1978

Accounting practices of real estate investment trusts : proposal to Financial Accounting Standards Board to amend Statement of position 75-2; Statement of position 78-02;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position on

78-2

Accounting Practices of Real Estate Investment Trusts

May 12, 1978

Proposal to Financial Accounting Standards Board to Amend Statement of Position 75-2

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTE

Statements of position of the AICPA Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority 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 and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

May 12, 1978

Donald J. Kirk
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting Practices of Real Estate Investment Trusts, an Amendment of Statement of Position 75-2, was prepared on behalf of the division by the AICPA's Committee on Real Estate Accounting for consideration of the Financial Accounting Standards Board and for such action as the board deems appropriate. It amends Statement of Position 75-2 to conform the recommendations of that statement to the provisions of Statement of Financial Accounting Standards 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience. The division would appreciate being advised on the board's proposed action on the recommendations set forth in this statement of position.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

Accounting Standards Division

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Accounting Practices of Real Estate Investment Trusts

Introduction

The recommended accounting for real estate loans and foreclosed properties in Statement of Position (SOP) 75-2, *Accounting Practices of Real Estate Investment Trusts,* issued June 27, 1975, is inconsistent with certain provisions of Statement of Financial Accounting Standards 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* issued by the Financial Accounting Standards Board in June 1977.

In the section of SOP 75-2 entitled "Losses from Loans," the accounting standards division recommended that real estate investment trusts (REITs) 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 (as defined in the SOP) 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 division recommended that the net realizable value at the date of foreclosure should become the cost basis of a foreclosed property that an REIT elects to hold as a long-term investment.

FASB Statement 15 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 because 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. (See paragraphs 13, 14, 19, 20, 28, 29, 33, 34, 35, and 42 of that statement.) The fair value of a property as measured under FASB Statement 15 may differ materially from its net realizable value as measured under the recommendations on losses from loans in statement of position 75-2.

The accounting standards division believes that SOP 75-2 should be amended, as set forth below, to conform its recommendations to the provisions of FASB Statement 15.

The Division's Conclusions

The following footnote referenced to "foreclosed properties" in the first sentence of the sixth paragraph under the caption "Losses from Loans" is added to SOP 75-2.

[2] Statement of Financial Accounting Standards no. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* prescribes the accounting required for assets received or transferred in troubled debt restructurings consummated after December 31,

1977, with earlier application encouraged. The recommendations in this section, "Losses from Loans," concerning loans and properties have been amended in certain respects to conform with FASB Statement no. 15. (See "Assets Affected by Troubled Debt Restructurings.") The recommendations in this section continue to apply to foreclosed properties acquired before the effective date of FASB Statement no. 15 and for which earlier application of that Statement is not elected.

The following section, "Assets Affected by Troubled Debt Restructurings," is added to SOP 75-2 to follow immediately after the section "Losses from Loans."

Assets Affected by Troubled Debt Restructurings

Properties acquired by an REIT in a troubled debt restructuring and accounted for in accordance with FASB Statement 15 should be recorded as if they had been acquired for cash at their fair value, which becomes their cost basis for accounting purposes. Periodically thereafter the properties should be evaluated and allowances for losses should be provided in accordance with the recommendations on "Losses from Loans."

When it is probable that an REIT will enter into a troubled debt restructuring with one of its *debtors* that will result in a loss determined in accordance with the provisions of FASB Statement 15 in excess of the allowance, if any, provided in accordance with the recommendation on "Losses from Loans" in this statement, a provision should be made for the excess loss. Thereafter, until the restructuring occurs, the loan receivable should be periodically evaluated in a similar manner, and the allowance for losses should be adjusted at each evaluation date for changes in the estimated loss. In no event should the loan, less the allowance for loss, exceed its estimated net realizable value.

When it is probable that an REIT will enter into a troubled debt restructuring with one of its *creditors* that will result in a loss on transfer of an identified asset (determined in accordance with FASB Statement 15) in excess of the allowance, if any, provided in accordance with the recommendations on "Losses from Loans" in this statement, a provision should be made for the excess loss on the identified asset to be transferred net of the related gain, if reasonably determinable, on reduction of the payable that will result from the asset transfer. The accounting standards division believes that it is appropriate to include the effect of the gain in providing for the additional loss, because it is the asset transfer that produces both the loss on transfer and the gain on restructuring. The provision for the excess net loss should be reported as an expense in determining income before extraordinary items. After providing for the excess net loss, the allowance for losses will be an amount that reduces the carrying amount of the identified asset to be transferred to its estimated fair value, net of the related estimated gain (not in excess of the loss on the identified asset to be transferred) on the reduction of the payable that will result from the asset transfer. In no event, however, should the identified asset to be transferred, less the allowance for losses, exceed its estimated net realizable value. The notes to the REIT's financial statements should disclose the effect on the allowance for losses of the estimated gain on the payable to be restructured as described in the preceding sentence. Also, the note should state that, when realized, such gain will be reported as an extraordinary item with a corresponding charge to income before the extraordinary item.