASB.

39. They argue further that another difficulty in the practical application of an interest-cost-to-carry factor is the problem of estimating the holding period for the development and sale of real estate held as collateral for a loan. Different lenders to the same debtor may have significantly different judgments as to the required holding period dependent on many circumstances, including the degree of conservatism exercised by the management of each lender and management's intent to sell the real estate, thereby making consistent treatment and comparability of results impractical if not impossible.

40. Some of those who believe that interest holding cost should not be considered in determining allowances for losses

on troubled real estate loans believe that the existing practices of each of the various types of lenders -- such as REITs, S&Ls, and banks -- on real estate should be the controlling factor in determining the need for each type of lender to consider interest holding cost. The AICPA Banking Committee is among those who strongly believe that interest holding cost should not be considered in determining loss allowances on troubled real estate loans held by banks. That committee argues (see paragraphs 22 to 24 of this paper) that banks, unlike REITs, S&Ls, and other lenders, have traditionally provided loss allowances on their total portfolios based on the identified exposure as well as the unidentified risks inherent in the overall portfolios. The committee contends that in its lending activities a bank's objective is to obtain a reasonable <u>net</u> positive yield at any given point in time and that current and traditional practices of banks are designed to achieve that objective.

41. The AICPA Banking Committee also argues that banks should not have to consider interest holding cost in providing loss allowances on troubled real estate loans merely to achieve consistency of practice among banks, REITs, S&Ls, and other lenders (see the discussion of consistency in paragraphs 53 to 58 of this paper). The committee argues that conforming the practices of various types of lenders is unnecessary. It believes that conformity accross industries

is not desirable when it would result in a single entity treating essentially similar transactions differently and that requiring banks to account for troubled real estate loans on a basis different from the basis they use for other types of loans is not supportable.

Arguments for including interest holding cost

42. On the other hand, some believe that, in the real estate industry, interest is clearly an economic cost of holding property and that all holding costs, including interest should be reflected in determining allowances for losses. Consistent with that view, they argue that FASB Statement No. 5, "Accounting for Contingencies," suggests that the future costs of holding troubled loans should be recognized as soon as they are both probable and estimable. They contend that interest is no different from any other holding costs and that all holding costs should be recognized in evaluating underlying collateral. For example, when evaluating real estate inventory that will be held for an extended period, interest costs are sometimes considered applicable in determining the estimated net realizable value of the inventory. Furthermore, they believe that including interest cost in the determination recognizes substance over form; the results are that losses are recorded in the period in which they occur and future periods are relieved of costs that will not be recovered from sale proceeds.

43. Some proponents of this view point to the recent FASB exposure draft on "Capitalization of Interest Cost" as additional support for their view. They point out that the

proposed statement of financial accounting standards effectively establishes that interest is a cost similar to other development costs and should be capitalized or allocated as part of the asset cost in certain instances. The concepts expressed in the exposure draft are supportive of and consistent with the use of interest as a cost to carry in determining estimated net realizable value. Accordingly, the proponents of this view believe that if interest cost is a legitimate item for capitalization in establishing cost of a real estate asset, it likewise should be included in holding costs in the determination of estimated net realizable value of collateral for troubled loans collateralized by real estate.

44. Some who support the view that interest holding cost should be considered believe that the answer depends on the answer to the threshold question (see the discussion in paragraphs 29 to 34 of this paper) of whether the loss allowance should be based primarily on the evaluation of the estimated net realizable value of the collateral. They argue that if the real estate collateral is viewed as the only source of recovery of a lender's investment in a troubled real estate loan, interest holding cost is an essential element in the evaluation.

45. Moreover, those who would include interest holding cost in the evaluation of troubled loans dispute the contention that to do so is to shift from the historical

cost framework of accounting to a form of current value accounting. In their view, reflecting interest holding cost in the evaluation does not result in a form of current value accounting because it does not require a current market yield; it results in a change in loan value reflecting only changes in the estimate of carrying costs. They point out that if taxes or any other holding costs on a property increase dramatically, an adjustment of holding costs and estimated net realizable value to reflect those economic changes does not constitute current value accounting. They contend that interest holding costs for a parcel of real estate is no different from other holding costs that change over time.

