1994

Comment letters on AcSEC's October 27, 1993 exposure draft, Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments

American Institute of Certified Public Accountants. Task Force on ADC Arrangements

AICPA

Post

INTERNAL MEMORANDUM

Date: May 13, 1994

To: Karen Neloms, Library

From: Richard Stuart, Accounting Standards File 3455

Subject: Comment letters

Enclosed are comment letters received on AcSEC's October 27, 1993 exposure draft, Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments.

The letters should be available for public inspection at the library until May 13, 1995.

Richard Stuart

Enclosure

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May 6, 1994

To the Accounting Standards
Executive Committee

File 3455

Enclosed are copies of comment letters received in response to the October 27, 1993 Exposure Draft of the Proposed Statement of Position Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments. Twenty two letters were received.

Based on review of the comment letters, the task force is recommending certain changes to the proposed SOP. The task force requests that you review the comment letters and consider the proposed changes listed below (minor wording changes have not been summarized here). These proposed changes are scheduled to be discussed at the June AcSEC meeting.

The recommended changes are as follows:

1. Paragraph 12

   This paragraph lists six criteria, one of which must be met in order for a real estate loan to be accounted for as a loan.

   The task force is recommending that an entity should be able to consider the criteria in the aggregate, rather than individually.

2. Paragraph 12(a)

   Paragraph 12(a) defines "substantial" in relationship to the minimum investment criteria in FASB Statement 66.

   The task force is recommending that the FASB Statement 66 guidance should be removed as a "bright line" criterion. Instead, the task force is proposing to include it in the discussion of conclusions as something the entity may wish to consider.

3. The task force would like to insert a condition that if the criteria in paragraph 12 are not met, there is a presumption that the entity has expected residual profit in the investment. The entity should have clear and convincing evidence that expected residual profit does not exist if it wishes to rebut this presumption.

Based upon the results of the June discussion, a revised draft will be submitted to AcSEC in July for clearance to issue.

Sincerely,

Richard Stuart

Richard Stuart, CPA
Technical Manager
Accounting Standards Division

Alex Arcady

Alex T. Arcady
Chairman
Task Force on ADC Arrangements

Attachments

cc: Task Force on ADC Arrangements

IDENTIFYING AND ACCOUNTING FOR REAL ESTATE LOANS THAT QUALIFY AS REAL ESTATE INVESTMENTS

Numbers beneath comments correspond to numbers assigned to individual comment letters.

Summary of comments opposing/supporting ED is intended to be objective. Letters that are silent concerning overall support are not reflected in summary of that issue.

General comments

1. Support/Opposition

Support SOP
4,6,11,12,13,14

Oppose SOP
1,5,7,8,10,15,16,18,19,20

Task force recommendation:

The task force notes that the majority of the criticisms of the ED related to the increased number of loans that would have qualified as investments. The task force has recommended changes that will reduce that number, and believes that the proposed accounting methodology remains correct.

2. Expected residual profit should not be eliminated as a criterion for determining whether investment accounting is appropriate.

1,2,5,8,10,15,16,20,21,22

Task Force recommendation:

The task force is recommending that reference to expected residual profit be re-inserted into paragraph 12. If name of the paragraph 12 criteria are met, there is a rebuttable presumption that expected residual profit exists.

3. Costs of applying SOP would exceed benefits.

1,5,7,8,10,15,18,19,20,21,22

Task Force recommendation:

The comments repeatedly cited three factors, which are discussed individually below:

a) The SOP would result in more loans being classified as investments, thereby increasing costs. The task force believes that the modifications that have been made to the ED (most notable the aggregation of the paragraph 12 criteria) alleviate this concern.

b) Access to information on projects is limited. The task force believes that in most instances where the investment is material to the entity, such information should be available already.

4. Allocation of depreciation to lenders is inappropriate.

1,8,16

Task Force recommendation:

Pass. The task force believes that in the hypothetical partnership setting, allocation of depreciation to lender (after capital account of borrower is reduced to zero) is appropriate.

5. Impairment accounting guidance may conflict with SFAS 114.

1,4,5,7,10,15,16,21

Task Force recommendation:

The majority of these comments asked which accounting guidance should be applied in event of impairment of a loan classified as an investment. The task force believes this is addressed in paragraph 8. Wording will be inserted in paragraph 21 that states that impairment of the investment in real estate should be accounted for in a manner similar to impairment of other investments.

6. Effective date should be delayed.

4,8,16

Task Force recommendation:

Agree. Delay to June 30, 1995.

Specific Comments

7. SFAS 66 criteria are not appropriate in determining whether borrower's investment is substantial (paragraph 12(a)).

1,5,18,22

Task Force recommendation:

The task force recommends that the SFAS 66 criteria be eliminated as a "bright line", but included as a suggestion for consideration when assessing whether borrower's investment is substantial.

8. The six criterion in paragraph 12 should be aggregated.

6,8,10,16,17,18

Task Force recommendation:

The task force recommends that the paragraph 12 criteria can be aggregated. This should decrease the number of loans that would have been required to be accounted for as investments under the ED.

9. SOP should apply to sales of real estate by the lender.

12, 17

Task Force recommends:

Disagree. Such sales are covered by SFAS 66.

10. The language in paragraph 5 should be modified. The Third Notice was being applied consistently at origination, but there is ambiguity in its provisions and diversity in subsequent accounting.

6

Task Force recommendation:

Delete first sentence in paragraph 5 of ED.

11. Definition of inception of a loan should be modified. Sometimes written agreements are prepared subsequent to negotiation of loan agreement.

3

Task Force recommendation:

Agree. Wording in paragraph 10 modified.

12. In paragraph 12(6), for purposes of determining value, disposal costs of assets must be considered.

6

Task Force recommendation:

Agree. Wording in paragraph 12(b) modified.

13. Reproduce sections of SFAS 66 that relate to paragraph 12(c).

3

Task Force recommendation:

Rendered most by proposed removal of SFAS 66 criterion as a requirement.

14. In a situation where a lender is precluded from pursuing both a guarantee and the project's assets (as discussed in paragraph 54), guarantees should not be combined with other paragraph 12 criteria for initial investment test.

6

Task Force recommendation:

Agree. Change to be made in paragraph 14.

15. Concepts of a lender's intent to enforce letters of credit, discussed in paragraph 54, should be incorporated into paragraph 12(c).

6

Task Force recommendation:

Pass

16. Certain wording in paragraph 12 (i.e., "recently", "reasonable amount of time") should be defined.

3,6,8,15

Task Force recommendation:

Pass

17. Paragraph 12(e) should be amended to refer to "sufficient net cash flows to service contractual loan amortization..."

7

Task Force recommendation:

Concept of contractual amounts has been introduced in paragraph 19. The task force believes this is a more appropriate insertion.

18. Conditions in paragraph 12(d) and 12(e) should be more restrictive. Conditional takeout commitments should not be considered characteristics of a loan unless it is remote that the conditions will not be met.

12

Task Force recommendations:

Pass

19. Conditions in paragraph 12(a) should be more restrictive. Insert materiality and/or distance requirements.

14

Task Force recommendation:

Pass

20. SOP should make it clear that a contribution of services performed prior to inception of a loan may be included in borrower's equity investment in determining if borrower's equity investment is substantial.

20

Task Force recommendation:

Pass. Definition of sweat equity in paragraph 10(6) addresses this comment.

21. The SOP addresses additional loans between the parties subsequent to the initial loan.

6

Task Force recommendation:

Agree. Paragraph 16 to be modified accordingly

22. Paragraph 30 appears to contradict paragraphs 33 and 34 with respect to allocation of depreciation.

10,11,17

Task Force recommendation:

Relevant section modified.

23. Example should be corrected/expanded.

3,4,6,10,11,12,14,15

Task Force recommendation:

Agree

COMMENT LETTERS

Exposure Draft of Proposed Statement of Position
<u>Identifying and Accounting for Real Estate</u>
<u>Loans That Qualify as Real Estate Investments</u>

<u>FILE 3455</u>

1. General Electric Company
2. ITT Corporation
3. AICPA-Division for CPA Firms
4. New Jersey Society of CPAs
5. NationsBank Corporation
6. Arthur Andersen & Co.
7. Aetna
8. The Chase Manhattan Corporation
9. Illinois CPA Society (Accounting Principles Committee)
10. Chemical Bank
11. Massachusetts Society of CPAs (Real Estate Subcommittee)
12. Teneyck Associates, Inc.
13. Savings & Community Bankers of America
14. Louisiana Society of CPAs (Accounting & Auditing Stds. Comm.)
15. NY State Society of CPAs
16. California Society of CPAs (Accounting Principles & Auditing Standards Committees)
17. Loscalzo & Company, CPAs
18. Wells Fargo & Company
19. Florida Institute of CPAs
20. CIGNA Corporation
21. National Association of Real Estate Companies
22. BankAmerica Corporation

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February 15, 1994

Ms. Arleen K. Rodda, Director
Accounting Standards Division, File 3455
AICPA
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Dear Ms. Rodda:

The Proposed Statement of Position, "Identifying and Accounting for Real Estate Loans that Qualify as Investments in Real Estate" (PSOP), should be dropped. Instead, AcSEC should investigate practice to determine whether clarification or interpretation of the Third Notice to Practitioners (Third Notice) is necessary. If practice, as some have asserted, is inconsistent, AcSEC should develop and issue targeted clarification.

We have four principal objections to the PSOP:

- Classifying instruments with loan return opportunities as investments sacrifices a vital set of data, obscuring the extent to which a particular reporting entity is entitled to investor-type returns and exempting them from the relatively rigorous disciplines that apply to impaired loans. We address this concern in Attachment A.

- Costs of obtaining information necessary to apply the PSOP are vast. See Attachment B for discussion of these costs, as well as our conclusions as to benefits.

- SFAS 66 criteria are conceptually and practically ill-suited for the role of distinguishing real estate investments from loans. See Attachment C for our reasoning and for examples of the unintended consequences of the PSOP.

- The PSOP's technique for assigning depreciation to hypothetical equity accounts distorts the reporting results for both lenders and true equity investors. We address our concerns about depreciation in Attachment D.

Other than these points, we completely support the PSOP.

Let us be clear on a fundamental point. There are deals, structured as loans, in which the putative lender has essentially all ownership rewards, and should, therefore, account for the property like an owner.[1] Consider the following example:

<u>Disguised Ownership Example</u>
Putative lender ("PL1") invests $999,999 in a property whose total cost, including closing costs, is $1,000,000. Putative owner ("PO1") invests $1, and will manage the property. PO1 is paid a management fee that is fair compensation for that management role, and is entitled to all of the "upside" with a total return limit of $2, including return of the original investment.

As a fundamental, bright-line point of departure, we believe that PL1 must account for this property as an investment—that is to say, must show the property as real estate owned and must depreciate it—and should not, under any circumstances, be confused with a lender. PO1 is simply a fee-for-service manager with a $1 performance incentive.

Now, let's modify the case to one that is more controversial, but see if we can find some common ground in so doing. Consider:

<u>Leveraged Loan Example</u>
Putative lender ("PL2") invests $950,000 in a property whose total cost, including closing costs, is $1,000,000. Putative owner ("PO2") invests $50,000, and will manage the property. PO2 is paid a management fee that is fair compensation for management of the property, and is entitled to 60% of the "upside" after the debt is repaid, without limit. PL2 receives the remaining 40% upside.

Most preparers would view this as a radically different deal than the first. The lender's "equity kicker" in this case is modest—reasonable compensation for risk, but far from ownership. "Control"—in a different context, the point that determines consolidation—more clearly runs to PO2 than PO1. Operationally, PL2 will be far more cautious than PL1 in the preceding case about exercising lending rights like foreclosure, since PO2 has invested substantive moneys and is entitled to significant rights in any property appreciation.

1Please note that we have directed our attention to "rewards," not the more customary, "risks and rewards." This was intentional. Lenders risk everything in a loan. We could debate whether a 99% lender "risks everything" to a greater extent than a 50% lender. But such a debate generates heat, not light. We believe that the Third Notice's indirect approach to this question is far more useful, viz., measure rewards! When one finds the majority of rewards, one has found the owner.

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We believe that deals like those of PL1 and PL2 need to be reported very distinctly. The PSOP would treat them similarly, at potentially grave cost to financial statement credibility and usefulness. More to the point, the PSOP would not stop at equity representation of the leveraged loan example, but would also extend, incredibly, to loans in which the lender is entitled only to a market interest-type return.

Inconsistencies in Application of Third Notice

Some allege that similar deals are now reported differently under the Third Notice. We have not experienced this problem, but stipulate the allegation for sake of this discussion.

What we will not stipulate, however, is the validity of AcSEC's response to this allegation. The Third Notice is conceptually reasonable. If the Third Notice has become a practice problem, it certainly would appear to be a problem of compliance, not concept. AcSEC's response—eliminate the Third Notice and develop a new model—is not a solution to the overall question of real estate lending practice problems. The PSOP, in our view, will substitute a much larger population of widely disparate accounting for what must be conceded to be marginal existing inconsistencies.

We therefore urge AcSEC to attack its alleged practice problem in a fashion that will reach a solution rather than create a set of different but potentially more intractable problems. One way of achieving this is to undertake steps such as the following:

1. Prepare a hypothetical real estate portfolio—a set of agreements with the characteristics that have been considered under the Third Notice as well as the PSOP.

2. Select a panel of users—preferably buy-side and sell-side analysts who specialize in the real estate industry—to ascertain their classification preferences. We would certainly be willing to recommend qualified specialists for this panel. Our strong sense is that such users will deem the PSOP to be a impairment of information.

3. Based on results of this study, develop and publish clarification, possibly as examples, of the Third Notice.

We judge the prospects for success to be far greater with an evolutionary approach to the Third Notice than they would be under the PSOP's proposed revolution.

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Conclusion
We believe that the Third Notice is a reasonable basis for real estate accounting, and we are not aware that it is being applied inconsistently. Stipulating the assertion that application is problematic, we urge AcSEC to take the specific steps to gauge and tailor appropriate clarification.

Sincerely,

Philip D. Ameen

Philip D. Ameen

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Attachment A

Sacrifice of Decision-Useful Information

Since loans classified as investments are not loans for reporting purposes, they are not subject to SFAS 15, 91 or 114; cannot become reportable as delinquent; cannot be disclosed as non-accrual; are subject to asset impairment write down rules rather than the more restrictive impaired loan rules; and related write downs cannot be reported as loan losses. By so classifying a loan, an institution simply circumvents many of the disclosures that are critical to users. The very population of loans identified as high risk would be exempted from the most meaningful disclosures.

Reduced earning and non-earning loans are now subject to extensive accounting guidance. Loan impairments will be further clarified upon application of SFAS 114. Investment impairment, on the other hand, is subject to much less clear guidelines. It seems inevitable that, if the PSOP is adopted, we will be faced with at least some cases of delayed recognition of economic losses. For perspective, it is helpful to keep in mind that, by the time depreciation "catches up" with the value of a loan that has stopped performing, the property often has long since been foreclosed. Investment accounting simply is not very adept at responding to this sequence of events. Suppose, for example, a lender forecloses on an "investment." The question of whether, similar to a loan foreclosure, a <u>further</u> write down to fair value of something that is already owned becomes, in our view, intractable.

These observations, of course, apply to loans that are treated as investments under the Third Notice. However, Third Notice investments are substantively different in one threshold respect—the lender is entitled to investor-type returns. Returns as a criterion have been dropped from the PSOP, forcing combination of equity-risk and money-over-money arrangements into one reporting pool. Indeed, the PSOP, for the apparent sake of at best a modest gain in theoretical purity, sacrifices enormously valuable information that we and others rely on for decisions.

Users of the respective financial statements of PL1 and PL2, the examples cited in our cover letter, would rightly expect—demand, perhaps—differential accounting treatment. The PSOP would deny that treatment.

The reporting perspective that seems to have driven the PSOP, that is, that users are only interested in detecting

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overstated income so the auditors can be sued and impoverished, provides a perilous framework for accounting pronouncements.

Users are much more straightforward creatures. They simply want to know—will demand to know—relevant information about positions in which the reporting entity retains meaningful upside rights, and they will distinguish their analysis quite sharply from the analysis of positions that offer only standard lending returns.

The PSOP fails to meet these fundamental user needs, in contrast to the reasonable success of the Third Notice. AcSEC should fix whatever is wrong at the margins of the Third Notice, but should stay with its precepts, not abandon them.

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Attachment B

Costs of the PSOP

The effort that will be required under the PSOP approach to obtain the additional detailed operating information is daunting, and further threatens to alter significantly the legal standing of lenders, jeopardizing their senior lien status.

We acknowledge that nothing to which AcSEC is directly subject requires explicitly that the Committee justify costs with benefits. So we share the following observations principally to ensure that you have had a foretaste of the enormity of the burden that you are threatening.

Fundamentally, the implicit assumption that timely, accurate property financial information is available to the lender is, in our extensive experience, simply, demonstrably, almost universally, wrong.

The level of accounting sophistication by borrowers runs a wide range. Some produce reasonable financial statements monthly, others quarterly, and others, shall we say, from time to time. The quality of these statements runs the gamut. Obviously, particularly for participation deals, we audit and rely on these financial records, both for covenants and for participation determination. But, unlike the reliance we would require for external reporting, we can and do negotiate loan arrangements that are tailored for a given level of owner controls and reporting sophistication. You will appreciate that we are far more concerned with processes and internal controls in the borrower's handling of cash than we are with the accuracy of borrower accruals. Internal control over computation and reporting of asset capitalization and depreciation, for example, is simply not relevant to us, and is of interest to owners solely from a tax perspective. At the property level, records are most often maintained on the cash or tax return basis, and we can fit satisfactory participation agreements to these records.

