1977

Proposed statement of position on accounting practices of real estate investment trusts : an amendment of position 75-2 ;Accounting practices of real estate investment trusts : an amendment of position 75-2

American Institute of Certified Public Accountants. Accounting Standards Division

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION ON ACCOUNTING PRACTICES OF REAL ESTATE INVESTMENT TRUSTS

AN AMENDMENT OF STATEMENT OF POSITION 75-2

DECEMBER 20, 1977

Issued by the Accounting Standards Division of the
American Institute of Certified Public Accountants
For Comment From Persons Interested in Accounting and Reporting

Comments should be received by January 20, 1978, and addressed to
Thomas W. McRae, Manager, Accounting Standards Division, File 4210D
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

AICPA

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

December 20, 1977

To Practice Offices of CPA Firms; Members of Council; Technical Committee Chairmen; State Society and Chapter Presidents, Directors, and Committee Chairmen; Organizations Concerned With Regulatory, Supervisory, or Other Public Disclosure of Financial Activities; Persons Who Have Requested Copies:

An exposure draft of a proposed statement of position entitled Accounting Practices of Real Estate Investment Trusts accompanies this letter.

Comments and suggestions on any aspect of the enclosed draft are sought and will be appreciated. They should be addressed to Thomas W. McRae, Manager, Accounting Standards Division, File Ref. No. 4210D, at the AICPA, by January 20, 1978. The Accounting Standards Executive Committee and the Real Estate Accounting Committee will be particularly interested in the reasoning underlying comments and suggestions.

Sincerely yours,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards
Executive Committee

Thomas W. McRae

Thomas W. McRae, Manager
Accounting Standards Division

PROPOSED STATEMENT OF POSITION ON ACCOUNTING PRACTICES OF REAL ESTATE INVESTMENT TRUSTS

INTRODUCTION

1. 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 (SFAS) no. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* issued by the Financial Accounting Standards Board in June 1977.

2. 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 values 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.

3. SFAS no. 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 SFAS no. 15 may differ materially from its net realizable value as measured under the recommendations on losses from loans in this statement of position.

4. The accounting standards division believes that SOP 75-2 should be amended, as set forth below, to conform its recommendations to the provisions of SFAS no. 15.

RECOMMENDATIONS

5. 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* (SFAS no. 15), 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 SFAS 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 SFAS no. 15.

6. 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

7. Properties acquired by an REIT in a troubled debt restructuring as defined in SFAS no. 15, consummated after December 31, 1977, 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 recommenda-

tions on "Losses from Loans."

8. In accordance with Statement of Financial Accounting Standards no. 5, *Accounting for Contingencies* (SFAS no. 5), 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 SFAS no. 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 net realizable value.

9. In accordance with SFAS no. 5, when it is probable 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 SFAS no. 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 the payable to be restructured. The 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 value 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 payable to be restructured; in no event should the identified asset to be transferred, less the allowance for losses, exceed its 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.

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, N. Y. 10036

Non-Profit Org.
U. S. POSTAGE
P A I D
New York, N. Y.
Permit No. 3681