46. Some of those who advocate the inclusion of interest holding cost in the evaluation of troubled loans also dispute the contention that the practice would lead to an unacceptable volatility of earnings. The argument that the practice will involve estimates that will change over time is not a compelling argument against the practice because estimates are essential to the overall accounting process. Furthermore, they believe that periodic changes in the estimated interest rate and the holding period for real estate held as collateral for troubled loans will not result in significant earnings fluctuation.

Rate Used in Determining Interest Holding Costs

47. If interest holding cost is to be included in the

evaluation of troubled loans, another significant issue is: Should interest holding costs be determined on the basis of a risk rate or on an entity's average cost of capital? Those who believe that interest is a holding cost that should be reflected in the evaluation have suggested several alternatives for calculating the amount to be included. Among the alternatives suggested are the following:

- Interest based on current market interest rates plus a provision for investor profit.
- Interest based on current market interest rates.
- Interest based on the specific cost of money associated with a project.
- Interest determined either on the basis of incremental interest rates, average interest rates on all debt, or average cost of money on all debt (including obligations to depositors), or average cost of money on all debt and stockholders' equity (average cost of capital).
- Interest based on the economic concept of cost of capital.

For the purpose of this paper the alternatives considered are limited to the risk or market rate and the entity's average cost of capital, because those are the alternatives advocated in the existing and proposed AICPA SOPs and audit guides.

48. SOP 75-2 as amended, the S&L guide, and the proposed AcSEC SOP on loan loss allowances advocate the use of an entity's average cost of capital with the objective of using rates that would, in light of existing agreements, correspond with the constant effective rates to be used for accruing interest on debt during the estimated holding period of the property. Supporters of this view believe that interest holding costs should be based on what the holder of the property anticipates incurring during the holding period.

49. Those who believe that a risk or market rate should be used believe that using an entity's cost of capital results in valuing an asset differently depending on (a) the credit standing of the entity and the resultant interest rate required to be paid on debt and (b) the entity's capital structure, the mix of debt and equity. They believe that net realizable value should be determined by looking only to the real estate and the market considerations related to the real estate. In their view, estimated net realizable value should be the same for all entities whose uses of the assets are the same; net realizable value should not be affected by which entity owns the asset or how that entity is capitalized.

Circumstances Requiring Loss Allowances

50. The following questions relate to circumstances in which loss allowances should be required. Since different answers may be appropriate for different circumstances, the

following questions should be addressed.

a. What should be the basis for determining the allowance for losses when a troubled debt restructuring is not anticipated?

b. What should be basis for determining the allowance for losses when a troubled debt restructuring involving a modification of terms is probable?

c. What should be the basis for determining the allowance for losses at the time of a restructuring involving a modification of terms.

d. What should be the basis for determining the allowance for losses after a restructuring involving a modification of terms has occurred?

51. In response to each of the questions in paragraph 50, some argue that the allowance for losses should be based on the loss, if any, determined under the provisions of FASB Statement No. 15. They believe that paragraphs 30 and 35 of that Statement support their view.

52. Others argue that determining the appropriate basis for determining an allowance for losses is a separate question not dealt with in FASB Statement No. 15. They cite paragraph 59 and 60 of that Statement in support of their view (see paragraph 13 of this paper).

Consistency among Industries

53. A collateral issue that should be addressed is: Should all industries engaged in real estate lending establish allowances on the same basis?

54. Some believe that the economic factors that affect the risk of loss on real estate transcend the nature of entities holding loans and foreclosed properties. Although entities that hold loans and other receivables collateralized by real estate vary in their nature and characteristics, generally each entity looks primarily to the real estate to measure the ultimate recoverability. They believe that the valuation of troubled loans and the accounting for those measurements should reflect that economic reality.

55. Some proponents of that view argue for consistency in accounting for loan losses across industries. They believe that a compelling argument can be made for consistency in the accounting treatment and valuation of troubled loans collateralized by real estate by all types of lenders. They believe that the accounting currently followed by REITs and S&Ls should establish industry precedence, since they are significant lenders to the real estate industry, and that there is no justification for other lenders to the real estate industry, such as banks, to carry such loans on a different basis merely because real estate is a less

significant portion of their overall loan portfolio.