In other words, quarterly accrual-basis net operating earnings is just not on our screens or the screens of many of our borrowers. It is simply irrelevant.

If such information were constructed and transmitted to lenders, lenders' reported results would be, to put it kindly, not subject to a comfortable level of controls. The "risk" of contaminating lender financial statements with these uncontrolled data is near certainty.

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Accurate maintenance of equity accounts, when there is not an agreement to follow, will also become terribly complex—among the most complex accounting extant. The PSOP's proposed hypothetical partnership equity accounts will be virtually impossible to keep. For example, following are a few of the normally recurring transactions that will affect these hypothetical accounts:

- Interest deferrals and loan amortization change the lender's equity account routinely.

- Borrower funding (e.g., interest payments, capital improvements, operating expenses) increase the borrower's equity account, and may or may not decrease the lender's equity account.

- Bill-to-borrower expenses (those paid by the lender and subsequently reimbursed by the borrower) increase the lender's account one month, then decrease it, with a corresponding increase the borrower's equity account in only certain cases.

- Cash flow from one property (financed by the same or different lender) pledged to support debt service on a second property will require adjustment to both equity accounts for both loans.

- Fundings subsequent to the initial funding increase the lender's equity account. Such fundings often take place periodically on a complex schedule over a number of years.

In practice, timely and accurate information to make many of the adjustments discussed above simply will not be available. Many of the entries will be based on raw estimates, and even the best cases will be extremely difficult to verify, even with maximum allowable deferral of reporting.

At another dimension, AcSEC needs to understand that many loans are made on a portfolio basis with any given loan collateralized by as many as two dozen properties. Beyond the data-gathering complexities this type of loan generates, it introduces the variability of making accounting decisions on a property-by-property versus a combined basis. In certain instances, specific loan amounts may be allocated to specific properties, while in others the loan may truly be on a portfolio of collateral. Under the PSOP, a substantial accounting effort would be required just to record the

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common event of a borrower selling one of the collateral properties in a portfolio.

There also is a legal issue on which the Third Notice is silent, but that seems central to this accounting issue. A lender who does not permit the owner to control the property sacrifices the senior security interest attendant to the loan through what is known as "equitable subordination." All lenders behave cautiously, acknowledging the contractual, managerial and legal restrictions placed upon actions relative to the collateral. An institution that makes an ownership investment has vastly different legal ability to influence the property and its managerial activities than does a lender. Owners make decisions about property positioning in the marketplace, new and renewal leases, extent and types of tenant improvements and concessions, and property improvements and amenities. If an institution is functioning as an owner, these actions will normally be undertaken by a distinct asset management unit.

This involvement is neither contemplated nor legally permissible in a highly leveraged lending arrangement. The lender's decision to make a loan absent that control is indicative of an economic lending arrangement. If AcSEC were to require "ownership" accounting, the absence—in fact, the legal prohibition against—any significant control seems to indicate that the cost method of accounting for investments would be more appropriate than the equity method.

Now, we would like to address a couple of the responses that no doubt come to mind as you think through this section:

Q. Sure, lending is complicated, but you have to keep these records anyway.

A. Incorrect. We keep discreet lending records, loan by loan, in accordance with explicit legal documents. It is a grave error to confuse these records with the hypothetical account balances on a full accrual basis that the PSOP will require.

Q. You're already doing this under the Third Notice. What's the big deal?

A. For Third Notice arrangements, we have established a separate accounting unit that is the recordkeeper for both the hypothetical partnership and us as lender. We devote an entirely different level of attention, at much higher per-unit cost, to these deals. This cost is economically justified by higher return potential on

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ventures. Incurring this cost to service a money-over-money portfolio is a significantly different matter.

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Attachment C

Inapplicability of Statement 66 Criteria

We fundamentally oppose using real estate sales criteria for determining whether an investment is to be accounted for as an investment or as a loan. SFAS 66 is quite effective at guarding against premature profit recognition on a sale in which there is not a complete transfer of risks. The PSOP would require these extreme measures in determining whether a loan is to be accounted for as a loan or an investment. The reporting concerns, it seems obvious, between profit recognition and reporting of the performance of an asset whose cost is not in question are quite different.

Analogies also promise to be puzzling.

Participations involving real estate loans, for example, would seem to be held to very strange standards if the PSOP is adopted. Whereas SFAS 77 clearly applies to their form, if we classify investments that we later participate as real estate investments under the PSOP, the quite restrictive criteria of SFAS 66 seem to be brought into play. We wonder, for example, whether the time frame of EITF Consensus 88-17 is appropriate in determining whether SFAS 66 criteria would apply to an "in-substance" syndication. Even without this challenge, it would seem conceptually that certain junior tranches (for example, an 85% to 95% loan tranche) would become real estate investments, in confusing disregard for the typically restricted returns and quite in conflict with the absolute unavailability of data to accomplish this accounting.

Further, it is quite clear that, under the concepts of the PSOP, a substantial portion of the residential mortgage market would be investment in homes by the originating lenders. The PSOP's scope exclusion for residential mortgages solves this issue, but the reasons for the exclusion are unclear. Related analogies are just as interesting. How, for example, would AcSEC propose that depreciation should be assigned and accounted for by, say, the principal-only Z-tranche of a CMO.

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Attachment D

Fallacious Depreciation Charges

First, let us establish firmly that we are not arguing, as some have alleged, that enterprises whose property has increased in value should be exempt from depreciation. Before the reader of this paper attaches that interpretation to our position, we request the courtesy of a full hearing.

Instead, we believe that depreciation clearly is associated with use benefit. In that light, we find PSOP paragraph 33 to be a remarkably bad accounting answer.

Concepts Statement No. 6, Paragraph 26, is useful in considering how to allocate depreciation. It states:

> the expiration of future benefits caused by using up a resource in production is the cost of using it.

Without putting too fine a point on this question, it would seem logical to associate depreciation with parties who (a) control the resource, and (b) stand to gain from appreciation.

Lending is an entirely different model, both economically and for accounting purposes. The "use benefit" is collection of future cash flows. Collection of future "use benefit" is a reduction of principal. Recognizing depreciation as recovery of investment would be a significant misrepresentation.

SOP 78-9 seems generally to follow the substance of "use benefit" in depreciation allocation, resulting in reasonable financial statements of both the venture and the investors in such ventures.

We believe that the PSOP takes extraordinary and unwarranted liberties with the SOP 78-9 language, including one of the most remarkable out-of-context quotations in memory, in order to reach an "answer" that makes sense neither conceptually nor practically. The "logic" AcSEC has chosen to follow apparently is as follows:

- Every real estate investment involving two or more parties is a "joint venture," irrespective of legal agreements.
- Agreements that, by their legal form, are real estate ventures will be accounted for under SOP 78-9, that is,

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depreciation and other results will be allocated according to legal form, subject to recovery prospects based on fair value as specified in paragraph 19 of the PSOP.

- Agreements that, by their legal form, are <u>loans</u> will become "substantive ventures," with terms created out of whole cloth, namely, depreciation recognized as soon as the historical cost of the equity investor is exhausted.

The requirement to recognize hypothetical depreciation appears to be, in effect, a forced write down of the institution's investment in the loan, when no loss may have occurred and the institution has no right to "use benefit." It seems very mysterious that we should require a recognition of the cost of a use benefit by a party that does not enjoy the benefits themselves.

Further, some real anomalies arise in this accounting. Depending on the net balance in the owner-partner's equity account, the hypothetical depreciation may be charged to the owner in one period, to the lender in the next period, and then to the owner again in the following period. Even though we can probably sort out the mechanics, it is very odd that timing of a cash distribution to the owner will control how much depreciation that equity account will absorb during a period. Thus, holding a December 31 distribution to the next day can mean that, for the December 31 period, the owner's equity account will absorb more depreciation and the lender's investment will be more profitable. The distortion opportunities seem endless.

SOP 78-9 states that, if it is probable that one or more investors cannot bear their share of losses, the remaining investors should record those losses. However, unlike the PSOP, SOP 78-9 provides for priority recapture of those losses by the investors who absorbed them. We certainly believe that a recapture provision is logical, and should be adopted in the PSOP.

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ITT

ITT Corporation

World Headquarters

Jon F. Danski
Senior Vice President
and Controller

February 15, 1994

Ms. Arleen K. Rodda
Director, Accounting Standards Division
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Draft SOP: Identifying and Accounting for Real Estate Loans That Qualify As Real Estate Investments ("ED")

The purpose of the ED is to bring consistency in practice with respect to identifying and accounting for real-estate loans that are in-substance investments in the real estate. The primary criterion under current GAAP for distinguishing "investments" from "loans" is the existence or absence of the nominal "lender's" participation in expected residual profits. Accounting is believed inconsistent in practice because of difficulty in identifying residual-profit participation buried in loan interest and fees. The ED proposes to drop the residual-profit criterion, specifying instead six determinants, any one of which can demonstrate the substance of ownership by the owner/borrower, qualifying the transaction as a loan.

"Participation in residual profits" may be buried beneath surface arrangements and difficult to find, but where that participation exists, effective "investment" seems unambiguous. We think that the proposed six determinants will not always be unambiguous. For example, a temporary loan may be extended to a real estate venture by a minority equity holder, particularly during preparation for operations, and there may not be yet a takeout loan commitment. Under the proposed determinants, the sum of the minority holder's equity and loan may push it into equity or consolidation accounting that will not exist when a permanent loan is arranged. It would be misleading to require equity accounting or consolidation for a short period, with the arrangement quickly reversed when permanent financing is obtained. An interpretation that such temporary loans constitute ownership would be chaotic, and conceptually inconsistent with the exclusion of consolidation accounting in ARB 51 "if control is likely to be temporary."

We recommend language that is sufficiently well-drawn so that literal interpretation of the proposed six determinants does not give rise to accounting treatment that is inconsistent with the transaction, particularly to avoid imputed ownership from temporary loans.

Sincerely,

#2 Jon F. Danski

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February 10, 1994

Ms. Arleen K. Rodda, Director
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Re: Exposure Draft on Proposed Statement of Position "Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments"

Dear Ms. Rodda:

One of the objectives that Council of the American Institute of CPAs established for the Private Companies Practice Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee ("TIC"). This communication is in accordance with that objective.

TIC has reviewed the proposed guidance contained in the above referenced exposure draft on accounting for real estate loans that qualify as real estate investments. Our comments and suggestions follow.

Inception of a Real Estate Loan

Paragraph 10(a) provides criteria on what constitutes a real estate loan. Although the definition provided appears adequate for most situations, our experience indicates that sometimes an entity will negotiate all of the provisions of a loan agreement and will either not prepare a written contract or will prepare one at a later date. Or, if a written agreement is available, it may not yet be signed by all the parties in interest. These agreements clearly do not meet the definition outlined in this proposal. However, because practitioners occasionally encounter loan agreements that could either be unwritten or unsigned, TIC believes the final statement of position should specifically state whether or not such agreements are encompassed by this statement.

Minimum Initial Investment Criteria

Paragraph 12(a) refers readers to the minimum initial investment criteria specified in paragraphs 53 and 54 of FASB Statement No.

#3

66. We believe that reproducing those two paragraphs in the final statement of position would increase the usefulness of the document. Readers should be able to determine the basic requirements of an authoritative document by considering information contained in the body of the document itself.

Classifying Real Estate Loans

The last sentence in paragraph 12(a) and the first in paragraph 12(e) discuss two terms that may need further clarification to avoid an inconsistent interpretation of the standard: "... **recently** acquired real estate..." and ... **reasonable** amount of time." Requirements expressed in vague terms can be subject to a wide range of interpretation and can lead to divergent results and diminished comparability. Accordingly, it may be desirable to include guidelines or parameters that will help practitioners objectively interpret such terms.

Financial Statement Presentation

Paragraph 40 provides that the carrying amount of real estate loans accounted for as investments should be disclosed either on the face of the balance sheet or in the notes. However, it is unclear whether the components of or activity in the capital accounts should be disclosed or just the net balances, To help practitioners develop the required note disclosures, it would be useful if the final statement of position contained examples showing the extent of information that should be disclosed.

Appendix A

The $300,000 allocated operating income for "Year 2" appearing in the cash flows schedule on page 24 should be displayed under the "19X2 - ABC (Lender)" column, not the "19X3 - ABC (Lender)" column.

* * *

We appreciate the opportunity to present these comments on behalf of the Private Companies Practice Section. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Robert O. Dale

Robert O. Dale, Chair
PCPS Technical Issues Committee

ROD:al
File 2220

cc: PCP Executive and PCPS Technical Issues Committees

#3

NJSCPA
New Jersey Society of Certified Public Accountants

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February 17, 1994

Arleen K. Rodda
Director, Accounting Standards Division
File 3455
AICPA
1211 Avenue of the Americas
New York NY 10036-8775

RE: Proposed Statement of Position entitled *Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments*

Dear Ms. Rodda:

The Auditing and Accounting Standards Committee (the "Committee") of the New Jersey Society of Certified Public Accountants ("NJSCPA") is pleased to submit its comments on the AICPA's Proposed Statement of Position entitled *Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments*. The views expressed in this letter represent the majority of the members of the Committee and are not necessarily indicative of the full membership of the NJSCPA.

In summary, the Committee is supportive of the issuance of a final standard that is based on the proposed SOP. We agree that real estate loans carry more risk than other lending arrangements and, therefore, the principles of the AICPA Third Notice to Practitioners applicable to ADC arrangements should be expanded and modified to cover all real estate loan activity. Presently, it is difficult in practice to determine when a real estate loan should be accounted for as an investment in the underlying real estate project; the draft SOP provides adequate, more definitive guidance.

On an overall basis, the Committee supports the paragraph 12 criteria as the paragraph establishes the substance of what needs to be met for a real estate loan to be classified and accounted for as a loan. We agree that there is no need to specifically incorporate a criterion that is based upon expected residual profits.

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It is worth noting that several Committee members believe that multiple criteria should be met in order to have a real estate transaction accounted for as a loan. These members believe that even if one of the paragraph 12 criterion is met, the substance of the transaction should still be analyzed on an overall basis. These members believe that multiple criteria should be met. However, since each of the specific criterion evaluates the risk of the transaction, the rest of the Committee is satisfied with meeting just one of the criteria.

The Committee offers the following comments for your consideration:

1. The Committee believes that the use of the term "hypothetical partnership" is confusing and adds undue complexity to the draft SOP. Due to this confusion, Committee members are not sure if we support the specific accounting outlined in the Appendix. Additional explanatory material as well as examples which include the accounting entries should be re-exposed so that what is intended is fully understood by your constituency.

2. Paragraph 20 states that the restructured loans should be accounted for in accordance with FASB Statement No. 15. Based upon the issuance of FASB Statement No. 114, we believe that a final SOP should also refer to that Statement.

3. Paragraph 48, which provides examples of situations where lenders assume risk, should be moved to the standard itself.

4. The SOP should not be effective until at least nine months after issuance. Adequate time is needed to allow users and preparers to implement and understand such a standard.

5. The example on page 24 of the Appendix appears to have a typographical error. The distribution of Year 2's operating income is incorrectly spread between years 19X2 and 19X3.

We appreciate your consideration of our comments. If you would like clarification on any of the points addressed in this comment letter, please do not hesitate to call.

Sincerely,

J F Yospe

Joseph F. Yospe
Chairman, Auditing and
Accounting Standards Committee

#4

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NationsBank

January 31, 1994

Ms. Arleen K. Rodda
Director
Accounting Standards Division
File 3455
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Rodda:

We appreciate the opportunity to comment on the proposed Statement of Position. These comments are on behalf of the nation's third largest banking organization.

We believe this proposal is without justification, and should be withdrawn. The draft makes the implicit assumption that real estate loans that involve all but a minimal level of credit risk are inherently impaired, despite the lack of any evidence that they will not perform according to their contractual terms. We believe that such an assumption is unwarranted. The draft is based on the concept that the assumption of credit risk by a lender is equivalent to investment in the collateral, but only if the collateral is real estate. We believe that is an inappropriate concept, and its application only to real estate loans leads to inconsistent accounting for like transactions based solely on the type of collateral.

While there may be real estate loans whose substance is that of a real estate investment, the criteria in this proposal appear inappropriate for the identification of those that are real estate investments. We believe that application of this method of accounting could mis-classify as real estate investments many transactions whose substance is that of normal lending transactions, resulting in financial reporting that is not representationally faithful. The proposal appears inconsistent with a number of existing accounting standards, notably FAS 66, FAS 77, FAS 107, and FAS 114. We find no allegation in the exposure draft that there are divergent practices or abuses that would provide justification for making a such changes in the accounting for real estate loans at this time. The cost of implementation will be high, and we see no benefits to justify the additional cost.

<u>Criteria For Determining That A Loan Is A Real Estate Investment In Substance</u>

The criteria in the proposal would result in accounting for a transaction as a real estate investment solely on the basis of credit risk assumed by the lender. The proposal does not recognize other characteristics universally accepted as being indicative of investment in or ownership of property: title, ability to influence usage, participation in profits from operations, and participation in gains upon sale.

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We do not believe that any reasonable definition of investment in real estate would extend to situations in which the supposed investor has no rights to profits from sale or operation, no ability to exert an owner's or shareholder's influence on the management, and no beneficial interest in the real estate or in the company that owns the real estate. Ownership provides the potential for enjoying the rewards of ownership. Normal, market rate interest and fees cannot reasonably be construed as the rewards of owning the underlying real estate. Absent the potential to share in the rewards of owning the underlying real estate, there is no investment in the real estate.

