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Accounting by participating mortgage loan borrowers; Statement of position 97-1;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

STATEMENT OF POSITION 97-1

AICPA

American Institute of Certified Public Accountants

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Accounting by Participating Mortgage Loan Borrowers

Issued by the
Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) establishes the borrower's accounting for a participating mortgage loan if the lender participates in increases in the market value of the mortgaged real estate project, the results of operations of that mortgaged real estate project, or both. It requires the following.

- At origination, if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the borrower should determine the fair value of the participation feature and should recognize a participation liability for that amount, with a corresponding debit to a debt-discount account. The debt discount should be amortized by the interest method, using the effective interest rate.
- At the end of each reporting period, the balance of the participation liability should be adjusted to equal the fair value of the participation feature at that time. The corresponding debit or credit should be to the related debt-discount account. The revised debt discount should be amortized prospectively, using the effective interest rate.
- Certain disclosures must be made in the financial statements.

This SOP is effective for financial statements issued for fiscal years beginning after June 30, 1997. Earlier application is encouraged. The effect of initially applying this SOP should be reported in a manner similar to that of the cumulative effect of a change in accounting principle.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Accounting by Participating Mortgage Loan Borrowers

Scope

1. This Statement of Position (SOP) establishes the borrower's accounting for a participating mortgage loan if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the results of operations of the mortgaged real estate project, or in both. This SOP applies to all borrowers in participating mortgage loan arrangements.

2. This SOP does not apply to participating leases, debt convertible at the option of the lender into equity ownership of the property, or participating loans resulting from troubled debt restructurings[1]. It also does not apply to creditors in participating mortgage loan arrangements.

Background

3. Through the 1960s, most loans collateralized by real estate projects had fixed interest rates and long-term payment periods with full amortization of principal. Thereafter, loans with variable features, such as adjustable interest rates and variable payments, began to emerge. The desire for instruments in which the return to the lenders was tied more closely to the performance of the property led to the introduction of participating mortgage loans.

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[1]Accounting for leases is addressed in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*. Accounting for debt convertible at the option of the lender into equity ownership of the property is addressed in Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Participating loans originating from troubled debt restructurings should be accounted for in conformity with FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

4. Participating mortgage loans and nonparticipating mortgage loans share the following characteristics:

- Debtor-creditor relationships between those who provide initial cash outlays and hold the mortgages, and those who are obligated to make subsequent payments to the mortgage holders
- Real estate collateral
- Periodic fixed-rate or floating-rate interest payments
- Fixed maturity dates for stated principal amounts

5. However, unlike a nonparticipating mortgage loan arrangement, in a participating mortgage loan, the lender participates in appreciation in the market value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or in both. The terms and economics of participating mortgage loan agreements vary by agreement. The terms and economics of one agreement may create a circumstance in which any participation payment is remote. In another agreement, the terms and economics may transfer many of the risks and rewards of property ownership.

6. A lender may be entitled to participate in appreciation in the market value of a project either upon the sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. In agreements in which lenders participate in results of operations, the definition of the results of operations may vary among agreements. Examples of these definitions include but are not limited to revenue, income, or cash flows before or after debt service.

7. The participation terms of a participating mortgage loan agreement usually are negotiated concurrently with the other terms of the underlying mortgage loan. A borrower agrees to participation rights generally because of market conditions, or in exchange for concessions granted by the lender on some other term(s) of the loan, such as a lower interest rate or a higher loan-to-value ratio.

8. The lender's participation reduces the borrower's potential realization of operating results or gain on the sale of the real estate. However, the participation also may reduce the following:

- The contract interest the borrower is required to pay

- The risk that the borrower will be unable to pay interest at the stated or floating rate in the loan agreement and, consequently, the risk that the borrower will default on the loan and need to sell the property
- The amount of capital the borrower has at risk, because the loan-to-value ratio normally is higher

Further, the obligation to pay the lender a share of the property appreciation does not increase the current exposure of the borrower to loss in its investment, because the participation payments are made only if the market value of the property appreciates.

9. In Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 86-28, *Accounting Implications of Indexed Debt Instruments,* the EITF considered indexed debt instruments, including participating mortgage obligations. The consensus indicates that the borrower's obligation under a participating mortgage to pay the lender a share of unrealized property appreciation should be recognized as a liability immediately when the property appreciates. A consensus was not reached, however, on how to account for the corresponding charge. In order to enhance consistency in practice, this SOP provides additional guidance that specifically addresses the borrower's accounting for participating mortgage loans.

Conclusions

At Origination

10. If the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the borrower should determine the fair value of the participation feature at the inception of the loan. The borrower should recognize a participation liability for that amount, with a corresponding debit to a debt discount account. The debt discount should be amortized by the interest method, using the effective interest rate.