56. Some proponents of that view reject the argument advanced by some that differences in capitalization and funding, for example, between banks and other financial institutions, make consistency undesirable. They point out that there are also differences in capitalization and funding among REITs and S&Ls. They stress that interest carrying costs will be determined on the specific capital and debt structure of the entity involved, producing the cost to carry appropriate to that specific institution's capital and debt structure, which they view as the desired accounting result. Proponents of this view believe that segmenting the evaluation of the allowance on loan losses is appropriate because it provides a rational, objective method of arriving at a reasonable allowance. The approach, they contend, is no different from employing separate statistical methods in developing those portions of the allowance applicable to consumer installment loans. Under their approach management is still able to evaluate the overall adequacy of the allowance for loan losses, considering all relevant factors.

57. Conversely, some believe that conformity for conformity's sake is not desirable when conformity results in dissimilar presentation of similar transactions within a particular entity.

They believe that there is no supportable basis for segmenting the accounting for loans within a single entity. In support of their view, they argue that banks and some other financial institutions have substantially diversified loan portfolios while real estate investment trusts lend only to the real estate industry and savings and loan associations have a substantial portion of their assets invested in real estate lending. They argue that, as history has shown, when problems developed in the real estate industry, real estate investment trusts, in general, were forced to liquidate their portfolios. On the other hand, banks and others with diversified portfolios were able to carry their troubled real estate loans and maintain a positive yield on their overall portfolios. Furthermore, they contend that banks have significant equity positions and noninterest bearing sources of funds, such as demand deposits, in addition to various diversified sources of borrowings to support their overall asset mix and that, conversely, other financial institutions do not have access to demand deposits and, generally, have less of a variety of funding sources.

58. They recognize, however, that in some instances, a bank may be suffering from financial difficulty and, thus, may not have the capability to work out troubled loans, including those secured by real estate. They agree that in

those circumstances an argument could be made that the bank may not be a going concern and that the accounting valuation of the bank's overall portfolio should reflect those circumstances. Nonetheless, they contend that there does not seem to be any basis for treating the bank's loans collateralized by real estate differently than the bank's other collateralized loans.

Issues Relating to Real Estate

59. In addressing the issues relating to allowances for losses on troubled real estate loans, similar allowancess on real estate owned directly should be considered and similar questions should be addressed. AcSEC's proposed SOP on allowances for losses recommends allowances based on estimated net realizable value for real estate acquired by foreclosure and for other specified real estate holdings of real estate developers and others (see "covered real estate," paragraph 17 of this paper).

60. Real estate acquired by foreclosure is treated the same as a troubled real estate debt. When a creditor acquires real estate by foreclosure, it is generally deemed to be held in lieu of the debt with the ultimate objective of disposing of the property to recoup, to the extent possible, all or a portion of the debt. Other specified real estate is limited to real estate held for sale or for development and sale on the grounds that it is similar to inventory. The proposed SOP excludes from consideration real estate that involves the broader question of when the value of long-lived assets should be considered to be impaired.

61. The questions, which should be addressed in light of the conclusions on the basic issues relating to troubled debt, are:

a. Should allowances for losses be provided to reduce real estate acquired by foreclosure to its estimated net realizable value?

b. Should similar allowances be provided for real estate held for sale or for development and sale?

c. Should an allowance to reduce the carrying amount to estimated net realizable value be deemed to establish a new cost basis or should the allowance be subsequently reduced to reflect an increase in estimated net realizable value to an amount that does not exceed the original acquisition cost?

d. Should similar allowances be provided for any other types of real estate investments.

The considerations and the pro and con arguments for allowances based on estimated net realizable value are the same as those presented in the discussion of troubled real estate loans.

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Advisory Conclusions

62. The Accounting Standards Executive Committee believes that interest holding cost based on the average cost of capital should be included in the evaluation of troubled real estate loans and in the calculation of allowances for losses on such loans including such loans held by banks. However, the AICPA Banking Committee unanimously supports the view that allowances for losses on troubled real estate loans held by banks should be based on an evaluation of individual loans without considering interest holding cost.