Secured lending involves the assumption of risks by the lender. The lender's risks are difficult to distinguish from those of the borrower/property owner, but they are not identical with those of the property owner. The property owner risks the loss not only of any cash or other assets securing the loan, but of the time and effort invested in the project, both before and after the lending transaction. The property owner also may have environmental risk, risk of liability for persons injured on the premises, and various other risks that are associated with holding title to property, and which are not shared by the lender.

A prudent lender limits the degree of risk he is willing to assume by setting underwriting criteria or by denying the loan application. A prudent lender also determines how best to protect himself from those risks, and the degree of protection needed. We do not believe it is appropriate, as it appears is attempted by this proposal, for AcSEC to decide what degree of risk a prudent lender should assume, or the type or degree of risk protection a prudent lender should require.

The proposal includes, as a criterion (¶ 12a) for accounting for the transaction as a loan an initial investment by the borrower that meets the initial investment requirement *for recognition of a gain on a real estate sale* of FAS 66. FAS 66 does not require that initial investment in order to recognize the transaction as a sale and to account for the purchase money mortgage as a loan. FAS 66 is superior in the GAP hierarchy to an AICPA SOP, and conflicts with the proposed SOP with regard to the criteria for accounting for a seller financing of a real estate sale.

Viewed in the context of gain recognition, the FAS 66 initial investment requirements may be reasonable. In the context of an investment required to justify accounting for a transaction that meets normal underwriting criteria as a loan, we do not believe the FAS 66 initial investment requirements are reasonable. Neither do we believe it reasonable to exclude from the borrower's investment value added by the construction or development activity that these loans frequently finance. Such activity does produce value that diminishes the lender's risk of loss, and increases the rewards of ownership that typically will be enjoyed solely by the borrower. Lenders generally require a high value relative to the loan amount, but "value" includes value added by the project.

We believe AcSEC is remiss to dismiss "sweat equity" so lightly. This concept encompasses the time, expertise, and out-of-pocket expenses of the borrower during the term of the loan. Were this an actual investment in the real estate project on the part of the lender, the time and expertise would have to be purchased, and the out-of-pocket expenses would have to be reimbursed to those hired to manage the project. The fair value of services provided by the borrower and the expenses borne by the borrower are

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the equivalent of capital contributions to the project. Keeping in mind that the typical construction loan is funded in increments as the project progresses, it is likely that the contributions made by the borrower will keep pace with the funding of the loan. To dismiss these contributions because they are not paid in cash at the date the loan is committed is not appropriate.

The remaining criteria for accounting for the transaction as a loan are generally inappropriate. While a prudent lender may decide to require some form and amount of other collateral, letter of credit or surety bond protection, or guarantee, the form, amount, and nature of the protection from credit loss is not relevant to the question of whether or not the lender is making an investment in real estate. Rather, the existence or absence of such protection from credit loss is relevant in analyzing possible impairment of a loan. However, the proposal is limited to new originations for which there should be a rebuttable presumption that impairment does not yet exist.

The criterion involving takeout commitments is particularly interesting, since it excludes commitments that are conditional. It is our experience that <u>all</u> takeout commitments are conditional. At least one of the standard conditions (completion) cannot be met or be said to be highly likely to be met until the project is substantially complete. Another standard condition requires the project to reach a stated level of rentals or other cash flows, which often will not occur until the project is completed.

AcSEC should also consider that lenders do not necessarily seek all the credit protection in one form. A loan may have low credit risk because it has several forms of credit protection, but could fail all the criteria because no one is at the level specified in the exposure draft. To classify such a loan as a real estate investment is not appropriate.

The criteria ignore the role in underwriting of the borrower's character and demonstrated ability to successfully complete similar projects and repay the loans financing those projects. These are intangible qualities, but their importance in a lending decision is at least as great as the tangibles included in the criteria in the exposure draft. These characteristics may lead a lender to take a greater than normal level of risk, whereas the absence of these characteristics may cause a lender to decline the loan or seek more protection from credit risk.

<u>Inconsistencies With Other Accounting Standards</u>

FAS 66 requires only that a sale should be consummated, as defined in ¶ 6 of that statement, in order to account for it as a sale. Only if not consummated does FAS 66 require the resulting asset to be accounted for by the deposit method, which classifies the asset as real estate. All other loans financing sales of real estate are classified as loans. The majority of FAS 66 deals only with the methods and timing of gain recognition. That interpretation has been accepted consistently by major public accounting firms and government regulatory agencies, including the SEC and OCC.

The proposed SOP is lower in the GAAP hierarchy than FAS 66, and cannot amend FAS 66. Therefore, if we are the seller of real estate, the proposed SOP is not applicable, and FAS 66 is the governing standard. If we are the seller, with seller financing, we can account for the transaction as a sale and classify the purchase money mortgage as a loan if the sale has been consummated as defined in FAS 66, whether or not it meets the criteria in ¶ 12 of the exposure draft. If the seller is a third party, and we are only the lender, the same loan would be subject to the proposed SOP, and might be classified as an investment in real estate. That produces an inconsistency in that we can remove real estate from our balance sheet by selling it with seller financing involving a high level of credit risk, while a third party financing the same transaction on terms involving a lower level of credit risk might have to add real estate to its balance sheet.

The emphasis on assumption of risk while ignoring the rewards of ownership is inconsistent with FAS 77, which allows sale treatment for receivables if the seller retains the credit risk but transfers the rewards to the buyer. Since real estate loans are receivables, even if they do not meet the criteria in ¶ 12 of the exposure draft, FAS 77 will still apply to their sale. That produces an interesting situation in that we might have to classify a normal real estate loan as an investment in real estate pursuant to the proposed SOP because the level of credit risk is high, but we could remove the asset from our balance sheet entirely under FAS 77 by selling it with recourse, retaining all the credit risk. That may produce a strong motivation for banks to sell their real estate loans.

The proposed SOP is inconsistent with FAS 107. The real estate loans that are classified as real estate investments pursuant to the criteria in the proposed SOP will still meet the FAS 107 definition of financial instruments. FAS 107 still requires the disclosure of the fair value of these instruments. However, it will be confusing to statement readers to report the fair value of some, but not all, the reporting entity's investments in real estate.

The proposed SOP is also inconsistent with FAS 114. We believe FAS 114, when adopted, will apply to real estate loans whether or not they meet the criteria in ¶ 12 of the exposure draft, if they meet the FAS 114 definition of impairment. An impaired loan's "net carrying amount" is the recorded investment in the loan reduced by a valuation allowance. That valuation allowance is a part of the reporting entity's reserve for loan losses. It seems clear to us that FAS 114 would require us to report any loan that became impaired as an impaired loan. That would require us to reclassify as loans those transactions that are loans in form but have been classified as real estate investments based on the proposed SOP.

It is also interesting to note that FAS 114 amends FAS 15 to narrow the definition of in-substance foreclosure to situations in which the lender receives physical possession of the property. As a result, the SEC has announced that, contrary to FRR 28, a loan that meets the criteria in FRR 28 may be classified as a loan rather than as real estate. For purposes of applying those criteria, borrower's equity includes value added by the project. That creates the interesting possibility that a loan secured by real estate, with no borrower equity, no other source of repayment, and little likelihood the borrower can rebuild equity or repay the loan is classified as a loan, but a real estate loan that is not impaired but has little equity other than sweat equity and no other source of repayment would have to be classified as a real estate investment.

<u>Lack of Justification For The SOP</u>

We believe AcSEC has failed to make a case for the need for this change in accounting standards for loans secured by real estate. It has failed to cite abuses that warrant the change, and has not alleged significant misstatements as a result of faulty interpretations

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or misapplication of the existing guidance. No case has been made for abandoning the existing criteria.

AcSEC may feel that the existing criteria are ineffective because they result in few loans being classified as real estate investments. It is certainly true that few loans are so classified, but that is because few loans that meet the criteria are made. This organization has had many opportunities to make loans that would meet the existing criteria for classification as real estate investments. However, accounting for the loans as real estate investments is so distasteful that we have declined such opportunities.

If the proposed SOP is issued as drafted, the number of loan applications we would decline purely as a result of the change in accounting standards might increase. We may not make a loan that requires the accounting treatment required by this exposure draft.

The proposal is not cost justified. It requires us to keep at least two sets of accounting records on each loan that is classified as a real estate investment - one for customer billing and tax reporting, and one for book accounting. None of our automated application systems is capable of keeping the set of records that is required only because of the proposed SOP. The cost of keeping the additional records manually, or of developing and operating automated systems to keep these records will be substantial. We have no way of recovering that cost. We see no benefits to the investors or other users of financial statements that will justify the additional cost.

The proposed SOP has the effect of carving out the accounting for one specific type of financial instrument, separate from the FASB financial instruments project. We believe this is inappropriate. If consideration of this topic appears to be necessary, it should be considered after the FASB financial instruments project has been completed. There has already been too much fragmentation of the financial instruments project.

Conclusion

In summary, we consider the proposed SOP to be unnecessary and inconsistent with other, higher-level accounting standards. We also consider the proposed criteria to be inappropriate, and believe implementation will be costly while providing no enhancement to existing practices. Therefore, we urge you to withdraw the exposure draft and cancel the project.

We would be happy to discuss our views on this issue with you. You may call me at (704) 386-9042.

Sincerely,

Joe L. Price

Joe L. Price
Senior Vice President
Director of Accounting Policy

#5

ARTHUR
ANDERSEN

ARTHUR ANDERSEN & CO. SC

Arthur Andersen & Co.

69 West Washington Street
Chicago IL 60602-3002
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January 31, 1994

Ms. Arleen K. Rodda
Director
Accounting Standards Division, File 3455
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Rodda:

This letter contains our comments on the AICPA's exposure draft of a proposed statement of position (SOP), *Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments*. We support the AICPA's efforts to clarify the accounting guidance in this area and we generally agree with the provisions of the SOP.

In summary, we agree that a loan may in substance be an equity investment. An asset that is deemed for accounting purposes to be a real estate investment should be accounted for as a real estate investment. No special rules are necessary for real estate investments that may in form be loans. Depreciation, an allocation of cost, is required for certain real estate assets regardless of the value of the asset. It is not within the scope of this project to conclude that depreciation of real estate assets is not required by GAAP even if the asset is appreciating economically. That is, for accounting purposes under GAAP, depreciation is real and someone must bear the cost. Which investor in a real estate project must bear the depreciation depends on the agreement between the investors. If they agree that investor A bears all depreciation until A's equity is used up and then investor B bears all depreciation, that should be the basis for the accounting. Once A's equity is depleted, the depreciation must be absorbed by B. It is not a question of whether B is picking up A's loss because it is not A's loss.

Our overall and specific comments follow.

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<u>Overall Comments</u>

Scope

The proposed SOP states that its primary focus is on the assumption of risk, and its scope is limited to real estate transactions. However, if the assumption of risk is the primary conceptual basis for the proposed accounting, no conceptual reason exists to limit the accounting to one type of collateral. The type of underlying collateral bears no relationship to the level of risk assumed by a lender. Clearly, some individuals may view certain forms of collateral as inherently riskier than others. However, the proposed SOP provides that the financial reporting classification of a loan be dependent on the <u>level</u> of risk assumed. Yet a single project financing (e.g., co-generation plant or an aircraft) can produce the same level of risk as a real estate loan and not be classified as an investment.

A consistent framework should apply to all types of loans. Paragraph 32 of FASB Statement 91 supports a consistent framework for all types of loans as indicated by the following:

> "After reviewing the nature of the lending process, the Board concluded that accounting for loan origination fees and costs should be consistent for all types of lending. That conclusion was generally supported by respondents to the Exposure Draft. No compelling arguments were made supporting a conclusion that the lending process for consumer, mortgage, commercial, and other loans or leases is fundamentally different. Nor were any substantive arguments made suggesting that different types of lenders should account for loans differently or that financial statement users for a particular industry or size of entity would be better served by accounting that differs from that of other lenders."

We believe that all loans should be evaluated using the same principles. However, we understand AcSEC limiting the scope of the SOP to real estate loans based on the existing accounting literature that differentiates real estate transactions (e.g., Practice Bulletin No. 1, FASB Statement 66, etc.) and would support the SOP's issuance if limited to real estate.

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Detachable Components Received in a Financing

The SOP should address the accounting to be followed for detachable equity instruments (e.g., kickers, warrants, etc.) received in a financing accounted for as a loan. This guidance should address the accounting to be applied at the inception of the loan (e.g., appropriateness of splitting out the equity component) and subsequent to origination (e.g., hold or sell instruments). The Third Notice addressed aspects of this issue, but its provisions seem to have been dropped in the preparation of the proposed SOP.

Specific Comments

Paragraph 5

The tone of the paragraph suggests that preparers and auditors are not applying the Third Notice in practice. However, the Third Notice did not provide guidance regarding the accounting to be followed subsequent to loan origination. Our observation is that, in general, the Third Notice is being applied at origination, but there is ambiguity in its provisions and diversity in the subsequent accounting.

We suggest that the language in paragraph 5 be modified.

Paragraph 6

The language used in item 4 in this paragraph should be conformed to FASB Statement 114 to avoid ambiguity. Specifically, the language should be "large groups of smaller-balance homogeneous real estate loans that are collectively evaluated for impairment."

Paragraph 7

The proposed SOP does not address the implications of securitization transactions. Since the legal form of these transactions is loans, a lender could securitize the loans even if they are classified as investments for accounting purposes. In the process of securitizing the pool of loans, the lender could create a series of debt and equity security tranches. FASB Statement 115 deals with the appropriate accounting for securities. If the lender accounts

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for the securitized loans as securities, a lender could potentially treat the debt securities as interest bearing assets.

The proposed SOP should address this situation and also provide guidance whether such transactions are considered financial instruments for purposes of applying FASB Statement 107. We believe that if a loan meets the conditions for treatment as an investment in real estate, real estate accounting and disclosures are applicable even though the loan is securitized or could otherwise meet the definition of a financial instrument.

Paragraph 12

Paragraph 12 should indicate that items meeting paragraphs (a) - (e) may be combined to meet the initial investment test. We agree with the use of specific (i.e., FASB Statement 66) initial investment criteria to provide the "bright lines" for the levels of risk in a project. Those risk levels are reduced by all of the items in paragraphs (a) - (e). As such, we believe that the paragraph should clearly indicate that the items in paragraphs (a) - (e) may be combined for purposes of applying the initial investment criteria as described in paragraph 12 (a) of the SOP.

As indicated in paragraph 54, a lender may be precluded from simultaneously pursuing both a guarantee and the project's assets. In those situations, we do not believe that guarantees should be combined with the other items in paragraphs (a) - (e) when meeting the initial investment test.

Paragraph 12 (b)

The SOP should indicate that for purposes of determining value, disposal costs of the assets must be considered.

Paragraph 12 (c)

The concepts in the last bullet of paragraph 54 which addresses the notion of the lender's intent to enforce the letter of credit or surety bond should be added to paragraph 12(c).

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Paragraph 12 (d)

This paragraph should be revised to be consistent with the additive nature of paragraphs 12 (a) - (e) in arriving at the initial investment criteria defined in paragraph 12 (a). For example, a borrower could arrange for a partial takeout with a lender willing to provide a subordinated (i.e., second mortgage) loan. Such a commitment should satisfy the criteria of 12 (a). However, if the takeout commitment is not subordinated to the original lender's position, then a full takeout commitment would be necessary to achieve loan accounting.

Paragraph 12 (e)

This criterion is used frequently as the basis to achieve loan accounting under the Third Notice. We believe the terms "normal" and "reasonable" need to be modified to avoid ambiguity.

In most cases, lenders no longer provide fixed-rate 30-year commercial real estate loans. Many loans are interest-only with much shorter terms (e.g., 5 to 7 years) with a balloon payment at the end of the term. Assuming a 5 to 7 years interest-only loan is considered "normal", debt service would not include principal payments as required by the proposed SOP. Therefore, the transaction would need to be modified to require some level of principal payments in order to account for the transaction as a loan. Further, a time period should be established as the "normal" amortization period for purposes of determining the level of principal payments that must be made. We suggest that the SOP provide objective guidance or refer to the appropriate sections of authoritative literature (e.g., FASB Statement 66, paragraph 12) to provide more objectivity.

The term "reasonable amount of time" is too judgmental to be operational. In what respect should it be reasonable? Over some percentage of the loan term? If the lender creates an interest-only loan with a balloon payment at the end of one year and expects that the loan will be rolled over for several years, would one year of net cash flow be sufficient? A more objective approach, consistent with the SOP, would be as follows:

1) Determine gross cash flows from the noncancelable contracts, leases, etc.

2) Estimate the total operating expenses over the term of the noncancelable contracts, leases, etc.

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3) Compute the net cash flows as the difference between steps 1 and 2.

4) Determine the level of net cash flows that cannot be withdrawn by the borrower over the noncancelable term (e.g., funds placed in escrow or used to pay debt service, etc.).

5) Using an equity rate of return, discount the net cash flows from step 4 that cannot be withdrawn by the borrower.

6) Combine the discounted amount from step 5 with other amounts to paragraphs 12 (a) - (d) to determine whether paragraph 12 (a) is satisfied.

Paragraph 14

The condition should incorporate a discussion of the lender's intentions to enforce the guarantee as addressed in the last bullet of paragraph 54.

Paragraph 15

The proposed SOP does not address the accounting to be followed in the event that a lender classifies the transaction as an investment and subsequently provides an additional loan to the borrower. SOP 78-9 allows a joint venture investor to make loans to the joint venture and treat them as loans. The proposed SOP should address such a circumstance and whether the transaction is to be treated as a loan or an investment. If sufficient capital exists in the transaction and a similar loan is not required to be made by the owner, the transaction could qualify as a loan. This conclusion would require that paragraph 26 be modified to address such loans and interest payments.