Interest Expense

11. Interest expense on participating mortgage loans consists of the following three components:

a. Amounts designated in the mortgage agreement as interest

b. Amounts related to the lender's participation in results of operations

c. Amortization of debt discount related to the lender's participation in the market value appreciation of the mortgaged real estate project.

Amounts Designated in the Mortgage Agreement as Interest

12. Amounts designated in the mortgage agreement as interest should be charged to income in the period that the interest is incurred. If the loan's stated interest rate varies based on changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate, or the United States Treasury bill weekly average rate), the calculation of the interest should be based on the factor (the index or the rate) as it changes over the life of the loan.

Amounts Related to the Lender's Participation in the Results of the Operations of the Mortgaged Real Estate Project

13. Amounts due to a lender pursuant to the lender's participation in the real estate project's results of operations (as defined in the participating mortgage loan agreement) should be charged to interest expense in the borrower's corresponding financial reporting period, with a corresponding credit to the participation liability.

Amounts Related to the Lender's Participation in the Market Value Appreciation of the Mortgaged Real Estate Project

14. As discussed in paragraph 10 of this SOP, if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, at the inception of the loan the borrower should establish a participation liability equal to the fair value of the participation feature. The corresponding debit should be to a debt-discount account and should be amortized by the interest method over the life of the loan, using the effective interest rate. This amortization should be included in interest expense.[2]

[2] Interest recognized pursuant to this SOP is subject to the requirements of FASB Statement No. 34, *Capitalization of Interest Costs.* Once capitalized, amounts should not be adjusted for the effects of reversals of appreciation.

Accounting for a Participation in Appreciation Subsequent to Inception of the Loan

15. At the end of each reporting period, the balance of the participation liability should be adjusted to equal the current fair value of the participation feature. The corresponding debit or credit should be to the related debt-discount account. The revised debt discount should be amortized prospectively, using the effective interest rate.

Extinguishment of Participating Mortgage Loans

16. If the participating mortgage loan is extinguished prior to its due date, the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt is a debt extinguishment gain or loss that should be reported as required by FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt.*

Disclosures

17. The borrower's financial statements should disclose the following:

- The aggregate amount of participating mortgage obligations at the balance-sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts
- Terms of the participations by the lender in either the appreciation in the market value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both

Effective Date and Transition

18. This SOP is effective for financial statements issued for fiscal years beginning after June 30, 1997, and for financial statements for interim periods in such years. The effect of the initial application of the provisions of this SOP should be reported as a cumulative effect of a change in accounting principle. Presentation of pro forma effects of retroactive application is not required. Restatement of previously issued annual financial statements is not permitted.

19. Early adoption is encouraged but not required. If a decision is made to adopt the provisions of this SOP in a fiscal year beginning

on or before June 30, 1997, and the decision is made in other than the first interim period of the fiscal year, financial statements for previous interim periods of that year should be restated.

20. For participating loans with variable interest rates, the cumulative effect of adoption should be calculated using the interest rate in effect at inception of the participating mortgage loan. The initial interest rate should be treated as a fixed rate for purposes of this calculation.

The provisions of this Statement of Position need not be applied to immaterial items.

Basis for Conclusions

At Origination

21. In a participating mortgage loan arrangement, the lender generally grants certain concessions to the borrower in return for the right to participate in either the appreciation in the market value of the mortgaged real estate project or the operations of the mortgaged real estate project, or in both. A common concession is granting an interest rate lower than that which would have been included in a comparable nonparticipating mortgage loan. Another common concession is a higher loan-to-value ratio than would be allowed at the same interest rate in a loan that does not include the participation in appreciation. AcSEC believes that in participating loan arrangements, the borrower has received something of value (the lower interest rate) in exchange for something of value (the participation feature) and that such exchanges should be given accounting recognition.

22. Paragraph 11 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, states that "If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in paragraph 7." The participation feature included in the loan represents such a right. The participation feature has a market value separate from the loan agreement itself. In order to eliminate the participation feature while retaining the other terms of the mortgage

loan, the borrower would be required to make a payment to the lender equal to the market value of the participation feature.

23. The proposed accounting in the exposure draft that preceded this SOP would have required that borrowers record the loan at inception without allocating any of the proceeds to a liability related to the participation feature. AcSEC had been concerned about the ability to separately price the rights to participate in appreciation in value. AcSEC was informed by several respondents, however, that borrowers do have the ability to price these participation features separately. AcSEC, therefore, modified its original position to require that a separate liability for the participation in appreciation be recognized at inception and that liability should be measured at the fair value of the participation feature.