Paragraph 19

The first sentence should be modified by adding the following to the end of the sentence "subsequent to the initial measurement performed in paragraph 12(a)." Further, the paragraph should be expanded to address the fact that the investment criteria of FASB Statement 66 change based on the characteristics of the property. For example, the initial investment criteria for a start-up hotel is 25%, while 15% is used for a hotel with cash

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flows sufficient to cover debt service. As an illustration, assume a lender finances a start-up hotel with a 20% initial investment. The initial investment criteria would not be met since 25% is required by Statement 66. However, once the hotel achieves cash flow sufficient to cover debt service, the required equity is 15%. Since the initial investment in this illustration of 20% exceeds the 15% requirement, the proposed SOP should address whether reclassification from investment to loan accounting is appropriate. Since the cash flows are being generated by external transactions, we believe that the project in this example qualifies for reclassification.

Paragraph 19 of the proposed SOP refers to Practice Bulletin 6 for guidance upon returning to loan status. The proposed SOP and Practice Bulletin 6 are silent on the accounting for, and treatment of, contingent cash flows (e.g., equity kickers, etc.). The SOP should clarify that only contractual amounts should be considered when determining the amount of discount to be accreted.

Paragraph 20

The discussion of in-substance foreclosure should be modified and footnote 2 should be deleted since a deterioration of collateral value is no longer considered to be an in-substance foreclosure according to FASB Statement 114. The paragraph should also refer to FASB Statement 114 directly as was done for Statement 15 and SOP 92-3. AcSEC should amend Practice Bulletins 7 and 10 as a result of the issuance of Statement 114 and amend the discussion in this SOP.

Paragraph 25

Delete the first occurrence of the word "generally" from the last sentence of the paragraph. Use of "generally" is not operative guidance. In addition, revise the text of the sentence by replacing the phase, "..., although the hypothetical partnership arrangement generally does not provide the lender-partner with a controlling interest, it ...," with the phase, "... the hypothetical partnership agreement...."

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Paragraphs 32-35

As indicated previously, we agree with the loss allocation approach described in the SOP. However, we recognize that allocation of losses also runs to the heart of the AICPA's project entitled, "Accounting for Investors' Interests in the Operations of Unconsolidated Real Estate Joint Ventures." AcSEC must ensure that the approach for allocating losses be consistent.

Paragraph 39

The paragraph indicates that a loan is to be classified at the time of origination or at time of purchase by applying paragraphs 12 to 16 of the SOP. However, evaluating the loan at two different dates can result in some anomalies and operational difficulties not addressed in the proposed SOP. For example, assume lender A originates a loan that meets the initial investment criteria in paragraph 12 (a) and, therefore, is classified as a loan at origination date. Subsequent to origination, lender A sells a 30% pari passu participation to lender B. If the borrower's equity has subsequently decreased below the amount required to satisfy paragraph 12 (a), the proposed SOP suggests lender B treat the participation as an investment while lender A retains loan classification. The result is different accounting for two pieces of the same loan.

From an operational perspective, the SOP needs to address the method of allocating losses and depreciation in cases where the borrower's GAAP equity reaches zero. We believe that lenders should share in depreciation on a proportionate basis if their interests are proportionate. In the example above, some might say that lender B is the only investor in the hypothetical partnership that can be allocated losses after the borrower's equity reaches zero. However, using a proportionate method, we believe, consistent with the substance, that lender B should only be allocated 30% of the losses.

Appendix A

The "facts" paragraph and the first table refer to "ADC arrangement" and "ADC project". Those term should be replaced by something similar to "financing arrangement".

The table of cash flows has misplaced operating income for year 2. The amounts should be shifted so that both amounts appear in the 19X2 columns.

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* * * * * * * *

We appreciate the opportunity to respond to the Exposure Draft of the Proposed Statement of Position and will be happy to discuss any of our comments at your convenience.

Very truly yours,

Arthur Andersen & Co

#6

Ætna

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January 31, 1994

Ms. Arleen K. Rodda, Director
Accounting Standards Division, File 3455
American Institute of Certified Public Accountants
1211 Avenue of the Americas
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Dear Ms. Rodda:

We appreciate the opportunity to provide you with our comments on the proposed Statement of Position (SOP), *Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments.*

This letter addresses our overall views about the SOP. Comments on certain areas addressed within the SOP are presented in the attachment to this letter.

We urge AcSEC to reconsider the need for the proposed SOP. Existing accounting standards already provide an adequate framework for accounting for real estate loans, including acquisition, development and construction (ADC) loans. If the carrying value of the asset is properly stated and recognition of income is proper (matters we believe are adequately covered in other guidance, including FAS No. 5, *Accounting for Contingencies,* FAS No. 114, *Accounting by Creditors for Impairment of a Loan,* the February 10, 1986 AICPA Notice to Practitioners, *ADC Arrangements,* and EITF Issue No. 86-21, *Application of the AICPA Notice to Practitioners Regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*), the proposed SOP primarily addresses balance sheet and income statement presentation.

The SOP seems to conflict with the in-substance foreclosure criteria contained in FAS No. 114. Accounting for a loan as a hypothetical partnership is, in concept, the same as accounting for a loan as an in-substance foreclosure, although procedurally more difficult. Since FAS No. 114 limits in-substance foreclosure accounting to cases where there is physical possession of the asset, it is unclear why the SOP would apply a broader standard to the determination of when a loan should be accounted for as real estate (or in this case, a hypothetical partnership) rather than a loan.

In considering the practicality of this SOP, it should be noted that at least three sets of books would be required once a loan must be classified and accounted for as a real estate investment: one to account for the contractual terms of the loan (interest, principal

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amortization, etc.); a second to account for the hypothetical partnership, and a third to account for the lender's share of the hypothetical partnership. Further, it may not be possible to obtain the necessary financial information from the borrower on a timely basis to create the hypothetical records. Significant additional costs will be incurred to require borrowers to supply additional information, and to account for, analyze, store and report on that information.

Accordingly, reconsideration should be given to whether the expected benefits from the SOP would exceed the cost of implementation. We question whether final issuance of this SOP will result in financial statements that are significantly more useful and relevant than would exist in the absence of such a standard.

* * * * *

We thank you for the opportunity to present our views on the proposed SOP and hope they will be taken into consideration. We would be pleased to discuss our views further with members of AcSEC or its staff.

Sincerely,

Robert Granon

Attachment

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Attachment

Should AcSEC choose to go forward with issuing a final standard, following are certain aspects of the SOP that we believe should be clarified or reconsidered:

Classifying Real Estate Loans

Paragraph 12e should be amended to say "...sufficient net cash flows to service contractual loan amortization of principal and a market rate of interest for a reasonable amount of time." This is consistent with FAS No. 114 guidelines regarding recognition of losses and impairment.

Applying the Equity Method

We support the views expressed in paragraph 57 that appreciation of the owner-partner's share should be considered in the allocation of depreciation. As long as the fair value of the underlying asset would permit payment of all outstanding interest and principal payments, any excess fair value attributable to the owner-partner should be available for the allocation of depreciation.

Impairment

If a loan accounted for as a real estate investment becomes impaired, which impairment guidance should apply, the FASB Exposure Draft (ED), *Accounting for the Impairment of Long-Lived Assets* or FAS No. 114? Application of the ED criteria may result in an asset which is valued less conservatively than if the asset were accounted for as a loan and FAS No. 114 was applied.

#7

The Chase Manhattan Corporation
33 Maiden Lane
New York, New York 10081

Lester J. Stephens, Jr.
Senior Vice President and Controller

CHASE

January 31, 1994

Arleen K. Rodda
Director
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, N.Y., 10036-8775

Re: File 3455

Dear Ms. Rodda:

The Chase Manhattan Corporation ("Chase") welcomes the opportunity to respond on the American Institute of Certified Public Accountants' ("AICPA") proposed Statement of Position entitled, Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments ("the Proposal").

Chase disagrees with the Proposal in its entirety. The perceived assumption of risk should not be the primary factor governing classification of real estate loans.

First, risk, as defined by the AICPA, is a nebulous concept that should not be the basis for accounting. Second, risk is implicit in all lending activities and the level of risk assumed in a particular lending transaction will vary from bank to bank depending upon such things as the bank's level of capital, the lender's relationship with the borrower and the credit review methodology employed by the bank. As an example, if two banks perform a credit evaluation of the same borrower, their analysis will likely place the borrower at different risk levels. As a result, each bank would require a different downpayment, collateral and the like and, under the Proposal, one bank could be forced to classify the transaction as an investment and the other bank as a loan simply because of different credit analysis methods. Additionally, banks are in the business of lending, not investing. The rewards that accrue to a lender are generally predetermined and limited, whereas the rewards that accrue to an investor include returns related to capital appreciation.

Existing bank regulations enacted under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) allow banks a wide range of flexibility in determining the amount of downpayment (or loan to value (LTV) ratio) necessary to establish a particular real estate loan. The applicable LTV limit is capital-driven, allowing well-capitalized banks the greatest amount of flexibility and the highest LTV ratio. Therefore, the Proposal would not only promote inconsistencies among banks, but it would also unfairly penalize banks that are well managed and that have demonstrated an ability to measure risk accurately and to maximize returns.

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The Financial Accounting Standards Board (FASB) already has accounting standards (such as Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for Contingencies") that address risk-related issues in lending and that correctly place emphasis on loss recognition as opposed to financial statement classification. Furthermore, SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," de-emphasizes financial statement classification as the primary issue in accounting for troubled real estate loans and states in paragraph 71 that "a loan for which foreclosure is probable should continue to be accounted for as a loan." The requirements of the Proposal represent a complete reversal of the progress made by the FASB and would once again place "in-substance" accounting in the forefront by requiring risk-driven "in-substance investment" classifications instead of valuation.

The risk-driven requirements of the Proposal may also be counterproductive to special programs and initiatives that have been recently undertaken by the federal government to promote real estate lending in underprivileged areas. In response to such initiatives, banks may have extended real estate loans, based upon industry and regulatory standards, where the level of downpayment or terms of the loans probably do not meet the loan classification criteria set forth in the Proposal. Given this drawback, it is an open question as to what impact the Proposal will have on such programs.

The fundamental shift in focus from classification based upon expected residual profits to classification based upon credit risk would likely result in an increase in the number of real estate loans classified as real estate investments. This would unnecessarily increase the recordkeeping burden and related costs for banks since three separate sets of records would have to be maintained - one for the customer's legal loan obligation, one for reporting and accounting for the loan as an investment and the other for tax purposes. The increase in recordkeeping cost would, by far, outweigh any perceived benefits to be derived from the Proposal.

We have included, as an attachment to this letter, detailed comments to specific paragraphs of the Proposal.

We would like to thank the AICPA for this opportunity to express our views on the Proposal. If you have any questions, please do not hesitate to contact either me at (212) 968-3817 or David M. Morris at (212) 968-3769.

Very truly yours,

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Attachment

The Chase Manhattan Corporation

Proposed Statement of Position
Identifying and Accounting for Real Estate
Loans that Qualify as Real Estate Investments

Additional Comments

Classification of Real Estate Loans:

Paragraph 12

- Expected residual profits, or similar reward related criteria, should be the principal determining factor for classification of real estate loans. Lenders seek to earn rewards that are predetermined and limited, and that are reflective of normal returns in a lending/borrowing marketplace. On the other hand, rewards earned by investors include not only income-related returns but also returns related to capital growth. As such, the focal point of the Proposal should be the level of rewards as opposed to perceived risk.

- If risk is to be the governing factor, then there should be some flexibility included in the classification criteria so that a loan may be classified as a loan even if it does not specifically meet any one criteria, but partially meets some of the classification criteria resulting in substantial risk reduction. For example, a loan could be structured to require a downpayment and collateral (other than the underlying real estate) that do not meet the individual levels required in the Proposal. However, taken collectively, the value of the downpayment and collateral exceeds the related threshold.

- The classification criteria fails to take into consideration the fact that a borrower's financial condition and credit history are significant barometers of risk. A lender may structure loans to two separate borrowers having diverse financial conditions and credit histories, in such a way that the downpayment or other financial consideration required from the financially stronger borrower does not meet any of the loan classification criteria specified in Paragraph 12, whereas the down payment or other financial consideration required from the weaker borrower satisfies the criteria. Although the terms of the loan to the stronger borrower do not meet the loan classification criteria, the actual risk level of the loan could be less than that of the loan to the weaker borrower. Therefore, under the Proposal, the treatment of these loans would conflict with the SOP's position concerning risk related classification.

- In order to promote consistent classification among lenders, clarification is needed concerning what constitutes a "reasonable amount of time" as discussed in Paragraph 12.e.

Consolidation, Equity Method, or Cost Method:

Paragraph 25

- This paragraph states that a real estate loan classified as a real estate investment should be accounted for under the equity method because the lender has significant influence over major

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operating and financing decisions and specifies the timing of cash distributions. It should be noted that the classification of a real estate loan as a real estate investment is simply an accounting event, and does not alter the way a bank manages the asset nor does it provide any additional privileges to the lender. Loans are normally originated without the lender having the ability to significantly influence the major operating and financing decisions of the borrower. It is erroneous to presume that simply because a particular loan does not have one of the characteristics listed in paragraph 12 the lender automatically obtains significant influence over the borrower. Furthermore, with respect to the timing of cash distributions, loan agreements normally stipulate the timing of payments and any resulting influence is superficial, since the borrower still determines how the funds for repayment are to be raised.

Results of Operations Including Depreciation:

Paragraph 30

- The allocation of depreciation to lenders is inappropriate since the lender does not hold the real estate in an income-producing capacity. As stated in Accounting Research Bulletin 43, the objective of depreciation is to allocate the cost of a productive asset over the period that services are obtained from the use of the facility. However, lenders do not obtain any utility from real estate facilities related to their loans.

Effective Date and Transition

- If the Proposal is issued in its current form, then the effective date should apply only to real estate loans entered into or purchased after December 31, 1995. This would allow lenders at least a year to make accounting and recordkeeping changes necessary to comply with the requirements of the SOP.

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ILLINOIS CPA SOCIETY & FOUNDATION

January 20, 1994

Ms. Arleen K. Rodda, Director
Accounting Standards Division, File 3455
American Institute of Certified Public Accountants
1211 Avenue of The Americas
New York, New York 10036-8775

The Accounting Principles Committee of the Illinois CPA Society ("Committee"), with the assistance of the Banks/Savings & Loan Committee, is pleased to have the opportunity to comment on the Exposure Draft of the Proposed Statement of Position, "Identifying And Accounting For Real Estate Loans That Qualify As Real Estate Investments" ("Proposed Statement"). The organization and operating procedures of the Committee are reflected in the Appendix to this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any of the members of the Committee and of the organizations with which they are associated.

The Committee is uncertain why the Proposed Statement was issued. If a final Statement of Position results from this exposure draft, it would be helpful if the introductory paragraph(s) would include a discussion of the reasons why these issues are being revisited at this time.

We disagree with paragraph 25 of the Proposed Statement which would preclude the use of the "cost method" of accounting for certain real estate loans that qualify as real estate investments. For example, if qualifying loans were provided by two independent lenders, one providing 35% (senior debt) and the other providing 10% (subordinated debt) of the project financing, the accounting in paragraph 25 would not necessarily be appropriate.

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The "cost method" is actually required accounting for an investment which represents less than 20% ownership of a project. The "equity method" is permitted for such an investment only when the investor <u>actually has</u> significant influence over major operating and financing decisions. The Proposed Statement presumes that all qualifying loans <u>have</u> such influence, whereas a 10% subordinated lender probably would not.

We would be pleased to discuss our comments with members of AcSEC or its staff.

Very truly yours,

Bernard Revsine

Bernard Revsine
Chairman
Accounting Principles Committee

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APPENDIX

ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES

1993 - 1994

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is composed of 27 technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to 15 years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions, representing the Society, on matters regarding the setting of accounting principles.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting principles. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which, at times, includes a minority viewpoint.

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CHEMICAL

Chemical Bank
270 Park Avenue, 28th Floor
New York, NY 10017-2070
212/270-7559

Joseph L. Sclafani
Senior Vice President
and Controller

January 26, 1994

Ms. Arleen K. Rodda
Director
Accounting Standards Division
File 3455
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Rodda:

Chemical Banking Corporation (CBC) appreciates the opportunity to respond to the AICPA's proposed Statement of Position, "Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments" (the proposed SOP). While we commend the Accounting Standards Executive Committee's (AcSEC) efforts, we do not understand the need for further guidance on this topic, nor do we understand why such guidance should differ from the February 10, 1986 AICPA Notice to Practitioners, "ADC Arrangements," (the third Notice) and Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures," (SOP 78-9).

We believe that the proposed SOP should be rescinded. The guidance provided in the proposed SOP will broaden the scope of real estate loans classified as real estate investments by creditors, thereby exacerbating the inconsistency in accounting for real estate loans by debtors and creditors. Furthermore, by requiring different accounting for the investment in the hypothetical partnership resulting from the classification of a real estate loan as a real estate investment from that for an ownership interest in a real estate venture as prescribed in SOP 78-9, the proposed SOP will create inconsistent accounting for these transactions which are both considered by AcSEC to be real estate investments.

Application of the provisions of the proposed SOP will be an onerous task, adding additional costs as well as effort, especially in light of the broadened criteria for classification of real estate loans as real estate investments. If obligated to comply with the terms of the proposed SOP, we believe that many creditors will alter the structure of financing arrangements or retreat from certain types of lending. Rather than reflect the action, the accounting will cause a reaction. This result is contrary to the objective set forth in paragraph 33 of the FASB's Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," which states that the role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be.

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We understand that the third Notice applies only to financial institutions and includes only ADC arrangements providing for the lender's participation in expected residual profit. However, the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force Issue No. 86-21, "Application of the AICPA Notice to Practitioners Regarding Acquisition, Development and Construction Arrangements to Acquisition of an Operating Property," (EITF Issue No. 86-21) reached a consensus that the guidance in the third Notice also should be considered in accounting for shared appreciation mortgages, loans on operating real estate, and real estate ADC arrangements entered into by enterprises other than financial institutions. Therefore, it appears that sufficient guidance exists to properly classify and account for real estate loans and real estate investments.

Nevertheless, in the proposed SOP, AcSEC asserts that, although many entities purport to follow the third Notice's guidance, the recommendations for identifying and accounting for loans that qualify as real estate investments are not being applied consistently in practice. Accordingly, AcSEC has concluded that additional clarification and guidance are needed to achieve consistent practice and to reinforce the third Notice's broad principles. We do not believe that the supposed lack of application of AcSEC's recommendations for identifying and accounting for loans that qualify as real estate investments necessarily requires further guidance, albeit different guidance, on this subject. We believe the issue is one of enforcement, not clarification.

We believe that, as long as a lender does not participate significantly in the profits of a real estate project, a real estate loan made in connection with that project is fundamentally a loan, not an investment. When making a real estate loan, CBC assigns a credit grade to the loan that reflects CBC's risks, and CBC requires a certain level of compensation, namely the interest rate on the loan, to accept that risk. Therefore, it is unnecessary to record a loan as an investment to reflect risk; risk is already reflected in CBC's grading system and in the loan's interest rate. CBC's credit officers closely monitor the credit grades of each loan; therefore, risks are appropriately measured and reflected in the financial statements via the various loan disclosures.

Furthermore, we believe that the motivation for issuing the third Notice and EITF Issue No. 86-21 was to ensure that impairment in the value of real estate loans involving significant lender risk is properly reflected in the lender's financial statements. However, impairment should not be an issue at the inception of a loan. In addition, we believe that further guidance on this matter is not necessary in light of the FASB's issuance of Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan," (SFAS 114), which provides guidance on measuring impairment of loans, including real estate loans. In fact, the proposed SOP seems especially illogical since it attempts to move the classification of certain real estate loans to other assets, while SFAS 114 will allow other loans that previously would have been classified as other assets (referred to as in-substance foreclosures) to remain classified as loans.

We do not see the need for further clarification on classifying and accounting for real estate loans that qualify as real estate investments, and we are concerned because the proposed SOP prescribes guidance that differs from that which has been previously established. The attached Appendix highlights the differences between the proposed SOP

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and current authoritative guidance that are of particular concern to CBC, outlines specific issues arising from the provisions of the proposed SOP, and poses questions on the application of the proposed SOP that should be addressed in the final statement, if issued.

We urge AcSEC to reconsider and rescind the proposed SOP. We would be happy to discuss our position with you at your convenience.

Sincerely,

Joseph S. Schlafer

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AICPA Proposed Statement of Position,
"Identifying and Accounting for Real Estate Loans
That Qualify as Real Estate Investments"

Removal of the Requirement to Participate in Expected Residual Profit

AcSEC determined that the third Notice's definition of expected residual profit (the amount of profit above a reasonable amount of interest and fees to be earned by the lender) was inadequate because a benchmark for the definition's reasonableness test had not been clearly defined. As a result, it was concluded that the classification decision regarding real estate loans should focus only on the assumption of the risks of ownership and exclude consideration of the rewards of ownership. Therefore, according to the proposed SOP, the presence of expected residual profit should not affect the classification decision.

This is a major departure from the third Notice, which only applies to cases in which the lender participates in expected residual profit; this change should not be taken lightly. The third Notice states that, if the lender participates in less than a majority of the expected residual profit, the risks and rewards relating to the transaction are similar to those associated with a loan. We believe that when a lender participates in a majority of expected residual profit, it makes sense that the lender's interest is more similar to an investment in a partnership, but when a lender receives a reasonable amount of interest and merely shares in profits in order to amortize the principal balance of the loan, the substance of the transaction is that a loan, not an investment, has been made.

If AcSEC's concern regarding expected residual profit stems from the adequacy of the definition of the reasonableness test in the third Notice, that is, the amount of profit (interest and fees) reasonable to indicate that the real estate loan is a loan, not an investment, one could look to current authoritative guidance for examples of application of a reasonableness test. In particular, Statement of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," (SFAS 15) applies a reasonableness test with regard to the assessment of whether the effective rate on a restructured loan is a "market rate" of interest, which could be applied to a real estate loan to determine the existence of expected residual profit. Specifically, paragraph 40 of SFAS 15 states that, subsequent to restructuring, a loan whose terms have been modified need not be disclosed as a reduced rate loan if its effective interest rate is equal to or greater than the rate the creditor is willing to accept for a new loan with comparable risk. Such rate has been termed a "market rate" of interest. To determine the existence of expected residual profit on a real estate loan, one could analogize to SFAS 15 and assume that anything over and above a market rate of interest represents expected residual profit. Then, once it is established that the lender is participating in expected residual profit because the effective interest rate to be received on the loan exceeds a market rate of interest, the provisions of the third Notice would apply to the transaction.

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We believe the existence of expected residual profit is crucial to classify a real estate loan as an investment. Accordingly, we believe that AcSEC should reconsider its position on expected residual profit.

Valuation of the Capital Accounts of the Hypothetical Partnership

Paragraph 24 of the proposed SOP states that the fair value of a borrower's equity in the real estate, if any, at the inception of the arrangement is analogous to an initial capital contribution to the hypothetical partnership by the owner-partner. The proposed SOP does not discuss the value of contribution of services or intangibles when determining capital contributions. In fact, paragraph 13 of the proposed SOP states that sweat equity should not be considered in assessing whether a borrower's equity in a real estate loan is substantial.

However, paragraph 32 of SOP 78-9 states that the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly-owned real estate project.

We believe that contribution of the borrower's services should be considered in valuing the owner-partner's capital account. The value of such services provided during the development and operation of the project should be added to the owner-partner's capital account to be available to absorb depreciation expense and operating losses on the project, if any.

Allocation of the Results of Operations of the Hypothetical Partnership

Paragraph 30 of the proposed SOP states that the results of operations of the hypothetical partnership, including depreciation, determined in conformity with generally accepted accounting principles (GAAP) should be allocated between the owner-partner and the lender-partner according to the allocations agreed to either explicitly or implicitly in the hypothetical partnership agreement. However, paragraph 33 of the proposed SOP indicates that, for a real estate loan classified as a real estate investment, depreciation should be allocated entirely to the owner-partner until its hypothetical capital account, determined on a GAAP basis, is reduced to zero. At that point, all further depreciation should be charged to the lender-partner. This appears to contradict the guidance in paragraph 30 of the proposed SOP. In addition, paragraph 35 of the proposed SOP also appears to contradict the guidance in paragraph 30 of the proposed SOP, since it states that operating losses before depreciation (exclusive of the preference return in the form of coupon interest) should be allocated entirely to the owner-partner until its hypothetical capital account is reduced to zero.

Furthermore, paragraph 25 of SOP 78-9 states that specified profit and loss allocation ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense. Therefore, the proposed SOP, as written, contradicts SOP 78-9.

Additionally, the proposed SOP stipulates that, since real estate loans typically are without recourse, the owner-partner's hypothetical capital account should not be reduced below zero. However, SOP 78-9 states that an investor, though not liable or otherwise committed to provide additional financial support, should provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero though the underlying profitable pattern of an investee is unimpaired. There is no such provision in the proposed SOP.

SOP 78-9 further states that if it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses. The proposed SOP's guidance is in line with this provision of SOP 78-9. However, SOP 78-9 further provides that when the venture subsequently reports income, those remaining investors (that bore the losses) should record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess losses they previously recorded. The proposed SOP does not have a similar provision for recovery of excess losses.

The proposed SOP asserts that certain real estate loans are more similar to investments than loans. It would seem that the accounting for the hypothetical partnership as a result of classification of a real estate loan as a real estate investment should concur with the guidance contained in SOP 78-9 on accounting for ownership interests in real estate, since AcSEC considers both of these transactions to be real estate investments.

Therefore, we believe that for real estate loans classified as real estate investments, deviations in accounting from SOP 78-9 should be thoroughly investigated and justified. AcSEC should rethink its position on accounting for real estate loans classified as real estate investments.

Impairment of Real Estate Loans Classified as Real Estate Investments

Presumably, AcSEC's concern regarding real estate loans is that the asset's carrying value may not appropriately reflect the risks assumed. However, the FASB's issuance of SFAS 114 should alleviate concerns over the valuation of real estate loans in that SFAS 114 requires that impaired loans be carried at the present value of expected future cash flows or, if collateral-dependent, the fair value of the collateral. Accordingly, it seems that the proposed SOP is unnecessary in light of the issuance of SFAS 114.

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Furthermore, the proposed SOP promulgates guidance that is not consistent with SFAS 114. While the issuance of SFAS 114 will most probably result in the rescission of the in-substance foreclosure rules that require loans meeting certain criteria to be reclassified to other assets, the proposed SOP is attempting to establish broader criteria by which to determine that a real estate loan should classified as a real estate investment. This inconsistency should be justified.

Finally, the proposed SOP does not provide guidance on accounting for permanent impairment of a real estate loan classified as a real estate investment. We believe that permanent impairment of real estate investments should be accounted for in accordance with paragraph 20 of SOP 78-9, which states that a loss in the value of an investment other than a temporary decline should be recognized under the accounting principles that apply to a loss in value of long-term assets. This guidance may need to be revisited, as the FASB has recently issued an exposure draft of a proposed Statement of Financial Accounting Standards entitled "Accounting for the Impairment of Long-Lived Assets."

Inconsistency in Accounting Between Debtors and Creditors Exacerbated by the Proposed SOP

While the proposed SOP does not apply to debtors, it broadens the scope of real estate loans to be classified and accounted for as real estate investments by creditors, thereby exacerbating the lack of symmetry in accounting for real estate loans between debtors and creditors. A debtor will classify and account for a real estate loan as a loan and may include the entire results of operations of the real estate project in its financial statements, while a creditor may classify and account for the same real estate loan as a real estate investment and will include its "share" of the results of operations of the real estate project belonging to the hypothetical partnership in its financial statements. This difference in accounting is especially illogical when the creditor does not share significantly in residual profit.

According to the provisions of the proposed SOP, depreciation expense and operating losses in excess of the debtor's (owner-partner) hypothetical capital account are allocated in their entirety to the creditor (lender-partner) irrespective of the fact that neither the form nor substance of a partnership exists. Presumably, such allocation is prescribed by the proposed SOP in order to appropriately reflect impairment in the creditor's asset. However, such circumstances do not necessarily result in impairment of the asset. For example, a creditor may make a loan to a debtor to develop property. The creditor may be aware that the project will operate at a loss for a few years before operating at a profit. As such, the loan agreement may stipulate that the principal is due at the end of the loan term. The debtor may fully intend to repay the loan, and the creditor may consider the loan collectible because the creditor believes that the debtor will have the ability to pay the loan when due. In fact, the loan may be current with regard to scheduled interest payments. It would, therefore, seem inappropriate that the creditor write down this asset.

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Other Points to Consider

- Paragraph 12 of the proposed SOP outlines characteristics, at least one of which must be met at inception, necessary to classify a real estate loan as a loan. It should be clarified that, with regard to certain of these characteristics, meeting the definition of "substantial" is a cumulative assessment of all the characteristics rather than a mutually exclusive or singular assessment of each characteristic. For example, a real estate loan may be made to a borrower whose equity investment would not, by itself, be considered substantial, and a guarantee on that loan may not, by itself, be considered substantial and, therefore, not be considered qualifying, but the combined effect of the borrower's initial investment and the guarantee would be considered substantial. It would be inappropriate to consider a substantial qualifying guarantee alone sufficient to warrant classification as a loan, but not to consider the combination of a guarantee and an equity investment by the borrower, together deemed to be substantial, to be sufficient to warrant such classification. This clarification should be explicit.

- Paragraph 15 of the proposed SOP indicates that the classification of multiple funding arrangements made at or near the same time should be determined in the aggregate. Such time frame should be more clearly defined.

- Paragraph 25 of the proposed SOP discusses the issue of control of the hypothetical partnership. AcSEC should consider that the issue of control is under review by the FASB as part of its consolidation project.

- AcSEC should consider providing an example of the entries required to reclassify a real estate loan classified as a real estate investment to a loan.

- Guidance should be provided on accounting for bullet loans. This is of particular concern when depreciation or operating losses are allocated to the lender-partner's capital account, causing the lender-partner to record losses on its investment in each period the loan is outstanding and reduce its investment in the hypothetical partnership. If full payment of the loan is subsequently made, the loan payment will exceed the balance in the capital account of the hypothetical partnership. Such excess presumably would be reported as income. This is clearly illogical.

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MASSACHUSETTS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, Inc.
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January 24, 1994

American Institute of Certified Public Accountants
Arleen K. Rodda, Director
Accounting Standards Division
File 3455
1211 Avenue of the Americas
New York, NY 10036-8775

Ladies and gentlemen:

The Real Estate Committee is a technical committee of the Massachusetts Society of Certified Public Accountants. The Committee consists of over thirty members whom are affiliated with public accounting firms of various sizes, as well as members in industry and government. A subcommittee of the Real Estate Committee has reviewed and discussed the Exposure Draft Proposed Statement of Position "Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments." The subcommittee's comments and suggestions are summarized in the following paragraph.

It is the consensus of the subcommittee that the criteria established in the Proposed Statement of Position are reasonable. However, we do have four comments: 1) clarification should be made in Paragraph 36 by better defining the "transfer of capital from the owner-partner to make up for the deficiency in the preference payment", i.e. is the transfer of capital what is discussed in Paragraph 37 or is it something else; 2) there is a typographical error on page 24-the items on the line "Year 2-$600,000" should be shifted one column to the left; 3) the implementation of this SOP may encourage entities to report on the income tax basis of accounting to avoid additional book/tax differences in reporting; and 4) Paragraph 33 appears to contradict Paragraph 30-clarification should be made whether Paragraph 33 is an exception to the general rule described in Paragraph 30 or, in fact, is Paragraph 33 the general rule.

Very truly yours,

Roger Yorkshaitis

Roger Yorkshaitis, Chair
Real Estate Committee of the MSCPA

P. Daniel Hurley

P. Daniel Hurley, Jr., Chair
Accounting Principles & Auditing
Procedures Committee of the MSCPA

#11

TENEYCK
ASSOCIATES, INC

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King of Prussia
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January 29, 1994

Ms. Arleen K. Rhodda, Director
Accounting Standards Division
File 3455
American Institute of Certified Public Accountants
1211 Avenue of Americas
New York, New York 10036-8775

Dear Ms. Rhodda,

We are pleased to have this opportunity to comment on the Proposed Statement of Position, *Identifying and Accounting for Real Estate Loans That Qualify As Real Estate Investments*.

We applaud AcSEC's efforts to readdress and clarify issues raised by ADC loans. We agree that an arrangement that (1) does not posses characteristics generally present in a lending relationship and (2) transfers substantial risks and possibly rewards of ownership to the lender should not be accounted for as a loan. We also appreciate the expanded guidance on applying the equity method. We encourage AcSEC to issue the proposed SOP in final form as soon as is practicable. To be useful, accounting and financial reporting should focus on the substance of transactions rather than their form. In some instances, current authoritative literature (e.g., the third Notice to Practitioners) permits accounting for the form of certain arrangements rather than their substance.

AcSEC has on its agenda a project to reconsider the accounting for real estate joint ventures. Although the conclusions reached in that project might impact the conclusions reached in a final SOP, we do not believe issuance of this SOP in final form should be delayed. We encourage AcSEC, however, to move forward with the project on joint ventures.

Included below are our specific comments on several aspects of the proposal.

#12

SCOPE

We do not believe that the real estate loans resulting from the sale of real estate by the lender should be excluded from the scope of this SOP. While it is true FASB Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate,* (SFAS No.66) provides some relevant guidance, its main thrust is provide guidance on profit recognition.

We believe the final SOP would be particularly useful to preparers and auditors if it provided further guidance on applying paragraphs such as 25 and 26 of SFAS 66. In particular, guidance is needed on how receivables from the sale of real estate be classified when there is continuing involvement without transfer of risk. If the transaction is accounted for as a financing or a profit sharing arrangement, should the proposed guidance in this SOP apply. We believe the answer is yes. There is no rational reason for a different accounting answer when the lender also is the seller. While we recognize that AcSEC cannot amend SFAS No.66, a practical approach would be to recognize a special line item classification for property "sold" under SFAS No. 66 but still a "real estate investment" under the SOP.

CLASSIFYING REAL ESTATE LOANS

We agree that a real estate loan should be accounted for as a loan only if it has one or more of the characteristics (described in paragraph 12) at inception. However, the conditions described in subparagraphs (d) and (e) should be more restrictive. In our opinion, conditional takeout commitments, as well as conditional sales contracts and lease commitments should not be considered characteristics of a loan unless it is remote that the conditions will not be met. This more restrictive test will further reduce the possibility of accounting for in-substance investments as loans.