24. Also, because of the participation feature, the stated rate of interest on the loan is less than the market rate of interest. AcSEC believes that, in accordance with paragraph 7 of APB Opinion 21, a discount, equal in amount to the fair value of the participation feature, should be established for this difference. That discount should be amortized over the life of the loan.

25. Although AcSEC notes that a participation in the operations of a mortgaged property can be valued similarly, AcSEC believes that the cost of monitoring and updating the information needed to record and review the ongoing estimate of such a liability would exceed the benefits to be gained by reporting the liability. Consequently, AcSEC concluded that amounts due to a lender pursuant to a participation in operations of the mortgaged real estate should be included in interest expense in the borrower's corresponding financial reporting period.

Interest Expense

26. Paragraph 15 of APB Opinion 21 requires that the difference between the present value and the face amount of a note be treated as a discount or premium and be amortized over the life of the note in such a way as to result in a constant rate of interest when applied to the carrying amount at the beginning of any given period. Consequently, AcSEC concluded that requiring amortization of the

debt discount using the interest method is consistent with paragraph 15 of APB Opinion 21.

27. Additionally, as discussed in paragraph 25 of this SOP, AcSEC believes that the cost of monitoring and updating the information needed to record and review the fair value of a lender's participation in operations would exceed the benefits to be gained by adjusting the liability. Consequently, AcSEC concluded that amounts due to a lender pursuant to a participation in operations of the mortgaged real estate should be treated as interest expense in the borrower's corresponding financial reporting period and that they should be accounted for in a manner consistent with the accounting for amounts designated in the mortgage loan agreement as interest.

Accounting for a Participation in Appreciation Subsequent to Inception of the Loan

28. This SOP requires adjustment of the participation liability at each reporting date to its fair value. The exposure draft would have required the borrower to estimate at each balance sheet date the value on which the participation payment would have been based. For example, if the borrower would have been required to make a payment to the lender pursuant to the participation feature if the property were sold at the balance sheet date, the borrower would have been required to recognize a participation liability at the financial statement date equal to the estimated amount of the payment.

29. Each period, the participation liability would have been debited or credited, if necessary, to adjust the balance in the account to the amount that would have been paid to the lender if the property were sold at its then-estimated market value or if the mortgage loan matured or was refinanced at that date. The corresponding debit or credit would have been made to the related debt-discount account. When applying the interest method, the borrower would have been required to recalculate the effective interest rate to reflect the changes in expected future payments (exclusive of payments related to participations in operations) assuming that (*a*) the expected future payment pursuant to the participation feature was to be paid on the due date of the loan and (*b*) the recalculated expected future payment amount was known at the inception of the loan. The debt

discount related to the participation liability would have been adjusted to the amount that would have existed had the new effective interest rate been applied since the origination of the participating mortgage loan. In addition, a corresponding charge or credit to interest expense for this cumulative interest adjustment would have been required.

30. Several respondents to the exposure draft commented that the proposed accounting in the exposure draft was unnecessarily complex and would have been costly and burdensome to apply. These respondents also commented that the proposed annual cumulative catch-up adjustment would lead to volatility of earnings. These respondents stated that changes in residual-value estimates and their effect on interest rates were more analogous to modifications of interest rates of debt instruments, which are accounted for prospectively. AcSEC considered these comments and agreed that the accounting should be simplified.

31. This SOP does not require that the borrower's entire debt obligation (including the participation feature) be recorded at fair value. The underlying debt obligation should be recorded at amortized cost, while the participation feature should be recorded at fair value. AcSEC notes that recording debt obligations at fair value is not common practice. Therefore, AcSEC concluded that the underlying debt obligation should continue to be recorded on an amortized cost basis.

32. However, AcSEC believes that the amortized cost basis is not meaningful with respect to the participation feature. AcSEC believes that because the fair value of the participation feature represents the best estimate of the amount at which it could be settled, the participation feature should be recorded at its fair value.

33. AcSEC believes that requiring recognition in the current period of the entire amount of the change in the fair value of the participation feature would result in unnecessary volatility. AcSEC notes that the impact of factors that affect effective yields (for example, changes in interest rates) is commonly recognized prospectively. Therefore, AcSEC concluded that changes in the fair value of the participation feature should be amortized into income prospectively as adjustments to the effective yield.

34. AcSEC believes that this approach results in relevant and reliable reported information about the obligation, that it is broadly consistent with existing practices in accounting for liabilities, and that it alleviates respondents' concerns about complexity and costliness.

35. Other methods considered and rejected by AcSEC included (*a*) offsetting changes in the participation liability by changing the reported amount of the related asset, (*b*) requiring disclosure, but not recognition, of the lender's share in the appreciation, and (*c*) requiring adjustment of the participation liability balance to the amount that would have been paid to the lender if the property were sold at its estimated market value at the reporting date.