#12

GUARANTEES

Paragraph 14 describes a "qualifying guarantee" under paragraph 12(f). We believe this guidance would be more helpful if the examples in paragraph 53 were included in the body of the final pronouncement. In addition, we recommend that AcSEC provide additional guidance on meeting characteristic 14(d). We believe, for example, that a lender's consistent history of enforcing its rights against guarantors would reasonably demonstrate an intent to enforce the guarantee.

ACCOUNTING FOR REAL ESTATE LOANS CLASSIFIED AS REAL ESTATE INVESTMENTS

Initial Capital Accounts -- Paragraphs 24 and 29

We agree that the fair value of the borrower's equity in the real estate is analogous to an initial capital contribution to the hypothetical partnership by the owner-partner. We further agree with the conclusion in paragraph 12(a) that the borrower's contribution of recently acquired real estate should not be valued at an amount greater than the borrower's acquisition cost. We recommend that this same limit be required when determining the initial hypothetical capital contribution.

Illustration of the Application of Paragraphs 27 to 37

We recommend that AcSEC provide additional illustrations of applying the equity accounting.

We would be pleased to discuss any of our comments with AcSEC or the AICPA staff at their convenience.

Respectfully submitted,

Ernest Ten Eyck by PS Clarence Sampson by PS

Ernest Ten Eyck and Clarence Sampson

#12

Savings & Community Bankers
of America

January 31, 1994

Ms. Arleen K. Rodda, Director
Accounting Standards Division, File 3455
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Rodda:

Savings & Community Bankers of America ("SCBA") is pleased to respond to the AICPA's Exposure Draft on *Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments* ("ED"). SCBA is a national trade association representing more than 2,000 savings and community financial institutions with assets in excess of $800 billion. Real estate loans represent a significant percentage of the total assets held by SCBA members.

SCBA is supportive of the AICPA Exposure Draft. Practice and accounting for real estate investments has been the subject of debate and evolution over time. SCBA believes that the ED provides a reasonable and purposeful guidance document for use by those financial institutions and other entities involved in making or purchasing real estate loans for determining when certain loans are to be accounted for as investments.

The scope of the ED is appropriate in directing its guidance to the diversity in practice brought about by multiple application of accounting rules intended only for acquisition, development and construction loans. SCBA is pleased that the AICPA did not attempt to address troubled debt restructurings, in-substance foreclosures, debtor accounting and other technical accounting issues that are related to real estate. These are areas have been subject to much controversy and have been addressed in current Financial Accounting Standards Board rulings or have become subject to bank regulatory accounting policies.

SCBA supports the AICPA's qualifying criteria for real estate loans, which generally provides that certain prudent underwriting characteristics are in place. The criteria are based on security measures other than relying solely on the underlying real estate collateral. Real estate credits that qualify as loans must include one of the following characteristics: recourse to other assets, letters of credit, credible take-out commitments, sufficient cash flow from leases or sales, and guarantees. These criteria are consistent with current real estate lending requirements imposed by the federal banking agencies pursuant to Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991.

#13

The ED provides that when real estate loans are classified as investments, the accounting treatment accorded is analogous to that of a hypothetical partnership agreement, and the equity method of accounting is required. SCBA supports the use of the equity method as appropriate in investment circumstances. AICPA's ED explicitly and appropriately describes accounting methods for capitalization of interest, establishing capital accounts and reporting the results of operations under the equity method. References to Financial Accounting Standards and existing statement of position are particularly useful to ensure clarity of the rule and uniformity in practice.

SCBA is pleased to have the opportunity to express our support for the AICPA's important work to develop an Exposure Draft that fosters uniformity in practice. Any questions you may have should be directed to Marti Sworobuk at (202) 857-5580.

Sincerely,

Alfred M. Pollard

Alfred M. Pollard
Director, Government Relations

#13

Received
1/24/94

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

Identifying and Accounting
For Real Estate Loans That Qualify As
Real Estate Investments

October 27, 1993

Accounting and Auditing Standards Committee
Louisiana Society of CPA'S

Comment Date: January 31, 1994

Name and Affiliation: Glen Vice, Chairman

Raymond Prince, Member

John D. Cameron, Member

COMMENTS: Good guidance, but with the following exceptions:

Paragraph Number	
12 a)	Add more strict guidance such as: If a loan exceeds $5,000,000 or 5% of the Bank's capital; and it is on a project that is further than 200 miles from the nearest branch of such bank, this requirement should be the <u>only</u> requirement that would allow a loan to be accounted for as a loan. In many cases b-f of paragraph 12 just don't "pan out" and the Bank is left with the project. Borrower equity makes the borrower work harder to pay the loan current.
Appendix A Page 24	$300,000 should be under the column ABC (Lender) 19x2 instead of ABC (Lender) Column 19x3.

#14

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OF
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nysscpa

February 14, 1994

Ms. Arleen Rodda
Director, Accounting Standards Division
File 3455
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position -" Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments," dated October 27, 1993.

Dear Ms. Rodda:

The New York Society of Certified Public Accountants is pleased to submit its comments on the subject Exposure Draft. These comments represent the combined views of the Society's Financial Accounting Standards Committee, Real Estate Accounting Committee and Banks and Savings Institutions Accounting Committee (the Committee).

Principal Conclusion

While sensitive to the need to provide additional clarification and guidance to achieve consistent practice in this area, the Committee's unanimous conclusion is that the proposed SOP should not be issued.

A number of specific comments need to be stated:

- The Committee believes that if the reporting of a loan transaction is to be accounted for based upon its substance over its form, the consideration of the rewards of ownership, as well as its risks, must be taken into account.

- The Committee believes that FASB Statement 114, "Accounting by Creditors for Impairment of a Loan", adequately addresses the valuation considerations inherent in risky lending.

- Further, as was considered in the modification of the in-substance foreclosure rules, obtaining property/partnership operating level information on a GAAP basis on a timely basis is extremely difficult when one is not in physical possession of the property. Accordingly, reporting results of operations as proposed would be logistically difficult and burdensome.

Should the SOP be issued, the Committee questions whether the benefits derived to the reader of the financial statements of classifying these loans as investment in real estate versus construction loans is outweighed by the complexity and hypothetical partnership accounting that the exposure draft requires. The following are comments on specific matters in the SOP.

#15

1. The deletion of the consideration of expected residual profits as one of the criteria for determining if the transaction should be recorded as a loan or investment is troublesome to the Committee. In situations where the lender will profit from the transaction only to the extent of a reasonable amount of interest and fees expected to be earned by a lender, we question whether the classification of this transaction in the hypothetical partnership is more consistent with a liability of the hypothetical partnership than as an equity interest in the partnership as described in Statement of Financial Accounting Concepts No. 6 "Elements of Financial Statements".

2. Paragraph 12(a), last sentence: we believe that fair value (if determinable) should be used instead of the borrower's acquisition cost. If not, the term "recently acquired" should be defined.

3. Paragraph 12's criteria may not anticipate future products and transactions. We suggest one additional criterion para-phrasing the first sentence in paragraph 45: The borrower otherwise retains the risks and rewards attributable to owning real estate. While this is admittedly a broad criterion, it would lessen the risk of auditors or examiners interpreting the SOP so narrowly that many future loans are reclassified as other real estate owned. Practice Bulletin #7, in which the interpretations required an amendment via Practice Bulletin #10, offers an example of such behavior.

4. Paragraph 54 should delete "or reviewed" from its first sentence to avoid a conflict with the second bullet point that makes the point that unaudited financial statements are less likely to provide full, reliable disclosure.

5. Page 24 of Appendix A has an apparent error: In year 2, ABC (Lender) should have 300,000 in 19X2 rather than 19X3.

6. The proposed SOP does not indicate how to determine a creditor's "hypothetical partnership" ownership percentage in situations where the lender does not participate in cash flow or profits.

7. As the proposed SOP excludes "equity kicker" as an indication of a non-loan situation, the example in rear should not contain a cash flow sharing arrangement.

If you wish to further pursue the comments herein, please let us know and we will arrange for someone from the Committee to contact you.

Very Truly Yours,

Robert Kawa

Robert W. Kawa, CPA
Chairman, Financial Accounting Standards Committee

Walter M. Primoff

Walter M. Primoff, CPA
Director, Professional Programs

RWK/WMP/jz

cc: Financial Accounting Standards Committee
John Burke, CPA
Accounting & Auditing Chairmen

#15

Rec'd 2/28/94

February 24, 1994

California Society Certified Public Accountants

Ms. Arleen K. Rodda, Director
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: File 3455 - Exposure Draft of Proposed Statement of Position: Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments

Dear Ms. Rodda:

The Accounting Principles and Auditing Standards Committee of the California Society of Certified Public Accountants (AP&AS Committee) has discussed the Exposure Draft of the Proposed Statement of Position: *Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments* (the "Proposed SOP"). The comments included in this letter are the results of the AP&AS Committee's deliberations.

The AP&AS Committee is the senior technical committee of the California Society of Certified Public Accountants. The 1993/94 Committee comprises 46 members, of which 17% are from national CPA firms, 52% are from local or regional firms, 20% are sole practitioners in public practice, 4% are in industry, and 7% are in academia. Five current or former members of the AICPA Accounting Standards Executive Committee serve on the AP&AS Committee.

The AP&AS Committee opposes the issuance of the Proposed SOP. The February 10, 1986 AICPA Notice to Practitioners, ADC *Arrangements* (the Third Notice), while not perfect, functions adequately in practice and we do not believe there are sufficient practice problems to warrant replacing it at this time. As to the provisions of the Proposed SOP, the scope of loans that might be accounted for as investments is both overly inclusive and unclear. Further, the AP&AS Committee does not agree with the proposed requirement to include depreciation in the ongoing measurement of the loan. In addition, there is a need to reconcile differences the Proposed SOP would create with other pronouncements dealing with real estate loans or investments.

The AP&AS Committee is not aware of any current pressing need for yet another pronouncement on ADC arrangements. To a large extent, it is "last year's issue". There has been a substantial diminution in the volume of new transactions that would be covered by the measurement provisions of the Proposed SOP. Further, practitioners and preparers of financial statements have had seven years of practice under the Third Notice, and inconsistencies that may exist in practice are of decreasing significance and would be grandfathered anyway. These factors, plus the other new accounting pronouncements discussed below, totally obviate the need for the Proposed SOP.

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#16

The applicability to loans that might be accounted for as investments is overly inclusive and unclear. Only loans in which the lender participates in expected residual profit should be included and the definition of "real estate loans" is unclear.

The Third Notice is clear as to its applicability: it applies to only ADC loans in which the lender participates in expected residual profit and that meet the other specific conditions in the Third Notice. This participation in residual profit, usually in the form of an equity kicker, in the final analysis, is the only factor that makes the loan really appear to be an investment; it clearly conveys to the lender both risks <u>and rewards</u> of ownership. Without the expected participation in residual profit, the lender has none of the potential rewards of an investor, and the risks are those of a lender. The lender's risks are no different than in any other highly leveraged lending transaction in which the borrower has little or no equity in the property or other assets that are the subject of the loan. Observers have noted that highly leveraged loans in other industries, including the typical "junk bonds", have significant aspects of an equity security; despite this, they are accounted for as loans under existing accounting principles.

If risk is to be the factor governing classification of real estate, then there should be some flexibility included in the classification criteria in paragraph 12 so that a loan may be classified as a loan even if it does not specifically meet any one criteria, but partially meets some of the classification criteria resulting in substantial risk reduction. For example, a loan could be structured to require a down payment and collateral (other than the underlying real estate) that do not meet the individual's levels required in the Proposed SOP. However, taken collectively, the value of the down payment and collateral could exceed the related threshold.

The classification criteria fails to take into consideration the fact that a borrower's financial condition and credit history are significant barometers of risk. A lender may structure loans to two separate borrowers having diverse financial conditions and credit histories in such a way that the down payment or other financial consideration required from the financially stronger borrower does not meet any of the loan classification criteria specified in paragraph 12, whereas the down payment or other financial consideration required from the weaker borrower satisfies the criteria. Although the terms of the loan to the stronger borrower do not meet the loan classification criteria, the actual risk level of the loan could be less than that of the loan to the weaker borrower. Therefore, under the Proposed SOP, the treatment of these loans would, in substance, conflict with the Proposed SOP's position concerning risk related classification.

Paragraph 25 of the Proposed SOP states that a real estate loan classified as a real estate investment should be accounted for under the equity method because the lender has significant influence over major operating and financing decisions and specifies the timing of cash distributions. It should be noted that the classification of a real estate loan as a real estate investment is simply an accounting event, and does not alter the way a bank manages the asset nor does it provide any additional privileges to the lender. Loans are normally originated without the lender having the ability to significantly influence the major operating and financing decisions of the borrower. It is erroneous to presume that simply because a particular loan does not have one of the characteristics listed in paragraph 12, the lender automatically obtains significant influence over the borrower.

The Proposed SOP fails to clearly define a "real estate loan". Applicability to loans made to acquire real estate and secured by that same real estate seem clearly covered. But, consider the following:

- A loan made for the purpose of acquiring real estate, but that is unsecured.

- A loan made for the purpose of acquiring real estate that is not secured by that real estate but is secured by other assets of the borrower with value no more than that of the real estate.

- A loan made to acquire a portfolio of assets that includes significant real estate, but that also includes significant non-real estate assets.

It is not clear whether or not those are within the scope of the Proposed SOP.

The AP&AS Committee believes that requiring depreciation on the "as if owned" property is inappropriate. The transaction is a loan, and if it is repaid in accordance with its terms, it will have behaved like a loan and depreciation would create a gain on the "as if sale" back to the borrower. This seems futile. On the other hand, if the loan will not be repaid in accordance with its terms, we now have literature, referred to below, clearly dealing with loan impairment which obviates the need for any "as if depreciation". Thus, the AP&AS Committee disagrees with the provision of the Proposed SOP that would require depreciation.

The Proposed SOP is one of several current or proposed statements that apply to various types of real estate, and is partially inconsistent with them.

- FAS 114 *Accounting by Creditors for Impairment of a Loan:* That standard does not make any exception for what are nominally real estate loans but that seem to be something else. Are we to be faced with a dual standard for real estate loans?

- SOP 92-3 *Accounting for Foreclosed Assets:* If a foreclosed asset is held for sale, it is carried at the lower of (a) fair value minus estimated costs to sell, or (b) cost. There is no need to reduce cost by depreciation; in fact AcSEC could not agree to a requirement to recognize depreciation on foreclosed assets. It seems inconsistent not to require recognition of depreciation in a foreclosure situation, where the real estate is actually owned by the lender, and yet require recognition of depreciation when the real estate is <u>not</u> owned. And, what happens if the loan that is accounted for as an investment is actually foreclosed? Is it then covered by SOP 92-3 and depreciation not required?

- Real estate joint ventures: The proposed statement is inconsistent with SOP 78-9 as well as AcSEC tentative decisions on its current project to amend SOP 78-9.

The Third Notice, and its predecessor notices, were written principally to deal with income recognition issues for loan fees and interest that were not paid in cash, or were paid from the lender's loan proceeds. If the "loan" was really an "investment", then income recognition was restricted. It did not attempt to specifically deal with impairment

#16

questions, or the need for a charge in lieu of depreciation. Since then, FAS 91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* has brought consistency to recognition of loan fees. FAS 114 provides significant guidance in accounting for impairment of collateral dependent loans, which would include the real estate loans within the scope of the Proposed SOP. These standards, in the view of the AP&AS Committee, substantially put to rest any concerns that may exist that are not directly dealt with in the Third Notice. The AP&AS Committee believes that the loan transaction should be accounted for as a loan, and not "as if" it were something else, unless the terms of the transaction clearly indicate it is something else through inclusion of an expected participation in residual profit. Furthermore, SFAS No. 114, de-emphasizes financial statement classification as the primary issue in accounting for troubled real estate loans and states in paragraph 71 that "a loan for which foreclosure is probable should continue to be accounted for as a loan".

If the Proposed SOP is issued in its current form, then the effective date should apply only to real estate loans entered into or purchased after December 31, 1995, rather than 1994. This would allow lenders at least a year to make accounting and record keeping changes necessary to comply with the requirements of the SOP.

We would be pleased to discuss any of our comments at your earliest convenience.

Very truly yours,

David C. Wilson, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants

CC: Susan Cain, Chair Depository Institutions Committee
Jim Kurtz, Executive Director
Charles Gielow, President

#16

Rec'd 6/28/94

Loscalzo & Company

CERTIFIED PUBLIC ACCOUNTANTS

February 16, 1994

Arleen Rodda
Director Accounting Standards Division
File 3455
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Rodda:

I would like to submit comments on the AICPA's proposed Statement of Position entitled *"Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments"* (the proposed SOP). I believe guidance is necessary in this area and that the AICPA Notice to Practitioners should be expanded and elevated to a category 2 level in the GAAP hierarchy. However, there are, I believe, several general and specific comments you should consider.

General Comments

1. There is a distinct difference between a loan that is:

   - in substance an investment. Such a loan should appropriately be treated as an investment and, I believe, equity accounting, such as illustrated in the proposed SOP, is appropriate. However, if this is the case, I believe it should be reflected as such on the books of the borrower.

   - of such risk that it would be inappropriate to recognize income other than on a cash basis. Such a loan should be separately classified and valued at the lower of cost or fair market value of the underlying real estate.

2. The proposal makes no distinction as to whether a "loan" is for construction or for the purchase of operating real estate. I believe that there is a fundamental difference in the degree of risk affecting construction loans. In a construction situation, the borrower must deliver a completed product in order to produce value. The bankruptcy and default of a borrower on a construction loan can create progress delays that can cause a rapid decline in the value of construction in progress. An operating property can often be operated during the foreclosure period, thereby reducing the amount of possible decline in value. The receipt of a deposit, albeit a significant one, does not, in itself, mitigate this risk. I believe that multiple characteristics are more appropriate than requiring only one of the characteristics discussed in Paragraph 12.

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#17

3. The proposal makes no distinction as to who the borrower is or its form of entity. For example, a limited partnership with a corporate or illiquid general partner bears substantially more risk than other types of loans, despite the "substantial down payment". This is especially true if the loan is "non recourse". Where the borrower has no substantial non-real estate assets at risk, other than the down payment, the risk is heightened. Again, I believe that a multiple characteristic approach similar to the AICPA Notice to Practitioners would be more appropriate.

Specific Comments

1. ¶ 6 states that the accounting should not apply to loans resulting from a lender's sale of real estate. A lender taking back financing when it sells property out of REO is most likely assuming the risks of an owner and is most similar to a true partnership where realization is dependent on results of the property. FASB 66 deals primarily with gain recognition. Thus, under FASB 66, for example, a "sale" with a one percent down payment might be reported as an installment sale, with the corresponding loan booked. I do not see why this should be treated substantively different than a lender initiating a "new" loan. I believe that to permit the effective reclassification from REO to a loan is inconsistent with the purpose of this statement.

2. ¶ 9 states that this accounting should not apply to the project's separate company financial statements. This is inconsistent. I believe that all too often accounting literature provides for different accounting treatment for the same transaction. This leads to confusion, dilutes the impact of the pronouncement and is illogical. Again, I believe that the distinction made in general comment 1 is important.

   The above treatment is also inconsistent with Paragraph 26 on page 14, which states that the partnership should not book the interest expense.

3. ¶ 30 states that operations, including depreciation, should be recorded in accordance with the hypothetical partnership agreement. I believe that this is inconsistent with paragraphs 33 and 35 which state that depreciation and losses should be allocated first to the "owner-partner" until his account is "0".

#17

4. ¶ 34. In today's environment, I believe it is inappropriate to say real estate loans are typically without recourse.

   Clarification is needed since there is a major difference in types of collateral; for example, securities vs. real estate. The GAAP treatment of an asset should not enter into the determination of how depreciation should be allocated. For example, if, at the time the arrangement is entered into, a building owned by the general partner is valued at $5,000,000 (cost of $1,000,000) and the value of the building declines to $3,000,000, no GAAP accounting would be required. If the collateral was IBM stock worth $5,000,0000 and the value declined to $3,000,000, GAAP (FASB 115) would require the securities to be recorded at $3,000,000.

5. ¶ 12. I believe a and f should be incorporated under a since these are, in fact, qualifying non cash down payments. Furthermore, I believe certain of the characteristics in ¶ 48 should be moved to ¶ 12 since a down payment alone would not necessarily insure that these items are met; for example, b, c and d. If this were done, it would then be appropriate to require multiple criteria prior to a loan being classified as an investment, in accordance with my general comment 1.

If none of the above comments are considered, I would strongly urge you to reverse your position of requiring the lender to record depreciation. Depreciation, for accounting purposes, is an allocation of cost and is not indicative of the "wasting away" of an asset. I believe it would be more appropriate to require valuation of the underlying real estate and require that any subsequent declines in value be recorded.

I appreciate your consideration of my comments.

Sincerely,

William Loscalzo

WL/tv

#17

Rec'd 3/7

WELLS FARGO & COMPANY

FRANK A. MOESLEIN
Executive Vice President
and Controller

March 3, 1994

343 Sansome Street
San Francisco, CA 94163

Arleen K. Rodda
Director, Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File No. 3455
"Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments"

Dear Ms. Rodda:

Wells Fargo & Company is a bank holding company and parent of Wells Fargo Bank, N.A. At December 31, 1993, Wells Fargo reported $1.1 billion of real estate construction loans, $8.3 billion of loans on completed commercial real estate and $.5 billion of other commercial loans to real estate developers. From time to time, Wells Fargo has originated construction loans which provided a participation in the cash flows or appreciation of the property financed and we have had experience in applying the *ADC Arrangements* Notice to Practitioners, now Practice Bulletin 1 (the PB). We appreciate this opportunity to comment on the AICPA's Exposure Draft (ED). All paragraph references below are to those of the ED, unless otherwise indicated.

We particularly value this opportunity for due process since we believe the ED will be a significant change from existing practice both by increasing the number of loans subjected to analysis for compliance with the "loan criteria" and from an added process and income deferral burden for the larger portfolio not treated as loans. Therefore, we believe the ED is one of major importance, the impact of which (process costs and financial statement results) merits careful consideration by the Task Force and AcSEC. Since the "discussion of conclusions" conveys the impression that AcSEC was seeking more objective criteria, as contrasted with stating that investment accounting needs to be expanded to a wider population of transactions for some reason, we believe that the impact of the proposal is a basis for terminating the proposed approach. Therefore, the discussion below attempts to convey why we feel the ED is inappropriate and, therefore, should be withdrawn.

The existing criteria (in the PB) applied to a rather limited population, those where we purposely arranged to include contingent interest features, so that whatever interpretation of the other criteria was necessary, was limited. The effect of the ED is to focus on a mechanical comparison of the borrower's equity investment to predetermined ratios (paragraph 12.a). Any loan failing that test would essentially have a presumption against it requiring a comparison against the criteria in 12.b through f. This does not reflect how construction loans are

#18

underwritten. Credit judgment involves more factors than those included in the ED. **More importantly, the relevant factors are considered in combination.** By requiring that one of the six criteria (12.a through f) be met ("..if it has one or more of the following characteristics at inception"), many properly underwritten construction loans, without profit participation features, will be considered investments under the ED's criteria. Please be reminded that insured financial institutions are required to risk grade their loans and these gradings are examined by the primary regulator of that institution. So, when we say "properly underwritten" we are not advancing some aberrant underwriting standard to you. Rather, we are talking about standards that are independently reviewed by examiners who spend their time evaluating loans at various financial institutions.

It should be reasonably easy to see that an otherwise similar construction project funded to:

a) an inexperienced developer, where absorption of the completed project is expected to take over 3 years, who does not have significant financial resources outside the project, who does not provide meaningful and enforceable guarantees or recourse to other assets but provides 25% equity through contribution of land upon which the project is to be constructed,

is not a superior credit compared to

b) an experienced developer who proposes a product in a market which will provide a shorter absorption period, who has significant financial resources outside the project and is known to the lender as the result of several previous successful construction loan relationships, who provides a third party repayment guarantee of 15% on the amount of the loan (structured to be enforceable even in a single-action, anti-deficiency jurisdiction), who provides interest carry and completion guarantees and provides 10% equity through contribution of land upon which the project is to be constructed.

Nonetheless, transaction a) would be accounted for as a loan under the ED's criteria and transaction b) would not. Any number of examples could be constructed to illustrate that the collective assessment of features (partially meeting several of the criteria proposed) results in a superior credit but fails the loan accounting test.

The "cook book" accounting of FAS 66's paragraphs 53 and 54 should not be applied to any other lending situations, as it was not intended for such purpose. While FAS 66 may be generally accepted for its intended purpose, perhaps for such reasons as: nearly any type of reporting entity may occasionally sell real estate but may be unsophisticated in underwriting a real estate loan; a seller (not in the business of lending) who has to finance the sale may have a property of questionable liquidity in the market; or a seller may be motivated to control the timing of front-end gain recognition through a transaction in the form of a sale which does not meaningfully convey risk to the buyer, but return of the property, later, to the seller still leaves the seller better off from a financial reporting standpoint. However, these are not the issues with a bank lending to unrelated parties. There is no front-end gain recognition at issue and

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FAS 66 does not require real estate investment accounting for the loan involved in the sale, even though cost recovery accounting may be used for the gain from the sale.

Construction projects are not commonly sold while construction is in progress, so again the examples in paragraph 54 of FAS 66 are not helpful guidance for a construction project. While our own underwriting guidelines for loan-to-value ratios may appear to be similar to the land and commercial start-up situations in FAS 66, these relationships are based on the value at completion of the project. The exclusion of sweat equity from the definition of equity means there is a significant difference between our underwriting standards (which are permitted by bank regulators) and those proposed in the ED. Construction lending is a specialized underwriting process and was not and is not contemplated by FAS 66. We have not used FAS 66 as the definition of "substantial" in the PB.

We believe there is a significant economic difference between a loan secured by real estate and an investment in real estate. State law governs these distinctions and protects the borrower from control by the lender and protects the lender from exposure to risks extending beyond its commitment to the borrower. When we make a participating mortgage, we do not rely solely on the basic law governing lending; other legal measures are used to ensure that third parties are put on notice and will not be permitted to infer the lender has the obligations of an investor. Banks are very careful to operate within the legal boundaries so they may obtain the protections of the law. While failure in this area may result from an error in judgment or a breach of internal control, a bank does not have "significant influence" over the borrower, never votes or sits on the management committee or otherwise exercises general management control over the project. The contention in paragraph 25 that "significant influence" exists, as that concept is intended in the authoritative accounting literature, is simply not true. If it were, it would apply to most or all commercial real estate loans, not simply to those that do not have the initial investment by the borrower derived from FAS 66. While there are similarities between loans and investments (they are both ways to fund a third party's commercial endeavors), there are clear and discernable distinctions that exist. The criteria proposed in the ED (or for that matter in the PB) do not faithfully represent the economic, legal or accounting distinctions between lending and investing.

Lenders often negotiate separate notes at various stages of a project (e.g., acquisition, phases of construction, interim loans on completed projects while lease up or cash flow stabilizes). We are concerned that this process, or the process of renegotiating certain terms (in a setting that does not constitute a troubled debt restructuring) to otherwise reflect the progress of the project, will result in notes being classified as investments primarily due to confusion over how appreciated value is to be used in meeting the criteria or the release of guarantees and collateral as the loan is paid down, even for transactions initially recorded as loans. **While we wanted to alert you to concerns about the reassessment criteria, we feel that the best use of the time** available for comment, and the more important issues for our comments, are the threshold issues.

While we agree that a real estate loan accounted for as an investment confers upon the lender a preferred return, with respect to that of the borrower, **we do not believe that the model proposed by the ED, with its hypothetical partnership accounts, faithfully conveys to users of financial statements the true "preferred return."** The lender has a senior interest in the net operating cash flows of the project, once such are generated, and the accounting must reflect that if it is intended to be representationally faithful. We object to the characterization in paragraph 45 that the ED meets that test. Nothing could better illustrate our concern than the example provided in the ED. The fact pattern presented is consistent with a real estate project going through the final stages of lease up, stabilization of rents and maximized rental income (such as might occur when the rent is based in part upon the revenues of the tenants). As the project becomes more successful and generates more "operating income" (definition as implied in the illustration), the lender's income calculated under the ED goes down, even though the lender has a senior interest, and the borrower/owner's relative percentage of income goes up, even though contractually, legally and economically that is the residual interest in the project. This is clearly inappropriate.

It appears that this project (the ED) has slowly, over the years, proceeded step by step to its illogical conclusion. The ED's conclusions represent an accounting structure constructed by adding on addition after addition, bearing no resemblance to the original design, until what ever logic serves as a foundation no longer supports the evolved structure to the point it has collapsed of its own weight.

After demolition, what is the next step? **The answer lies in more careful assessment of the developments in the authoritative literature which have occurred while this ED was in development.** Since the ED seems to have a focus on risk, that aspect is addressed in FAS 114. The accounting model has changed from ultimate recovery of principal to one where collectibility of future interest is included in the impairment assessment and recorded but uncollected interest becomes part of the recorded investment. FAS 114 establishes that income can be recognized with the passage of time. Recognition of income is no longer the issue; rather assessment of collectibility (i.e., impairment) is the issue. Therefore, AcSEC no longer needs to be concerned about the use of the lending model for the situations covered by the ED and it need not find ways to manipulate income recognition. Rather, the solution lies in making sure that lenders have adequate methodologies for assessing risk in the portfolio and considering it when assessing the adequacy of the allowance for loan losses. AcSEC should also consider that under FAS 114 a troubled debt restructuring is afforded income treatment based on expected future cash flows, this is for a loan which has acknowledged problems such that the performance will not be in conformity with the loan agreement. How then is it reasonable for the ED to propose that loans which are not experiencing difficulty, but merely have down payments less than the FAS 66 criteria, be subjected to revenue recognition that is far more restrictive merely out of concern about possible risk that might arise? These concerns should not modify loan accounting until the risk of impairment is evident according to FAS 114 criteria.

Both FAS 114 and FAS 115 take a strict form perspective in setting the scope for the type of asset governed by each. This is a major development and provides the objectivity sought in the production of the ED. The accounting standards have evolved and it is important that the project at hand reflect those changes. For example, bankers have believed there was also a "substance" aspect that delineated a loan from a security (for purposes of applying the accounting model for each). For example, certain government entities borrowed in the form of a security because they were required to do so by law. Typically, the underwriting bank held the entire issue, no market was made in the security and it was underwritten and accounted for as a loan; bank regulatory agencies held the same view. FAS 115 has changed that and the EITF has confirmed the strict form perspective (see D-39 in the EITF Abstracts). In a similar fashion, FAS 114 has put an end to the in-substance foreclosure issue, see the attached letter from the FASB to the AICPA. The AICPA had proposed to extend the investment analogy in a fashion similar to that in the ED. So, while prior to these developments it might have been more acceptable to proceed with rules to define in-substance for this or that, such a perspective, as it applies to the matter at hand, should be dropped.

The ED refers to the guidance in EITF 86-21, which states that the third Notice should be considered. The ED goes considerably beyond that. Given the developments in authoritative literature noted above, the only common elements between construction lending as described in the third Notice and loans on operating real estate and shared appreciation mortgages is the simple matter of recognizing income (contractual interest) merely through the passage of time. So, for an asset documented as a loan, that should be the only issue AcSEC needs to address, after withdrawing the PB. **The issue is not one of invoking an accounting model by calling an asset an investment or a loan. Rather, the issue is one of revenue recognition for an asset documented as, and legally qualifying as, a loan.** Income (interest) should only be recognized with the passage of time if it contractually accrues with the passage of time. Contingent interest, kickers, participating mortgages and other interests in operating cash flows, appreciation or profits upon sale, or based on any other future event should not be recognized until the future event has occurred and the amount due to the lender is fixed in amount and determinable (no longer contingent). Income based on such events as those described above should not be anticipated and accrued based merely on the passage of time (because the asset is a "loan"). These views are consistent with FAS 5, paragraph 17. **The burdensome, supplemental record keeping proposed in the ED to reflect the hypothetical partnership is not needed to properly recognize income on real estate loans.**

For all of these reasons, we believe the ED should be withdrawn. However, the continued existence of the PB, with its reference to real estate investment accounting (in paragraph 16),

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and EITF 86-21 may continue to cause confusion. This is particularly true since the AICPA is also working on a project on the accounting for investments in real estate ventures. Whatever clarification of real estate venture accounting is needed should not be complicated by having possible effects on real estate loans. We urge AcSEC to find a way to obtain closure of this project so that the continued existence of the PB with its reference to real estate joint venture and investment accounting will not perpetuate the same issues that caused the ED.

We will be pleased to discuss any of these issues or respond to questions you may have with respect to our comments.

Sincerely,

Frank A. Moeslein

Attachment

#18

Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Fax: 203-849-9714

DENNIS R. BERESFORD
Chairman

June 2, 1993

Mr. Walter P. Schuetze
Chief Accountant
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Mr. Norman N. Strauss
Chairman
Accounting Standards Executive Committee
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Gentlemen:

The FASB recently issued Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. Statement 114 requires that a creditor measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor must measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable.

Statement 114 also amends paragraph 34 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, to clarify the applicability of that paragraph. Paragraph 34 was intended to apply to a narrow set of circumstances; that is, a troubled debt restructuring or other circumstance in which a debtor surrendered property to the creditor and the creditor was in possession of the asset with or without going through formal foreclosure procedures.

The Board recognizes that in practice paragraph 34 of Statement 15 and the term *in-substance foreclosure* are applied in situations other than troubled debt restructurings or situations in which a debtor surrenders property to the creditor. The SEC's Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, establish the criteria for determining when a loan is in-substance foreclosed and require a creditor to account for the collateral of an in-substance foreclosed loan as if foreclosure had occurred. The Basis for Conclusions of

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Statement 114 indicates that the Board recognizes the practical problems of accounting for the operations of an asset the creditor does not possess and concluded that a loan for which foreclosure is probable should continue to be accounted for as a loan.

In light of the issuance of Statement 114 and the clarification of paragraph 34 of Statement 15 as it relates to in-substance foreclosure, I suggest that it would be appropriate for the SEC and AcSEC to consider the withdrawal of FRR 28 and Practice Bulletin 7.

Sincerely,

Denny Beresford

Dennis R. Beresford

#18

Rec'd 3/7

FLORIDA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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TELEPHONE (904) 224-2727 • FAX (904) 222-8190

Richard Stuart

January 31, 1994

Arleen K. Rodda, Director
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

RE: File 3455

Dear Ms. Rodda:

This comment letter sets forth the views of the Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants (the "FICPA Committee") on the AICPA's Exposure Draft, Proposed Statement of Position, "Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments".

The comments in this letter were derived from a discussion of the Exposure Draft in a recent meeting attended by members of FICPA Committee. The members who participated in this discussion collectively possess a broad knowledge of issues involving real estate loans and real estate transactions.

GENERAL COMMENTS

Our committee expressed concern regarding the necessity of the Exposure Draft, the lender's ability to obtain financial information on a timely basis for inclusion in his financial statements, and the establishing of "hypothetical" entities.