Increasing the Reported Amount of the Asset

36. AcSEC considered a method under which any change to the participation liability would have been offset by changes in the reported amount of the related asset. This method was proposed by several respondents to the exposure draft. These respondents noted that the change in value of the asset was the underlying and directly offsetting source of the change in the participation liability. They commented that it was troubling that the determination of the property's value is considered reliable enough to recognize and measure a potential obligation and a charge to operations in accordance with FASB Statement No. 5, *Accounting for Contingencies,* but is not reliable enough to recognize an increase in the value of the asset. AcSEC concluded that to use an asset to account for changes in the value of the property would be inconsistent with the historical cost model of accounting. Furthermore, AcSEC believes that amounts due pursuant to participation features represent additional interest on the participating mortgages. Therefore, AcSEC believes that the amount should be recognized as interest expense over the life of the loan. If the change in the participation liability had been offset by changing the reported amount of the related asset, that change would have been recognized through depreciation over the remaining depreciable life of the asset, which only coincidentally would match the remaining life of the loan.

Disclosure

37. Several respondents to the exposure draft recommended that AcSEC require only disclosure of the lender's share of the

appreciation in value of the property or properties. This position appeared to be linked to disagreement with the accounting proposed in the exposure draft. These respondents opposed recording a lender's share of the appreciation in value without recognizing a corresponding increase in the value of the asset. AcSEC considered these comments but notes that disclosure is not a substitute for recognition in financial statements for items that meet recognition criteria.

Disclosures

38. AcSEC believes that the disclosures required by this SOP are necessary to provide users with adequate information related to the financial position of borrowers in participating mortgage loan arrangements. AcSEC believes that, given the susceptibility of real estate to fluctuations in value, requiring disclosure of the terms of the participations provides users of financial statements with information that is helpful in assessing the risks facing participating mortgage loan borrowers.

Transition

39. AcSEC believes that the adoption of this SOP constitutes a change in accounting principle for which the advantages of retroactive treatment in prior-period financial statements do not outweigh the disadvantages, as discussed in paragraphs 27 to 30 of APB Opinion 20, *Accounting Changes.* Accordingly, AcSEC concluded that the effect of initial application of this SOP should be reported as a cumulative effect of a change in accounting principle.

APPENDIX

Illustration of a Participation in Appreciation

A-1. Assume that on January 1, 19X1, Borrower Co. purchased a property for $10 million. On that date, Borrower paid $1 million cash and entered into a participating mortgage loan agreement with Lender Co. in the amount of $9 million.

A-2. The loan agreement has the following terms:

- Fifteen-year term
- Interest-only periodic payments, principal to be repaid at end of term
- Five-percent stated interest rate
- Twenty-percent participation in appreciation in the value of the property above $10 million, payable at maturity (or earlier if the asset is sold or the loan is refinanced)

A-3. Assumptions related to the fair value of the participation feature are as follows:

Date	*Fair Value*	*Estimated Payment*	*Years in Future*
1/1/X1	$25,055	$300,000	15
12/31/X1	40,063	320,000	14
12/31/X2	54,122	333,000	13

A-4. Based on the preceding assumptions, Borrower Co. should make the following journal entries for this participating mortgage loan.

a. On January 1, 19X1, the following journal entries should be recorded:

Cash	$ 9,000,000	
Loan discount	25,055	
Mortgage loan payable		9,000,000
Participation liability		25,055

To record participating debt and estimate of participation liability (based on fair value of participation feature).

Property	$10,000,000	
Cash		10,000,000

To record purchase of property.

b. By the end of 19X1, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

Interest expense	$451,159	
Interest payable		450,000
Loan discount		1,159

To record interest expense and amortization of debt discount using the interest method and an effective rate of 5.03 percent (rounded).

Loan discount	$ 15,008	
Participation liability		15,008

To adjust balance of participation liability to fair value at end of period. The adjustment is calculated as follows:

Fair value at 12/31/X1	$ 40,063
Fair value at 1/1/X1	25,055
Adjustment	$ 15,008

Note: For purposes of this illustration, the fair value of the participation feature at 12/31/X1 is based on a revised estimate of the equity participation that would be payable in fourteen years of $320,000.

c. At the end of 19X2, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

Interest expense	$451,979	
Interest payable		450,000
Loan discount		1,979

To record interest expense and amortization of debt discount, using the interest method and an effective rate of 5.04 percent (rounded).

Loan discount	$ 14,059	
Participation liability		14,059

To adjust recorded participation liability of $40,063 to fair value at 12/31/X2 of $54,122.

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(1995–1996)

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