SPECIFIC COMMENTS

We believe the reporting by the lender in a manner which differs substantially from the reporting by the borrower may lead to confusion by users of the financial statements familiar with the terms of the loan agreement.

The FDIC Improvement Act of 1991 and recent changes by Regulatory Agencies relating to lending activities by financial institutions generally prohibit or discourage lending arrangements which the Exposure Drafts addresses. We are concerned whether there exists a need for the Exposure Draft and if so, what organizations would the Exposure Draft apply.

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Present disclosures required by generally accepted accounting principles appear to be adequate for the users of financial statements to evaluate lending arrangements covered by the Exposure Draft.

The Exposure Draft does not address minority interest and the character of the equity on the lender's accounting records for the arrangement.

Paragraph 12 (d) "full amount due" - We question whether "full amount due" is necessary and if "substantial" would be more appropriate.

We believe the condition described under paragraph 14 (d) to be superfluous.

Our committee appreciates the opportunity to comment on this proposed Statement of Position. Members of our committee are prepared to discuss any questions members of the Board might have concerning our response.

Sincerely,

Stephen H. Kattell, MBA, CPA
Chairman, Committee on Accounting Principles and Auditing Standards
Florida Institute of Certified Public Accountants
(904)486-5340

Members of the Committee:

Steve Berwick	Robert Fahnestock
Kevin Kenny	Audrey Lewis
Paul Munter	Javier Nunez
Bill Odendahl	Mike O'Rourke
John Rizzo	Frank Scheuerell
Mary Scribner	Dan Spivack
E.F. Thomas	Pete Warner

#19

CIGNA Corporation

Hartford, CT 06152
(203) 726-4630

Gary A. Swords
Vice President and
Chief Accounting Officer

March 10, 1994

Ms. Arleen K. Rodda
Director
Accounting Standards Division
File 3455
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, N.Y. 10036-8755

Dear Ms. Rodda:

CIGNA Corporation is pleased to have the opportunity to comment on the AICPA Exposure Draft (ED), Proposed Statement of Position, Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments. We recognize that these comments have been delayed beyond the requested date, but hope that they will be helpful in the deliberations.

The ED extends the scope of the February 10, 1986 AICPA Notice to Practitioners, "ADC Arrangements", to include loans on operating real estate where there may not be a residual sharing arrangement. We disagree with this scope expansion because the risks and potential rewards of a lender who does not have a residual interest are not comparable to those of an owner. In addition to the appreciation potential and various other privileges of ownership not shared by the lender, there are numerous ownership risks not borne by the lender. These include liability for environmental risks and other ownership liabilities such as those arising from slip-and-fall accidents, the obligation to pay trade creditors, etc. Because of these significant inherent differences, we recommend that the ED be narrowed to its original scope, and be limited to lending arrangements with residual interests.

Without the potential for recognizing the benefits of ownership, and without having assumed all significant risks of ownership, lenders should not be required to account for loans as equity ownership interests. This position is consistent with that taken by the FASB in Statement of Financial Accounting Standards No. 114, which states that in-substance foreclosure accounting should only be applied when the lender has physical possession of a property securing a loan.

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We also believe that the cash flow tests set forth in ED paragraph 12e are too onerous. If historical cash flow coverage has been adequate to service debt, and if projections indicate that such coverage is reasonably expected to continue, then it is not appropriate to view a loan as an investment in a real estate partnership. This is particularly evident in the case of refinancings which do not meet the ED's exemption for troubled debt restructurings. In today's environment, it is not uncommon for a financial services institution to refinance loans which originally met the paragraph 12a equity tests for loans but, due to declining market conditions, no longer meet them at the time of refinancing. The refinancing would be evaluated as a new loan for accounting purposes and, assuming that the technical requirements of paragraph 12e for written leases is not met (particularly relevant to hotels and apartments), accounted for as a hypothetical partnership investment under the ED. We do not believe this is an appropriate outcome. Loans which have adequate cash flow coverage should be accounted for as loans, especially in instances where the borrower's original investment in the underlying property was adequate to meet the standards for loan accounting and any subsequent loss of equity by the borrower is the result of declining market conditions rather than failure of the property itself.

A practical concern is that one of the privileges of ownership the lender does not have is direct access to financial information about the underlying real estate projects. Partnership accounting would require that the lender obtain monthly or quarterly financial information from borrowers. With no current requirement for audited financial statements, which could add significant cost to the borrower, the accuracy and reliability of financial information provided would be questionable. Thus, lenders would be faced with a requirement to account for hypothetical partnerships based on unreliable, untimely, or even nonexistent information.

Given the impracticability of obtaining timely and reliable financial information from borrowers, if partnership accounting is required, the ED should recognize the need for estimates of income, depreciation or amortization. We suggest that, if the lender does not have timely access to reliable property financial statements, one of the following alternative accounting methods should be permitted:

- recognize income based on actual cash debt service received (and not funded by the lender), provided that, in lieu of hypothetical depreciation, the lender should treat a portion of the cash payment as return of capital (i.e., principal) in an amount not less than the greater of the scheduled principal payment of the loan or the principal payment pursuant to a normal amortization plan; or

- account for the loan on a non-accrual basis for income recognition purposes and reserve annually, against cash basis income, an allowance for implied depreciation (e.g., not less than 2.0% of the original loan amount).

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Overall, the ED's requirements do not seem to be cost justified. In addition to the difficulty of obtaining financial information from the borrower, an insurance company would have to maintain accounting records on a lender/borrower basis, on a statutory basis and on the hypothetical partnership basis. The depreciation accounting requirements of the ED are particularly cumbersome. Taken as a whole, the ED's accounting requirements appear to be onerous enough to discourage lending practices which are acceptable from a business perspective.

Apart from our general concerns discussed above, we have the following specific comments intended to clarify the provisions of the ED so that their requirements can be applied to loans on operating properties:

- Paragraph 12 should be split into two parts - one for development loans and one for loans on operating properties. For development loans, a "reasonable period of time" (for which cash flows are sufficient to service loan amortization) should be defined. For operating properties, we believe that loan accounting treatment should be permitted if leases in place and projected renewals, viewed together with historical experience, provide at least 1.0 debt service coverage for a normal loan amortization schedule. For operating properties which are typically not leased on a long term basis-- e.g., apartments and hotels -- we believe that loan accounting treatment should be permitted if there is adequate projected debt service coverage or a reasonable period of projected coverage from hotel income (e.g., 6 months), again viewed in the context of historical experience.

- Additional clarification to paragraph 12 would be helpful regarding application to a loan on operating properties. We suggest that paragraph 12a include a statement that for loans on operating properties, borrower equity is the excess of fair value over the loan amount. In paragraph 12e, we believe there should be a statement that for loans on operating properties, cash flows should be determined from current financial statements, with consideration given to any additional cash flow from unconditional sales contracts or signed leases not yet in occupancy.

- Regarding "sweat equity," the ED should make it clear that a contribution of services performed prior to the inception of a real estate loan may be included in the borrower's equity investment by using the fair value of the property as the base measurement for purposes of determining whether the borrower's equity investment is "substantial".

- It appears to be the intent of paragraph 21 that a foreclosure of a loan accounted for as a hypothetical partnership would not be subject to SOP 92-3 and that normal equity real estate investment valuation guidelines would govern. In this regard, SOP 92-3 should be clarified or amended.

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In conclusion, we believe that the extension of the theory of equity ownership to incorporate loans other than those with some form of residual sharing arrangement is inappropriate. Loans without any upside potential beyond repayment of debt should not be required to be treated as hypothetical real estate partnerships. Although some loans have higher risks than others, lenders' risks are different from owners' risks. If, at the time of origination, there is no intent on the part of the borrower to share the potential rewards of equity ownership with the lender and the lender does not expect to either control the management of the property or participate as an equity owner, and if the debt service can reasonably be expected to be covered, then hypothetical partnership accounting is both impractical and theoretically inappropriate.

If you would like clarification of any of these issues, or if I can be of further assistance, please do not hesitate to contact me.

Very truly yours,

Gary A. Swords

Gary A. Swords

#20

NATIONAL
ASSOCIATION OF
REAL ESTATE
COMPANIES
NAREC

March 11, 1994

Ms. Arleen K. Rodda, Director
Accounting Standards Division, File 3455
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036

Dear Ms. Rodda:

The National Association of Real Estate Companies, ("the Association") is composed of representatives from companies engaged in a broad range of real estate activities as well as independent accountants, lenders and others associated with the real estate industry. One of the major objectives of our Association is to define and promote the use of sound accounting and financial reporting principles.

The Association is pleased to respond to the AICPA's Exposure Draft of a Proposed Statement of Position (SOP), *Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments*. The members of the Association are engaged in diverse activities and include members with substantial involvement in the preparation and distribution of financial statements in accordance with generally accepted accounting principles. Members are involved with financial reporting for both private entities as well as public entities that are SEC registrants. The Association believes it has a good basis for the comments provided below, given its members substantial experience in the preparation and dissemination of a wide range of financial statements.

We do not see the need for the proposed SOP since we believe that the existing accounting standards already provide an adequate framework for accounting for real estate loans, including Acquisition, Development and Construction loans. However, if AcSEC chooses to go forward with issuing a final standard, there are certain aspects of the SOP that should be expanded upon or clarified. We have the following comments:

- The Exposure Draft conflicts with the in-substance foreclosure criteria which was clarified in FAS No. 114. Accounting for a loan as a hypothetical partnership, as described in the proposed SOP, is essentially the same as that for an in-substance foreclosure. This conflicts with the FAS No. 114 clarification which specifies physical possession of the asset as a criteria for in-substance foreclosure accounting.

- Paragraph 22 could be read to mean that an extension of a loan at maturity, at a market rate, may be considered a re-negotiation of the loan terms. Therefore, it would be subject to re-qualification as a loan under paragraph 12 even without the assumption of additional risk. We believe that extensions of loans at maturity, at market rates and without the assumption of additional risk, should not be considered a re-negotiation of the loan terms. A clarification of this point appears to be warranted.

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#21

- Paragraphs 33 and 34, as well as the examples in Appendix A, which provide an illustration of the application of paragraphs 27 to 37, may be setting precedent for joint venture accounting. We understand that joint venture accounting is being addressed in other projects being conducted by the AICPA and FASB and, therefore, to avoid potential conflicts, we recommend that the examples be deleted from this SOP.

- If the intent of the proposed SOP is to codify the guidance provided in the February 10, 1986 Notice to Practitioners, *ADC Arrangements,* and the FASB Emerging Issues Task Force Issue No. 86-21, *Application of the AICPA Notice to Practitioners Regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property,* the scope should not be expanded by dropping reference to expected residual profits as a determining factor in the classification of real estate loans.

- If a loan accounted for as a real estate investment becomes impaired, which impairment guidance should apply -- FASB Exposure Draft (ED), *Accounting for the Impairment of Long-Lived Assets, or FAS 114?* Application of the ED criteria may result in an asset which is valued less conservatively than if the asset were accounted for as a loan and FAS No. 114 criteria applied.

- In considering the practicality of this SOP, it should be noted that at least three sets of books will be required once a loan must be classified and accounted for as a real estate investment: one to account for the contractual terms of the loan (interest, principal amortization, etc.); a second to account for the hypothetical partnership; and a third to account for the lender's share of the hypothetical partnership. Further, it may not be possible to obtain the necessary financial information from the borrower on a timely basis to create the hypothetical records. Significant additional costs will be incurred to require borrowers to supply additional information and to account for, analyze, store and report on it. Finally, significant judgment will be required in applying the "hypothetical partnership agreement" concept which will inevitably result in inconsistent application.

We appreciate the opportunity to comment on this important subject and would be pleased to have you contact us to further discuss the matters outlined above.

Very truly yours,

Jeffrey P. Mayer

Jeffrey P. Mayer
Chairman
Financial Accounting Standards
Committee of the Association

#21

BankAmerica Corporation

Joseph B. Tharp
Executive Vice President and
Financial Controller

March 18, 1994

Ms. Arleen K. Rodda
Director
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

<u>Proposed Statement of Position</u>
<u>"Identifying and Accounting for</u>
<u>Real Estate Loans That Qualify as</u>
<u>Real Estate Investments"</u>
<u>File 3455</u>

Dear Ms. Rodda:

We are pleased to comment on the proposed Statement of Position "Identifying and Accounting for Real Estate Loans that Qualify as Real Estate Investments" (proposed SOP) prepared by the AICPA's Task Force on ADC Arrangements. As the parent of several financial institutions, BankAmerica Corporation takes great interest in accounting standards that affect lending.

Although we agree with the basic premise of the proposed SOP (i.e., that certain loans more closely resemble real estate investments), we believe it is unnecessary and should be withdrawn. Accounting guidance covering these loans is contained in the AICPA Notice to Practitioners, "ADC Arrangements" (the third Notice), which is included in AICPA Practice Bulletin 1. We believe this guidance is sufficient to identify all loans that are, in substance, real estate investments and that should be accounted for as such.

We have two objections to the proposed SOP. First, we believe it inappropriately expands the criteria included in the third Notice for identifying loans that should be accounted for as real estate investments. In addition, the proposed SOP requires ongoing accounting for such assets that is unnecessarily complex and not cost beneficial. The remainder of this letter discusses these two points in more detail.

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IDENTIFICATION OF LOANS TO BE ACCOUNTED FOR AS REAL ESTATE INVESTMENTS

Application of FAS 66 Criteria

The proposed SOP requires a real estate loan to meet at least one of six criteria to be accounted for and reported as a loan. These criteria are very different from and greatly expand the criteria included in the third Notice. One significant new criterion is that the loan must meet the initial and continuing investment requirements of Statement of Financial Accounting Standards No. 66 "Accounting for Sales of Real Estate" (FAS 66). We are extremely concerned about this criterion, and believe it is an inappropriate application of FAS 66, which provides guidance on gain recognition of sales of real estate. FAS 66 was never intended to provide guidance for balance sheet classification of loans.

The proposed SOP would require lenders to use the matrix in Appendix A of FAS 66, which details the required initial investment for gain recognition on sales of real estate, to determine if a borrower has made a substantial investment in a project. However, a matrix as rigid as the one in FAS 66 cannot incorporate all the variables inherent in the lending process and does not afford financial institutions the ability to meet the needs of their customers based on individual credit quality. We believe that a borrower's investment is substantial if the borrower has made the down payment required by a bank's loan underwriting guidelines.

If the proposed SOP were implemented, lenders ultimately would be forced to change their underwriting criteria to ensure that new loans meet the initial and continuing investment criteria of FAS 66. In effect, the proposed SOP would require financial institutions to conform their underwriting guidelines to FAS 66, a purpose for which FAS 66 was never intended. Banks are already required by their regulators to follow safe and sound banking practices, which include the development of sound underwriting standards. Therefore, we find it inappropriate for accounting standards to unnecessarily influence loan underwriting practices.

Change in Focus from Rewards to Risks

Another significant change from the third Notice is the deletion of the criterion regarding residual profit participation. Briefly; under the third Notice, if a lender had a significant residual profit participation, the loan could be considered a real estate investment. A lender would have to retain substantial risks <u>and</u> rewards before a loan would be classified as a real estate investment. Under the proposed SOP, the determination of how to classify and account for a real estate loan focuses on the extent to which a lender retains <u>risk</u> in the transaction. We disagree with this exclusive focus on risk, which is an inherent part of lending. Banks assume risk whenever they enter into a lending transaction. In contrast, rewards of ownership, in the form of residual profits, accrue to owners or investors. What changes the substance of a transaction from a loan to an investment is the retention by the lender of <u>rewards</u> of ownership.

#22

ONGOING ACCOUNTING FOR LOANS CLASSIFIED AS REAL ESTATE INVESTMENTS

In addition to providing guidance regarding the initial classification of loans as real estate investments, the proposed SOP provides guidance related to the ongoing accounting for such assets. The proposed SOP requires that a loan accounted for as a real estate investment be considered the equivalent of an investment by the lender in a hypothetical partnership. The real estate collateralizing the loan is considered to be the hypothetical partnership's real estate project.

We recognize that there is little guidance regarding ongoing accounting for real estate loans classified as investments, and we realize that some inconsistencies in ongoing accounting for these loans may have developed in practice. However, it has been approximately eight years since the issuance of the third Notice, and we believe that banks have developed reasonable and practical solutions to the lack of guidance, such as deferral of revenue. We strongly believe that hypothetical partnership accounting is not the solution to any inconsistencies that may have developed in practice.

The hypothetical partnership accounting approach is extremely complex, and the costs to implement such accounting seriously outweigh any benefits that may be realized. The costs associated with maintaining and reporting the books and records of the hypothetical partnership will be immense. In addition, we believe it is inappropriate to try to create a "hypothetical partnership" and a "hypothetical partnership agreement" out of loan documents that were not drafted for this purpose. It is not possible to draw reasonable analogies between accounting for a "hypothetical entity" and accounting for a real entity.

Finally, the hypothetical partnership approach will be difficult to implement due to a lack of availability of the information necessary for such accounting. Banks will be forced to rely on the borrowers for the information needed to keep the books of the hypothetical partnership. Borrowers will not want to provide this information, and in many cases, the loan documents will not allow us to require it. At best, timing and quality of information problems will arise.

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To summarize, the proposed SOP is unnecessary and we strongly urge AcSEC to withdraw its consideration. We believe that the scope and criteria established by the third Notice are sufficient to identify loans that should be accounted for as real estate investments. Further, the costs of performing the proposed ongoing accounting guidance greatly outweigh the benefits.

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If you have any questions or comments, please contact me at (415) 624-0413 or Paul Ogorzelec at (415) 624-1009.

Sincerely,

Joseph B. Tharp
Executive Vice President and
Financial Controller

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